Headlines

Worldwide Pay and Benefits

Compiled and written by Towers Perrin

Canada

Government seeks to raise savings limits for retirement plans

Canadian employers will need to consider the cost and other financial implications of the 2005 federal budget on their retirement plans. The budget, which is still to be approved by lawmakers, seeks to raise the savings limits and eliminate the foreign investment restrictions that apply to company-sponsored retirement plans.

Higher savings limits

After years of successive government delays in implementing any increases to the savings limits in the 1990s, the 2005 budget extends the above-inflation increases that were reinstituted beginning in 2003.

- For defined benefit registered pension plans (DB RPPs): the limit on the annual benefit (per year of service) of C\$2,000 (US\$1,652, £875, €1,276) in 2005, rises to C\$2,444 in 2009 and is indexed thereafter. The increases are retroactive in that they apply to benefits accrued for service before 2005 as well as future service. Depending on the plan terms, the RPP may have to be amended to take advantage of the higher limits.
- For defined contribution registered pension plans (DC RPPs): the annual contribution limit of C\$18,000 in

2005 rises to C\$22,000 in 2009 and is indexed thereafter.

- For registered retirement savings plans (RRSPs): the annual contribution limit of C\$16,500 in 2005 rises to C\$22,000 in 2010 and is indexed thereafter.

In general, the higher savings limits represent a 9–13 per cent increase over the 2005 limits announced in the 2003 budget, although they are still substantially less than those of Canada's major trading partners with private pension systems, particularly the USA and the UK.

Foreign investment limit

The budget removes the 30 per cent foreign investment limit for tax-favoured plans effective for 2005 and subsequent years, making it easier for pension fund managers to create internationally diversified investment portfolios. Plan sponsors who have previously used devices such as synthetic foreign equity funds and multiple pooled fund trusts to get around the foreign content limit will now be able to eliminate the cost associated with the devices, which can be over 1 per cent per year in some cases.

Implications for employers

As in 2003, employers will need to investigate how liabilities and costs for their own plans might be affected by the

revised government guidelines. Three particular areas to look at are:

- Cost increases and lower funded ratios may arise in cases where the company-sponsored RPP automatically incorporates the higher defined benefit limits.
- For employers that provide additional benefit coverage through supplementary plans, the new tax limits may shift pension liabilities and costs from the supplementary plan to tax-favoured plans.
- If a company's supplementary (or top-up) plans are not properly coordinated with the other retirement plans, the supplementary plans might provide benefits that could be provided under the registered plan. This could make the supplemental plan subject to funding, vesting and other standard pension requirements.

Plan sponsors may also wish to review their plan's asset allocation in light of the increased investment flexibility that will become available to them and determine whether a higher foreign content would better meet the overall financial management objectives of their retirement programmes. However, employers should also keep in mind that if the current government is forced to call for elections, new legislation will have to be introduced.

Europe

EC acts against more countries over tax discrimination

The European Commission (EC) has asked Sweden and Finland to adopt legislation to remove discriminatory tax provisions relating to cross-border pension plans.

The action is the latest in the

long-running EC campaign to prevent the practice of providing favourable tax treatment for company-sponsored domestic pension plans. Of the 15 old member states of the European Union, the EC has now referred three states — Denmark, Spain and Belgium — to the European Court of Justice and, in addition to Sweden and Finland, started infringement proceedings against another five. Only Germany, the Netherlands, Luxembourg and Austria are considered by the EC to have nondiscriminatory tax policies for pension plans, while the situation in Greece remains unclear.

IASB issues amendment to pension accounting rule

The International Accounting Standards Board (IASB) has amended IAS 19, its standard for employee benefits accounting, to provide an alternative method of recognising actuarial gains and losses, address issues relating to participation in a multi-employer or group plan, and to require additional disclosures for defined benefit plans.

The amendment is effective for financial years beginning on or after 1st January, 2006, although earlier adoption is permitted. If, however, a company elects to adopt the new alternative method for recognising actuarial gains and losses prior to the 2006 effective date, it must also adopt the other changes required by the amendment.

