Headlines

Worldwide Pay and Benefits

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Canada

Government increases limits for tax-assisted plans

Canadian employers will need to consider the cost and other implications for their tax-assisted employee benefit plans following the increases in contribution and benefit limits announced in the 2003 federal budget.

Passed into law on 19th June, 2003, the increases to the annual contribution limits for defined contribution registered pension plans (DC RPPs), registered retirement savings plans (RRSPs) and deferred profit sharing plans (DPSPs) went into effect immediately. Corresponding increases in the annual benefit limit for defined benefit (DB) RPPs take effect for retirement benefits commencing after 2003 and are retroactive in that they apply to benefits accrued for service before 2004 as well as future service. The increases to the

annual contribution limits are shown in Table 1.

The benefit and contribution limits are indexed to wage inflation, and the DPSP limits are one-half of the DC RPP limits.

The schedule of increases will restore some of the inflation erosion caused by successive government delays in implementing increases over past years. However, while the increased limits will be welcome news for many individuals and employers, Canada's limits on tax-assisted retirement savings are still substantially less than those of its major trading partners with private pension systems, particularly the USA and the UK.

The specific impact of these increases will depend on the individual plan's design, funded status and demographics. Sponsors may wish to review the funding and accounting implications of these increased limits on their

Table 1: Increases to annual contribution limits

Year	DB RPP maximum pension benefit (per year of service) (Can\$)	DC RPP annual contribution limit (Can\$)	RRSP annual contribution limit (Can\$)
2003	1,722.22	15,500	14,500
2004	1,833.33	16,500	15,500
2005	2,000.00	18,000	16,500
2006	Indexed	Indexed	18,000
2007			Indexed

arrangements. Where companies provide benefit coverage in excess of the DB RPP limit through a supplemental plan, the higher limit will shift liabilities from the supplemental plan to the RPP.

European Union

Implementation phase for new Pension Directive begins

Member states have until 23rd September, 2005, to implement the EU's Pension Directive.

The Directive, which sets standards for the prudential supervision of pension plans in the EU, was approved by the European Parliament and the Council of Ministers at the beginning of June 2003. After an unusually long delay, it was published in the EU's Official Journal on 23rd September, 2003, which makes it EU law and starts a two-year implementation period.

The Directive covers employer-sponsored, separately funded pension plans. It does not apply to book reserve or to pay-as-you-go plans. The extent of the changes required will depend on each member state's current laws, but key changes that could impact company-sponsored pension plans are:

- investment restrictions will be liberalised. Plans will be required to invest their assets in line with the prudent person principle, although some quantitative investment limits can be retained up to certain ceilings;
- minimum actuarial and funding standards will be imposed. Individual member states have some flexibility in prescribing these standards;
- financial and other information must be given to plan members each year — a particularly relevant requirement given the reduced funding levels prevailing in most countries.

The Directive also introduces a framework for cross-border pension plans, although the tax treatment of these plans remains a controversial issue that is being tested in the EU courts and by the European Commission through its infringement proceedings.

Consultation on pensions mobility

The European Commission is also starting to tackle the issue of portability of pensions within the EU in an attempt to ensure that employees do not lose out when they change jobs. In a consultation paper published in September 2003, the Commission invited unions and other social partners to negotiate an EU-wide collective agreement allowing more mobility-friendly occupational pension arrangements. The aim is to reduce vesting periods, give employees the right to transfer their accrued pension rights or, if leaving them behind, protect the benefit from inflation. At present, the protection given to employees varies greatly among member states.

Mexico

Government tightens tax deductions on benefit plans

Employers will need to review the funding of their retirement benefit and termination indemnity plans as well as the terms of their social aid plans in light of changes in Mexico's tax laws.

The laws were issued at the beginning of 2002, but since then law-makers have approved a number of amendments that have created some confusion among employers. While further changes in the tax law next year may come as a result of government-backed fiscal reforms, here is a summary of our understanding of how current tax law may impact on

employers sponsoring retirement and termination indemnity plans in Mexico.

Retirement and seniority premium plans

In Mexico, tax deductibility still applies to employer contributions to fund company-sponsored retirement and seniority premium plans (which fund the mandatory indemnity payment required upon voluntary termination of employment of workers who have completed a minimum of 15 years' service). However, the new tax law will make it more difficult to obtain a full tax deduction in the year that contributions are paid. This is because tax deductions on contributions for past service benefits are spread evenly over ten years and the new law makes it mandatory to apportion all contributions between funding for past and future service.

Plans are also restricted in the investments they can make in the sponsoring employer. The proportion of the funds invested in the company's stock cannot exceed 10 per cent of the market value of the plan's total assets and must be approved by government authorities (*Comision Nacional Bancaria y de Valores*). Plans that exceeded this limit were required to eliminate the excess by the end of 2002 in order to continue qualifying for tax-favoured status.

