



Federal Budget of February 18, 2003

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Yesterday afternoon John Manley, the federal Minister of Finance, presented his first budget. The budget introduces significant changes to retirement savings and healthcare. This document briefly summarizes the main changes and their impact.

MEASURES RELATED TO RETIREMENT SAVINGS

Money Purchase Limit

Minister Manley announced an increase in the money purchase limit. Starting in 2003, the maximum contribution to a defined contribution (DC) plan will be \$15,500, compared to the \$14,500 limit for 2003 before the budget was tabled. The maximum contribution limit will increase to \$16,500 for 2004 and to \$18,000 for 2005. From 2006, the \$18,000 limit will be indexed annually to increases in the average industrial wage in Canada.

Defined Benefit Limit

The defined benefit limit is the maximum benefit that can be paid for a given year of service in a defined benefit (DB) plan. Under income tax rules, the defined benefit limit is set at 1/9th of the DC limit, and may not be lower than \$1,722.22. For 2003 the defined benefit limit will remain unchanged. Effective 2004, the limit will increase to \$1,833.33 and then to \$2,000 in 2005. Starting in 2006 this limit will be indexed annually to the annual increase in the average industrial wage in Canada. The planned increase in the 2004 defined benefit limit is the first increase in the maximum pension limit since 1976.

The maximum employee contribution to a DB plan will also rise, from the current limit of \$11,430 to \$12,130 in 2004 and \$13,180 in 2005.

A past service pension adjustment (PSPA) will not be required for any benefit increases that are the direct result of the increase in the defined benefit limit.

DPSP Contribution Limit

A deferred profit-sharing plan (DPSP) is a plan in which the employer contributes a portion of company profits to a trust on behalf of employees, usually in order to provide them with a retirement income. Income tax rules do not allow employees to

contribute to a DPSP. The maximum annual contribution an employer can make to a DPSP is 50% of the defined contribution limit for the year. Based on the budget as tabled, the maximum an employer will be able to contribute to a DPSP in 2003 is \$7,750.

RRSP Contribution Limit

The 2003 maximum contribution to a registered retirement savings plan (RRSP) will be set at \$14,500, compared to the 2003 limit of \$13,500 before the budget was tabled. This limit will rise to \$15,500 in 2004, \$16,500 in 2005 and \$18,000 in 2006. From 2007, the maximum annual contribution to an RRSP will be set at the defined contribution limit for the previous year.

Note that any unused contribution room from previous years must be added to find the overall RRSP contribution room. Further, the annual RRSP contribution must still be reduced by the total pension adjustments (PAs) reported by the employee for participation in one or more of the following plans: a DC plan, a DB plan or a DPSP.

The table below summarizes the maximum allowable contributions for a DC plan, DPSP plan or an RRSP as well as the defined benefit limit for a DB plan, starting in 2003.

Year	DC Plan	DPSP	RRSP	DB Plan
2003 (expected before budget)	\$14,500	\$7,250	\$13,500	\$1,722.22
2003 (after budget)	\$15,500	\$7,750	\$14,500	\$1,722.22
2004	\$16,500	\$8,250	\$15,500	\$1,833.33
2005	\$18,000	\$9,000	\$16,500	\$2,000.00
2006	\$18,000 + AIW* increase	1/2 of DC Plan limit for the year	\$18,000	1/9 of DC Plan limit for the year

* Average industrial wage

Based on the budget, the new income tax limits for 2003 will be reached as soon as an individual's compensation exceeds \$86,111 for the defined benefit and defined contribution plan limits and \$80,556 for RRSPs. (Before the budget was tabled, the defined benefit compensation limit was \$86,111, while the compensation limit for defined contribution plans was \$80,556 and the compensation limit for RRSP contributions was \$75,000.) This increase in eligible earnings is modest and is still well below the maximum earnings eligible for tax-sheltered savings in other industrialized countries (such as the United States and Great Britain).

Impact on DC Plans

The impact of the higher contribution for DC plans will depend on the current plan wording regarding contribution limits. In most cases, the maximum employee and employer contributions will both increase, although a given plan may set the maximum employer or employee contribution at a limit that is lower than the applicable legislation. Plan sponsors will want to take a closer look at this immediately.

Pension Payable by a DC Plan

To date, income tax rules have prohibited a DC plan from paying a pension directly. The budget proposes to remedy this situation, starting in 2004, by authorizing a DC plan to pay pension benefits in the same manner as a RRIF. This means that a member in a DC plan may, upon retirement, withdraw a minimum amount each year (but withdrawals must start in the year of the member's 70th birthday). The minimum amount will be calculated according to the rules for RRIFs. This is a significant change.