Companies affected by the European Union requirement to follow international financial reporting standards (IFRS) in preparing their financial statements must await the EC's approval of the revised standard before applying it.

Gains and losses recognition options

Under IAS 19, as a minimum, companies must amortise actuarial gains

and losses falling outside a 'corridor' — defined as 10 per cent of the greater of the plan's benefit obligation or the fair value of the plan assets — over employees' average expected future years of service. Alternatively, companies can choose more rapid amortisation, including immediate recognition of the gains and losses through the income statement (P&L). Despite the conceptual arguments favouring immediate recognition, most companies have opted to follow the corridor approach because pension cost, and therefore net income, is less volatile.

The amendment recently issued by the IASB adds another alternative — one that allows companies to recognise immediately actuarial gains and losses *outside P&L*, in a statement of changes in equity called the Statement of Recognized Income and Expense (SORIE). This is similar to the current requirements of FRS 17, the UK standard on accounting for retirement benefits.

Additional disclosures

The amendment to IAS 19 also requires plan sponsors to make additional disclosures, many of which are consistent with comparable US and Canadian standards covering pension accounting. In addition, plan sponsors must provide a five-year history of asset- and liability-related gains and losses. This history may help investors and analysts assess how optimistic or pessimistic a company may have been in setting its assumptions. A similar requirement exists under FRS 17.

Implications for employers

An employer may elect to recognise gains and losses immediately, outside the income statement, beginning with its

2004 financial statements (provided its fiscal year ends on or after 16th December, 2004), but must adopt the other amendments at the same time. In addition, prior period financial statements need to be restated to reflect the new accounting methods.

Some employers in Europe may wish to adopt these revisions to IAS 19 in 2005, in connection with their initial adoption of IFRS. Factors to take into account include:

- the company's perspective on how and when gains and losses should be recognised
- an assessment of the likelihood that recognition of gains and losses outside the P&L will survive the joint IASB-FASB project to reconsider benefits accounting
- materiality considerations.

Note, however, that the date on which the EC approves the amendment may affect the timing of adopting the IAS 19 revisions.

There are also new accounting and reporting requirements for multi-employer and group plans that need to be factored into the planning process for year-end accounting.

Singapore

Proposal to allow private pension plans is set aside

Singapore's Central Provident Fund has indefinitely postponed a proposal to allow individuals to invest their retirement savings through privately managed pension plans (PPPs). The delay leaves in place the current investment options available to employees under the CPF Investment Scheme.

PPPs were first proposed by the government-appointed Economic

Review Committee in 2002 as a means of offering a simple, low-cost option for long-term investments and enhanced returns on the funds of CPF members.

Currently Singapore workers and their employers are required to contribute a portion of their earnings to the government-managed CPF. Members' contributions are invested very conservatively, with an annual fixed rate of return declared on individual member accounts. In order to offer members greater flexibility and the possibility of higher returns on their accounts, members are currently also allowed, under the CPF Investment Scheme, to invest a portion of their account balances in other approved investment products. The PPPs, to be structured as unit trusts, were proposed as an additional investment option designed to help participants achieve better returns on their long-term investments, cut administrative costs and simplify choices for members.

While industry experts generally agreed that higher returns could indeed be achieved if CPF funds were invested over the long term in well-diversified portfolios with some equity exposure, two key features of the original proposal — the lack of upfront sales charges and the voluntary nature of the plans — proved unpopular with the fund management industry.

UK

Government raises taxes on pension plans

With the launch of the Pension Protection Fund (PPF) and the establishment of a proactive Pensions Regulator on 6th April, 2005, the UK began a new era of pension plan regulation funded by higher levies, or taxes, paid by employers.

The PPF is the first UK compensation arrangement to protect members of a defined benefit plan when the employer becomes insolvent. If the plan's assets are insufficient to meet the benefits, then the PPF will take over and pay the benefits — within certain limits — out of its funds.

