

Policy Bulletin #20 Flexible Pension Plans

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A new variant on the defined benefit pension plan, the "flexible pension plan" or "flex plan" is now permitted under the *Employment Pension Plans Act* (the Act) and the *Employment Pension Plans Regulation* (the Regulation). This bulletin summarizes the relevant provisions of the Act and Regulation and how they are interpreted with respect to flex plans. It reflects changes made to the Act and Regulation effective March 1, 2000. It has no legal authority. The Act and Regulation should be used to determine specific legislative requirements.

Legislative Reference

Several new provisions were added to the Act and Regulation to accommodate contributions to, and benefits paid from, flexible pension plans.

ACT

- Section 1 contains definitions of "optional ancillary contributions" and "ancillary benefits".
- Section 35 excludes from the locking-in requirement any part of a person's pension benefit that derives from optional ancillary contributions (OACs).
- Section 36 requires that interest be paid on OACs at the fund's rate of return.
- Section 37 exempts optional ancillary contributions and benefits from the requirement that the employer fund at least half the cost of a defined benefit.
- Section 42 prescribes what sorts of ancillary benefits may be provided by a pension plan.

REGULATION

- Sections 13, 14, 15, 16, 19, 22 and 24 prescribe disclosure requirements regarding OACs and the benefits that may be purchased. The sections set out what information must be provided to members or others entitled to benefits when they join the pension plan, annually, and when a benefit becomes payable such as at retirement.

- Section 33 adds detail about the application of interest to OACs.
- Section 68 exempts OACs from the usual requirement for locking in, in the event that a transfer to another pension plan is requested and the amount to be transferred exceeds the maximum that can be transferred under the tax Act.

What is a Flexible Pension Plan?

A flexible pension plan, for the purposes of this bulletin, is a defined benefit pension plan with an added feature: members are permitted to purchase optional ancillary or "add-on" benefits to augment the value of the pension as calculated under the basic formula. "Add-ons" could include cost-of-living adjustments, an early retirement "bridging benefit" or other specified benefits. The rules outlined in this bulletin do not apply where an employer makes contributions to pay for ancillary benefits on behalf of the member.

Flex plans are a response by the pension industry to the federal Income Tax Act rules (the "tax rules") regarding registered pension plans. The maximum that an individual can contribute to an RRSP is reduced, by an amount known as the Pension Adjustment (PA), if he belongs to a Registered Pension Plan. How much it is reduced depends on how his pension plan accrual is valued.

For a defined benefit pension plan, the PA is an amount approximating the capitalized value of his pension accrual that year. This capitalized value is derived by multiplying the accrual for that year by an annuity factor of 9. The factor of 9 assumes that the plan promises generous ancillary benefits, even though most pension plans do not provide a high level of ancillary benefits. Therefore, in order to increase the value of benefits accrued under a defined benefit plan, without incurring more cost as an employer or causing greater loss of the employee's RRSP room by generating a higher PA, some employers allow their employees to make contributions to purchase ancillary benefits.

Contributions to Flex Plans

A pension plan offering this feature must clearly establish, when contributions are made, that they are optional ancillary contributions and will be used to provide optional ancillary benefits (OABs). The member does not have to decide on specific benefits at the time the contributions are made.

The contributions are not locked in if the member terminates and elects a transfer of pension entitlements rather than a deferred or immediate pension. The member may receive them as a cash refund or have them rolled over into a non-locked-in RRSP if he has RRSP room. This does not mean that the member will necessarily receive the full value of his OAC account. At termination, a notional calculation is made of the maximum value of OABs that may be provided for the member according to the tax rules, and if the member's OAC account exceeds that value, the excess is retained in the plan – that is, effectively forfeited by the member. The remaining OACs are transferred or refunded on a non-locked-in basis. Note that this "excess" is not the same as the "excess contributions" that may arise as the result of applying the "50% test" set out in section 37 of the Act. The "50% test" is normally required to be performed in a contributory defined benefit plan when the member terminates, retires or dies or the plan terminates. It ensures that the member's contributions have not paid for more than half the commuted value of his benefit.

Because the purpose of OACs and OABs is to provide an entirely employee-funded benefit, the "50% test" is not applied to OACs and OABs. To meet this requirement, CCRA accepts two different methods of applying the "50% test" in a flex plan:

1. the OACs and OABs are completely excluded, and the test is performed comparing the commuted value of the basic benefit to the member's required contributions, or
2. the total benefits (basic plus OABs) are compared to the total member contributions (required plus OACs).

Either of these methods meets the requirements of the Act.

Interest on OACs is applied at the plan fund rate. If the member is allowed a self-directed OAC account, the interest applied is the actual return earned by the member on his account.