The budget also states that former plan members who have transferred the value of their DC plan account to an RRSP (locked-in or not) or to a RRIF (locked-in or not) will be able to return these amounts to the DC plan.

Impact on DB Plans

The 2004 increase in the defined benefit limit will not have any immediate impact on DB plans which expressly limit the lifetime pension that can be paid by the plan to \$1,722.22 per year of participation. Even then, such plans will be under pressure to increase the limit. In the case of many DB plans, the current plan wording will cause the new defined benefit limit to apply automatically, which can have an impact on funding requirements and potentially on accounting expense.

Where the pension credited to some members has already reached the \$1,722.22 limit (or is projected to do so), application of the new defined benefit limit in 2004 will increase pension liabilities and current service cost now. It will also result in higher pension expense on the employer's income statement, which will have a direct impact on company profits. Taken in conjunction with the poor returns of the past two years, which in many cases have reduced pension fund assets, application of the new defined benefit limit will result in higher deficit or reduced surplus positions.

Administration Systems

To the extent that the new limits apply to their plans, DC and DPSP plan administrators will want to review their administration systems. Employers must also ensure that their payroll systems are modified to take into account, as applicable, the increase in the maximum employee contribution limit for DC and DB plans.

Supplementary Employee Retirement Plans (SERPs)

To provide pension benefits over the maximum pension limit contained in registered pension plans (RPPs), many employers have set up SERPs. Typically, a SERP provides an eligible employee with an additional benefit that is equal to the difference between the pension the employee would have received from the RPP if there were no maximum pension limit and the pension the employee will actually receive from the RPP. Some SERPs are funded and others are not. The impact of the budget on a SERP will vary depending on whether the RPP is affected by the new defined benefit limit or not.

If the new defined benefit limit applies to the RPP:

- A larger portion of the member's pension will eventually be payable from the RPP, which will decrease the pension payable from the SERP and therefore the SERP's obligations as well. When the SERP obligations are reduced, that plan may move into a surplus position if the SERP is funded, which would mean the employer could possibly take a contribution holiday and may even recover some of the surplus.
- If the SERP is not funded, application of the new defined benefit limit for the RPPs will not change anything, except to reduce the pension payable from the SERP and therefore that plan's obligations as well.

If the new defined benefit limit does not apply to the RPP:

- It could pose a problem whether or not the SERP is funded. In some jurisdictions, applicable legislation states that where an RPP entitles members to the maximum benefits under income tax rules, then, and only then, is the SERP not

subject to the applicable legislation. Thus, if the RPP limits pension benefits to \$1,722.22 (rather than the new limit), the SERP might become subject to the applicable RPP legislation. The benefits derived from the SERP would be subject to all of the tax rules set out in the applicable RPP legislation (and thus to the rules of vesting, locking in, funding, etc.). However, some SERPs have rules (such as no vesting of benefits if departure occurs before age 55) that do not conform to applicable pension legislation. An employer who wants to continue to apply these rules in a SERP would have no choice but to amend the RPP so that the new defined benefit limit would apply, or the SERP would become subject to the applicable RPP legislation.

The overall impact from an accounting perspective (impact on the RPP and SERP) will have to be evaluated with reference to the situation at each organization.

Tax Pre-paid Savings Plans

The government plans to hold consultations on the possibility of allowing tax pre-paid savings plans (TPSP). A TPSP is a savings vehicle like an RRSP, except that TPSP contributions are not tax deductible. However, TPSP interest income and withdrawals are not taxed. Before allowing TPSPs, the government will consider issues such as the impact such plans could have on government income and on the behaviour of savers, as well as their administrative efficacy.

OTHER MEASURES

Funding for Healthcare

The budget calls for the injection of major amounts into healthcare to support the healthcare funding objectives established at the first ministers' conference. The budget thus allocates funds to the development of primary care (family medicine groups) and home care, as well as to accelerated access to sophisticated diagnostic equipment. It also provides for the institution of coverage for expensive prescription drugs for all Canadians before the end of 2005-2006.

Overall, these measures will have a positive impact on private employee benefit plans by reducing the pressure created by government disengagement from the healthcare sector in recent years.

Special Employment Insurance Benefits for Care for a Seriously Ill Family Member

To support individuals who must care for seriously ill family members, a special six-week employment insurance benefit will be instituted effective January 4, 2004. The eligibility requirements for the benefit will be the same as for other special benefits. Benefits will commence after the usual two-week delay and can be shared among eligible members of the same family.

Reduction in Employment Insurance Contribution Rates

The budget reduces the employment insurance contribution rate from \$2.10 to \$1.98 per \$100 of insurance earnings effective January 1, 2004 and provides for a new funding mechanism in 2005.

For more information about the impact of the budget on your pension plans, please contact us at info@morneausobeco.com.

February 19, 2003