The Pensions Regulator replaces the Occupational Pensions Regulatory Authority (Opra) and will differ in its operations in a number of ways. In particular it has a defined set of statutory objectives, has wider powers to investigate plans and take action and intends to pursue a more proactive risk-based approach to regulation.

Pensions Protection Fund (PPF) levy

The PPF levy is a new tax to fund the PPF and is to be paid by plans with defined benefit liabilities. The initial levy is based on the number of members with defined benefit entitlements. The rates for the year beginning 1st April, 2005 are:

- £15 (€22,US\$28) for each active employee and current pensioner, and
- £5 for each former employee not yet retired.

The initial levy will be replaced, starting 1st April, 2006, with a levy of which at least 80 per cent must be based on risk factors such as the level of underfunding in the plan. As the initial levy has been set in order to raise only about 50 per cent of what is estimated to be needed, many plans can expect to see substantial increases in the amount they have to pay from April 2006.

On top of this, plans have to pay an administration levy to meet the costs of running the PPF. This is based on a sliding scale according to the total number of plan members with defined benefit entitlements, with a levy of

£0.74 per member for plans with 10,000 or more members (subject to a minimum of £10,600).

General levy

The general levy is an existing tax on all types of pension plan to cover the costs of the UK pension regulatory authorities — the Pensions Regulator, the Pensions Ombudsman and the Occupational Pensions Advisory Service.

The levy for the year beginning April 2005 is set at the same rates as the PPF administration levy. This represents a doubling in the existing rates, so for example, the cost for a plan with 15,000 members will rise to just over £11,000. The increase reflects the need to pay for setting up the new pension regulatory regime in the UK, although the government points out that this is the first increase since 2000.

Impact on employers

Most commentators (including the chairman of the PPF) believe that the initial funding levy is unlikely to be high enough to secure the PPF's liabilities over the long term. Sponsors of UK defined benefit plans can expect this cost to increase in future years. Plan sponsors may, therefore, wish to assess how to minimise the impact of the levy by reviewing the levels of risk in their plans and the funding level relative to the PPF requirements.

New measures give greater protection for employee transfers

Companies acquiring businesses in the UK will need to consider the impact of new rules that provide additional pension protection for employee transfers.

The new rules under the Pensions Act 2004 became effective 6th April, 2005

and apply to employees who are transferred from one employer to another, usually as a result of a business transaction. They do not affect transactions involving the purchase of a company's shares, rather than its assets, because under UK law there is no transfer of employment in those situations.

Previously, while employee transfers had employment protection under the TUPE (Transfer of Undertakings Protection of Employment) regulations, employer-sponsored retirement plans were specifically exempt. The new rules now require that if the transferring employees were members of the previous employer's retirement plan or eligible to participate in it, then the new employer must operate some form of arrangement and make it available. It is not necessary to mirror the type of plan and the level of benefits of the previous employer, but the benefit levels must meet minimum standards that depend on whether the new employer is offering a defined contribution or defined benefit arrangement:

Defined contribution arrangements

The new employer must match any contributions by the employee up to a maximum of 6 per cent of basic pay.

Defined benefit arrangements

Benefits under the new employer's pension plan must be at a level that is either

- at least sufficient to meet the UK's reference scheme test (broadly, a pension of 1/80th of 90 per cent of average band earnings in the last three years of service — currently limited to a cap of approximately £28,500 for tax year 2005/2006) or
- at least equal in value to a contribution rate of 6 per cent of pay

for each year of service, plus any contributions that employees are required to make. The employees' required contribution level cannot be more than 6 per cent of pay.

Implications for employers

In the past, the question of future pension arrangements in company acquisitions has been a matter of agreement between the seller and the buyer or the decision was left to the buyer. Under the new TUPE rules, the buyer will now have to consider whether its proposed pension arrangements meet the new requirements. The new regulations apply equally for companies taking on staff through an outsourcing contract and in the event of a company restructuring.

