

**Research Project # 16: Tax Policy and Occupational Pension Plans**  
**Research Paper: Impact of Tax Policy on Coverage and Funding of**  
**Corporate-Sponsored Pension Plans**

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**Executive Summary**

Corporate-sponsored defined benefit (DB) plans and defined contribution (DC) plans are referred to as “registered pension plans” (RPPs) under the Income Tax Act. The decline in DB coverage and the under-funding of DB plans have been well reported elsewhere. This Report examines the extent to which tax policy has contributed to these problems in the case of corporate-sponsored DB plans. It relies primarily on existing empirical data and secondary literature.

Part 2 of this Report discusses whether the decline of the coverage of corporate DB plans is related to, or caused by, major changes in tax policy, such as the universal contribution limit for all tax-assisted retirement saving plans, the contribution limits, and reductions in tax rates for individuals and corporations.

The Report concludes that the 1991 tax reform has clearly reduced the relative advantage for DB plans by integrating the tax treatment of DB plans, DC plans and RRSPs and by increasing the tax-sheltered contributions to DC plans and RRSPs. Empirical data show an increase in DC plans and RRSP coverage during the era of decline in DB coverage. It is clear that tax policy has encouraged the expansion of RRSPs and DC plans. However, it is not clear whether, or if so, to what extent, such expansion has occurred at the expense of DB plans. It is true that small DB plans have tended to disappear, and some may have been replaced by a DC plan or group RRSP, but the question remains whether these DB plans would have disappeared regardless of the option of DC plans or group RRSPs. RRSP contributions made by individuals who are not covered by DB plans (e.g., new workers, part-time workers, the self-employed, and workers in smaller firms) are not

resulted from shifting from DB plans. Therefore, the growth of RRSPs and DC plans may represent additional retirement savings, especially in cases where individuals with higher earnings tend to contribute to both RPPs and RRSPs.

Lowering marginal tax rates for individuals and corporations can be a double-edged sword. Lower tax rates result in more after-tax income, and thus more funds available for making contributions. On the other hand, the value of the tax assistance is determined by the marginal tax rate. Lower rates mean less value for the tax assistance, and thus, less tax incentive. There is no conclusive empirical evidence, however, on the extent of the decline in DB coverage being related to the lowering of tax rates.

Part 3 discusses the role of tax policy in respect of the funding of DB plans. More specifically, it examines the role of the 10 per cent surplus rule, the lack of flexibility in funding DB plans, and the foreign property rule.

The effect of the 10 per cent rule is to deny corporate sponsors their tax deductions for the contributions to “over-funded” plans, resulting in a “tax cost” to the employer (the amount is dependent on the applicable corporate income tax rate). The purpose of this rule is to allow moderate amount of surplus to be retained in a plan while limiting the government revenue cost associated with deferrals of tax on amounts over and above those required to fund the promised pension benefits. Empirical evidence shows that:

- It is not clear that the 10 per cent rule is the sole, or major, cause of contribution holidays taken by corporate sponsors in the late 1990s;
- there is no observable relationship between the number of contribution holidays taken by plan sponsors and plan funding ratios;
- the percentage of under-funded plans that did not take contribution holidays was sometimes greater than those that did take contribution holidays between 1994 and 2003;
- but 45 per cent of under-funded plans would have completely eliminated their current actuarial deficit if contribution holidays had not been taken.

Overall, the 10 per cent rule is counter-intuitive: it does not encourage companies to “save for rainy days”; it is, thus, not an effective “smoothing” mechanism.

The Income Tax Act currently recognizes DB plans and DC plans and provides limits on various

aspects of a DB plan that can be registered for tax purposes. It does not encourage any innovation in designing corporate pension plans, such as “cash balance plans” recognized by the US Pension Protection Act of 2006. A cash balance plan may violate the benefit accrual requirements for DB plans.

Part 4 of the Report suggests a re-evaluation of the pension tax policy in light of changing environment for corporate pension plans. Although no exact data can pinpoint the impact of the 10 per cent surplus rule on the funding status of DB plans, this rule is too rigid and fails to function as a buffer for companies whose financial position changes dramatically from year to year. The surplus limit may be raised. In light of the increasing popularity of DC plans and remaining relative advantages of DB plans in managing pension

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risks, it is also worth considering to reform the tax rules so that they can accommodate “cash-balance” plans that have features of both DB plans and DC plans.