Social aids

The new tax law also tightens up on social aid plans. Many employers operate these tax-deductible plans, which reimburse employees for healthcare and a variety of other expenses.

Under the new law, medical and hospital expenses, savings funds and social security payments are no longer considered to be on the list of social aid programmes. However, they still qualify for tax-favoured status under independent new rules. Reimbursements of expenses for disability, scholarships, day nurseries,

funerals, food and restaurant coupons are still classed as social aid benefits.

Contributions to these plans for non-union employees are now only tax-deductible on the condition that the same benefits are granted to union employees and (as previously) the average benefit paid for non-union employees does not exceed that for union employees. For non-union employees, the benefit limit of 10 per cent of taxable income up to a cap of the monthly minimum wage still applies.

Compulsory pension system

The government has given employees a tax incentive to pay voluntary contributions to their chosen *Administradoras de Fondos para el Retiro* (AFORE), a private pension fund administrator of the compulsory pension system established in 1997. This change, which took effect on 1st January, 2003, sets a deductibility limit of 10 per cent of total income, capped at five times the yearly minimum wage (\$78,570 pesos).

In addition, although the law is not very clear, it seems that employees may also make contributions to other specially established retirement accounts of up to \$152,000 pesos with the same tax incentive. However, contributions to these accounts may not be withdrawn within five years, except on death of the participant.

Singapore

Government overhauls employer-backed pension rules

The Singapore Government has announced a sweeping set of new rules for the Central Provident Fund (CPF), the country's main employer-backed system of savings for retirement, healthcare and housing.

Prime Minister Goh Chok Tong

announced the changes on 29th August, 2003, saying they are essential to lower the cost of doing business in Singapore and keep the country competitive with China, Malaysia and other emerging Asian nations. Singapore, which has achieved economic success over the years by making itself an attractive centre for multinational companies, is now experiencing a loss of manufacturing and white-collar jobs as a result of low-wage competition elsewhere.

CPF contributions go into three types of accounts: Ordinary (for housing and other specially-designated purposes, as well as retirement), Special (retirement only) and Medisave (for in-patient hospitalisation expenses for members and immediate family).

Changes for employers and employees

The changes announced by the Prime Minister make adjustments to the CPF in three major areas: employer and employee contribution requirements, the minimum sum rules and the early withdrawal rules. This is how the new requirements will work.

Reductions in CPF contributions

- As of 1st October, 2003, the combined CPF contribution rate was lowered from 36 per cent to 33 per cent. Employees will continue to pay 20 per cent, while the employer rate is reduced from 16 per cent to 13 per cent. Over the long term, the employer's CPF contribution rate will be based on a range of 10–16 per cent, depending on the state of the economy.
- Currently, the employer and employee contribution rates are lower for employees over the age of 55. These rates do not change. However, as of 1st January, 2005, the combined CPF rate will be lowered to 30 per

cent for employees in the 50–55 age bracket, with an employee rate of 19 per cent and an employer rate of 11 per cent. The combined rate will be lowered again on 1st January, 2006, to 27 per cent, with 18 per cent coming from employees and 9 per cent from employers.

- As of 1st January, 2004, the CPF salary ceiling will be reduced from \$6,000 to \$5,500 a month. It will fall to \$5,000 on 1st January, 2005, and to \$4,500 on 1st January, 2006.
- As of 1st October, the employee contribution rate for the Special account is 5 per cent for members aged 35 and below, 6 per cent for those aged 35–45 and 7 per cent for those aged 45–55. Previously, the rates for these age groups were 4 per cent, 6 per cent and 6 per cent respectively. The Medisave contribution rates remain at 6 per cent for CPF members aged 35 and below, 7 per cent for those aged 35–45 and 8 per cent for those above 45.

Increases in CPF and Medisave minimum sums

Employees wishing to withdraw sums from their CPF accounts for specified reasons must keep a combined minimum sum in their Ordinary and Special accounts after they retire. The current minimum sum is \$80,000, of which up to half can be in the form of a property pledge (ie up to \$40,000 equity in Singapore real estate). Starting on 1st July, 2004, the CPF minimum sum will be raised by \$4,000 a year and adjusted for inflation, taking it to \$120,000 in today's dollars by 2013. As before, half of this can be in the form of a property pledge.

Beginning on 1st January, 2004, CPF members must have a minimum sum in their Medisave account when they reach age 55. Any shortfall must be made up

from any excess in their Ordinary or Special accounts before any cash withdrawal from those accounts. The minimum sum starts at \$2,500 and will be raised by \$2,500 a year, with an adjustment for inflation, to \$25,000 (today's dollars) by 1st January, 2013.