Optional Ancillary Benefits

A pension plan can offer a number of optional ancillary benefits. These typically include (but are not limited to)

- cost-of-living adjustments,
- enhanced spousal survivor pensions,
- lower or nil reduction of benefits upon early retirement,
- early retirement bridging benefits (augmenting the pension temporarily until Canada Pension Plan and Old Age Security begin), or
- a more favourable formula for determining pensionable salary (e.g., best 3 years instead of best 5 years).

Care should be taken to avoid designating as an optional ancillary benefit any of the benefits considered under the tax rules to be "exempt benefits", which are, generally speaking, lifetime retirement benefits, and are not considered under the tax rules to be "optional ancillary benefits".

When the member is ready to commence the pension, the plan administrator informs him of the level and value of ancillary benefits that may be purchased using the OAC account. The member then makes his choice of benefits. If the value of the account is greater than the maximum value of the ancillary benefits he can purchase, the tax rules require that the balance of his account be retained in the plan fund. Because of this possibility of forfeiture, administrators must plan and monitor employee contributions to flex plans very carefully. Some employers offer to reimburse the employee outside of the pension plan if forfeiture should occur. This is permitted, but not required, under the Act.

When valuing the ancillary benefits that could be purchased by the member, the administrator must not use an overly conservative actuarial basis. It should be consistent with accepted actuarial practice, such as the plan's funding basis, the current Canadian Institute of Actuaries (CIA) Recommendations for the Computation of Transfer Values from Registered Pension Plans, or a smoothing of the current CIA transfer basis.

If a member terminates and elects a transfer of his pension entitlements instead of purchasing a deferred or immediate pension, the termination benefit is to include the entire OAC account, with interest at the rate set out above, except to the extent that the account balance exceeds the maximum value of benefits available for purchase. If that is the case, the tax rules require that the excess be retained by the plan. The same applies if the plan terminates or if the member dies before retirement.

In marriage breakdown situations, the value is also determined as if the member were terminating. Unlike the basic pension benefit, the Act does not limit the pension partner's portion to half of the OAC account. This allows greater flexibility in dividing pension entitlements – the pension partner could, for example, receive the whole of the OAC account to offset some or all of his or her entitlement to the basic benefit. Canada Customs and Revenue Agency (CCRA), which administers the tax rules, does not require that the OACs be tested to determine whether there is a funding excess at the time of the marriage breakdown, because a benefit is not at that time being paid to the member.

Disclosure to Members and Others

Particularly because of the possibility of forfeiture of contributions, plan administrators must be careful to provide full disclosure to members and others who become entitled to benefits through the member.

When the member joins the flex plan, or when the plan is first amended to provide flex benefits, the members must be given:

- a statement of how the plan's assets are invested or the investment choices available if the account is to be self-directed;
- how interest will be applied to the OACs, and where the method may give rise to a negative interest rate, a statement of that fact;
- an explanation of the ancillary benefits available for purchase at pensionable age and their estimated cost; and
- a statement explaining the risk of forfeiture of contributions due to restrictions under the tax rules.

In the statements given to members annually, OACs are to be dealt with as a separate category of contributions. The information provided regarding those contributions is the same as if the contributions were required member contributions, that is:

- the balance at the end of the previous fiscal year;
- the contributions made during the fiscal year in question;
- the amount of interest accrued during the fiscal year in question, and
- the rate of interest applied and the manner in which it was applied.

When the member or the plan terminates before the member is eligible for a pension, or the member dies before pension commencement, the statement must contain the information about OACs and interest as shown for the annual statement, updated appropriately, plus an explanation of the options available with respect to optional ancillary contributions as well as the deadlines for choosing an option.

When the member wants to commence the pension, he or she must receive, in addition to the information about contributions shown above for the annual statement, updated appropriately, a statement as to the selection of OABs available to him to enhance the pension. If the member's OAC account exceeds the maximum value of OABs that may be purchased, the statement must indicate the amount of the excess and state that it will be retained by the plan.

Please note that, as long as the information outlined above is provided to the member in an accessible format, the Act and Regulation permit the information to be delivered electronically. The electronic method of delivery can take many forms, including an interactive program that allows members to make selections.

Further Information

It is strongly advised that administrators and their advisors consult the CCRA newsletter about tax rules relating to flexible plans, Newsletter 96-3, available on the CCRA website www.ccradrc.gc.ca under the Registered Plans sub-menu.

A related document, a Communiqué on flexible pension plans from the Canadian Association of Pension Supervisory Authorities (CAPSA), is available at [CAPSA's website](#).

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