New early withdrawal rules

Currently, at age 55, CPF members may withdraw up to 50 per cent of their combined Ordinary and Special account balances even if that leaves them with less than half of the minimum sum, or \$40,000. The percentage is being reduced over a five-year period starting in 2009, so that by 2013 early withdrawals will be allowed only if a member has satisfied the CPF and Medisave minimum sum requirements.

Choices for employers

How employers handle the lower CPF contribution requirements is crucial.

At companies that are struggling and need to stress cost-cutting, adopting the rate reduction will be acceptable to employees compared with other alternatives such as layoffs, a wage freeze or a reduction in base salary. For other companies that are still managing to stay profitable, there will be some pressure to compensate employees through other HR mechanisms funded by CPF savings.

For example, the contribution cuts and reductions in the salary ceiling will have the greatest impact on the higher earners. Introducing a supplementary executive retirement plan may address the benefit loss for this group of employees. If change to a broad-based plan is preferable, a company may be able to boost productivity by adopting a performance-based variable bonus.

Overall, there are many HR initiatives to which the savings from the new government requirements can be

reallocated. Finding the right plan that makes the most sense for your organisation, and communicating it effectively to employees, is key.

Switzerland

Government cuts minimum yield on pensions

The Swiss Government lowered the guaranteed interest rate on assets in company-sponsored pension plans from 3.25 per cent to 2.25 per cent. The change takes effect from 1st January, 2004 and was announced by the Interior Ministry following a decision by the Swiss Federal Cabinet. The government said the aim is to stabilise the private pension system and help ensure its long-term viability.

Last year, the government lowered the guaranteed rate on pension plan assets from 4 per cent to 3.25 per cent, as of 1st January, 2003. In doing so, the government said it would periodically review the rate to reflect market conditions. The rate is especially important for companies that sponsor DC plans, whether the assets are invested in insurance policies or managed by the plan itself.

If the plan assets are held in insurance policies, the insurer is responsible for meeting the guarantee and bears the investment risk. Plans that do not invest in insurance policies bear the liability of the guaranteed minimum return themselves.

Implications for employers

Employers sponsoring DC plans in Switzerland should review the minimum yield policy for their 2004 plans. The minimum yield is applicable to the compulsory minimum level of required benefits under the Federal Law on Occupational Old Age, Survivors' and

Disability Benefit Plans (known under the initials LPP in French and BVG in German). For the supplemental part of the coverage, the plan trustees can decide on the level of guaranteed yield they wish to apply.

Beginning on 1st January, 2004, insurance companies plan to segregate the minimum requirements from the supplemental portion, with the minimum yield guaranteed only on the minimum LPP/BVG level of benefits. Depending on the pension plan insurance contract involved, the insurer might not guarantee any yield on the supplemental portion. Employers sponsoring DC plans should therefore carefully review their pension plan minimum yield policy under the framework of the new pension plan ruling.

USA

IBM court ruling poses added challenges for plan sponsors

The recent court ruling that IBM's pension plan violates age discrimination laws has raised new challenges for many plan sponsors by creating additional legal uncertainties about cash balance and other hybrid plans.

The decision by the US District Court for the Southern District of Illinois (*Cooper et al. v The IBM Personal Pension Plan*) immediately prompted protests from large employers who have been seeking more clarity about the legal status of hybrid plans, which have become an increasingly popular approach for delivering retirement benefits to employees.

The district court ruled that the cash balance and pension equity formulae in IBM's pension plan are age discriminatory and violate the Employee Retirement Income Security Act (ERISA). More specifically, the judge

concluded that the rate of benefit accrual for plan participants favours younger employees over older employees. IBM immediately announced that it would file an appeal.

Participants in the IBM plan are generally eligible for a pension equity or a cash balance benefit, depending on their date of hire and certain transition provisions. All participants in the cash balance benefit receive an annual 5 per cent pay credit and interest credits at a rate one percentage point higher than the rate on one-year Treasury bills. Participants who are eligible for the pension equity benefit accumulate points according to a formula that includes an age-weighted schedule. (Unlike a cash balance plan, a pension equity plan credits employees with a lump sum benefit value that is determined as a percentage of final average pay and years of service.)

Inconsistent decision

Towers Perrin believes that the court's decision is inconsistent with years of legislative and regulatory history relating to the US pension system and should be overturned on appeal. The decision marks yet another confounding result that points to the need for clarification and modernisation of existing pension law and regulations. If the district court's ruling were to be upheld on appeal and become the accepted legal interpretation, it would make nearly all cash balance and many other hybrid plans illegal, significantly harming the US pension system and millions of plan participants.

Towers Perrin has urged Congress and the Treasury to act immediately to clarify once and for all that well-designed hybrid plans have always been permissible under current laws. Otherwise, companies that sponsor hybrid plans will evaluate the potential

risks and rewards associated with continued plan sponsorship.

An estimated 30 per cent of all large DB plans in the USA are hybrid plans. These newer plan designs allow companies to provide a valuable retirement benefit to US workers in a highly competitive business environment. Many companies have chosen to implement hybrid plans rather than DC plans, and in doing so they have continued to provide a floor of economic protection rather than shifting investment and longevity risk to their employees and retirees.

Implications for employers

While the IBM decision is clearly an unfavourable development for hybrid plan sponsors, employers need to keep things in perspective. IBM has announced its intention to appeal, and the decision currently is binding only on IBM. Here are some other points to keep in mind.

- The decision does not mention the extensive and well-reasoned decision in *Eaton v. Onan Corporation*, another federal district court decision that held that cash balance plans do not inherently discriminate based on age.
- The decision makes no mention of the proposed Treasury regulations on age discrimination in retirement plans, including cash balance plans. These proposed regulations say that cash balance plans are not inherently discriminatory on the basis of age, and specifically in the rate at which benefits accrue.
- Federal courts generally defer to final agency regulations. Thus, final Treasury regulations, which, it is understood, might come before the end of 2003, could have a significant impact on any future litigation on these issues.

FASB seeks to expand disclosures about benefit plans

The Financial Accounting Standards Board (FASB) is seeking more information about plan assets and cash flows in its proposal to expand financial statement disclosures about employer-sponsored pension and other post-retirement benefit plans.

The proposal, issued in the form of an exposure draft, would replace the current disclosure requirements under FAS 132 and is in response to concerns raised by analysts, investors and creditors about the lack of transparency in financial reporting about pension plans. It would require plan sponsors of DB pension and other post-retirement plans (eg retiree medical, life insurance) to supply information about the expected rate of return on each category of asset held, expected contributions to the plan and expected benefit payments.

Stepped-up requirements

The FASB proposal represents a significant expansion of financial disclosure requirements for pension and post-retirement plans. As currently drafted, it would make plan sponsors subject to more scrutiny, including questions regarding investment strategies and the reasonableness of their investment return expectations, cash flows and other information not previously disclosed in the corporate annual report. In addition, the disclosure of plan information in quarterly reports and any other interim financial statements could prompt questions about accounting decisions and adjustments to financial information that occur during the year.

As proposed, the new disclosure requirements would take effect for calendar year 2003 financial reporting and would apply to all publicly traded companies that follow US generally

accepted accounting principles (GAAP), including non-US companies. Non-public companies would be subject to slightly reduced disclosure requirements.

However, the FASB acknowledged that it may be difficult for companies, especially those with non-US plans, to fully comply with the proposed standard in such a short time frame. This will undoubtedly be one of the issues addressed in comments to the FASB on its proposal. Comments were due by 27th October, 2003.

Current requirements retained

The new disclosure rules would require plan sponsors to continue providing most of the information about their benefit plans currently required by FAS 132, except for the tables describing the change in the benefit obligation and the change in plan assets during the year. However, disclosure of the actual return on plan assets, employer contributions, participant contributions and benefits paid, which are currently included in those tables, would continue to be required.

Additional disclosures proposed

Among the additional disclosures that the FASB proposes, employers would have to:

- state the accumulated benefit obligation (ABO) for all DB pension plans. The ABO is used to determine the minimum liability and is currently disclosed only for underfunded plans;
- list assets held, by major asset category (eg equity securities, debt securities, real estate and other), identifying by category:
 - the percentage of total assets represented
 - the targeted allocation

- the expected long-term rate of return.

The maturity characteristics for debt securities would also be required;

- estimate future benefit payments (used in determining the projected benefit obligations), presented separately for each of the next five years, and the total expected payments thereafter;
- state the amounts expected to be contributed to the plans in the next fiscal year, separately identifying minimum contributions required to meet funding requirements and voluntary employer contributions. The amount and description of any non-cash contributions (eg company stock) would also have to be disclosed.

In addition, the FASB is proposing that quarterly reports and any other interim financial statements include disclosure of the net periodic cost, by cost component. Updated information on contributions paid or expected to be paid where the amounts differ significantly from the amounts previously reported would also be required.

As with FAS 132, employers with multiple plans would generally be allowed to continue aggregating their disclosures for all DB pension plans and for all other post-retirement benefit plans. Similarly, disclosures about domestic and foreign plans may be combined unless the benefit obligations of the foreign plans are significant relative to the total benefit obligation and the foreign plans use significantly different assumptions. Employers would continue to recognise cost for DC plans the way they do now under FAS 132.

After considering comments received on its proposal, the FASB will reconsider the issues and make final decisions about

the disclosures that employers should provide about their pension and other post-retirement benefit plans. A final statement is expected to be issued before the end of the year. However, the board has acknowledged that it may be difficult for some companies to comply with all of the disclosure requirements in their 2003 reporting and could choose to

delay the effective date for some of the disclosure requirements. For a copy of the FASB's exposure draft, visit www.fasb.org.

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