A particular point of issue is that there is a possibility that the new employer may have to offer better pension arrangements than the old employer if the old employer's arrangements are below the minimum level. For example, employees transferring from a money purchase plan where the existing employer matches only 3 per cent of pay could opt to pay in 6 per cent under the new plan, requiring the new employer to pay 6 per cent.

USA

Phased retirement gets a lift from IRS

US companies interested in setting up a phased retirement programme — or in building on an informal programme that they already have in place — now have some long-awaited guidance from the Internal Revenue Service (IRS) in the form of a notice of proposed rulemaking that would allow certain in-service distributions from pension plans before normal retirement age.

The IRS proposal, issued in November, is a welcome development for many employers because it puts the government squarely on the side of supporting bona fide phased retirement programmes. At the same time, numerous important details remain to be settled, and at this point it appears that the proposed rules do not go far enough in giving many companies the flexibility they would like to fully address employee needs. The proposal also contains administrative requirements that many employers may find burdensome.

The proposed rules, if and when they are finalised, will not take effect before plan years beginning on or after 1st January, 2006, at the earliest.

What is phased retirement?

The IRS regulations would permit an employee's accrued pension to be paid prior to normal retirement age, provided the amount paid is no more than the proportionate reduction in hours worked. For example, a full-time employee who agrees to reduce customary hours by 40 per cent would be eligible to receive up to 40 per cent of the accrued pension. Phased retirement benefits that are less than the maximum would also be permitted. Employees participating in a programme would have dual status — partially retired and partially employed.

Issues for employers

Under the proposed regulations, a phased retirement programme would be required to have written guidelines and meet a number of conditions. Notably, employee participation must be voluntary and limited to employees who are at least age 59½. The rules would allow the employer and employee to increase or decrease an employee's work schedule and change the amount of the payable

benefit accordingly. In some cases an adjustment to the phased retirement benefit could be required, and situations where the work schedule is changed repeatedly could result in complex benefit calculations and administration.

An employer looking to develop a phased retirement programme will have to address numerous issues related to eligibility, the impact on reward strategies in general, workforce planning, the cost and the impact on cash flow, and other key areas of HR management.

Benefit plans under closer government scrutiny

Employer-sponsored retirement plans, health and welfare plans, and executive compensation plans are under intensifying scrutiny in the USA as federal agencies step up their efforts to assure compliance with relevant laws and regulations. For qualified retirement plans in particular, the government is essentially putting companies on notice to fix their plans voluntarily if they have operational defects or face potentially severe financial penalties if the defects are discovered during a formal audit.

Those penalties can be high and include large fines, loss of tax deductions and costly, government-mandated remedies. In a worst-case scenario, a major operational defect in a benefit plan can damage relations with employees or retirees and lead to unfavourable publicity.

At the Internal Revenue Service (IRS), additional funding is in place for a rigorous new audit programme targeting large, qualified retirement plans with 2,500 or more participants. Unlike traditional audits that last from 36 to 50 hours, these broader reviews targeting both defined benefit and defined

contribution plans can involve a team of IRS auditors spending from 200–300 staff days examining company records and interviewing company officials. Under this initiative, the IRS is planning to conduct 90 large plan audits a year using six regionally based teams.

The IRS also indicated that it will be rolling out a new ‘package audit’ programme to examine compliance in a range of executive compensation programmes, including nonqualified deferred compensation. This new initiative will target equity incentives, fringe benefits and other key areas for tax compliance.

Actions for employers

Employers should consider undertaking a voluntary compliance self-review, which typically includes:

- evaluation of compliance with relevant laws and regulations
- consistency between plan documents and actual administrative practices
- identification of specific risk areas and remedies.

These reviews can be scaled according to the size of an organisation and the resources available. In the case of qualified retirement plans, the government maintains voluntary correction programmes. Under these programmes, employers that have identified compliance problems through a self-audit can limit or eliminate exposure to costly sanctions that would result if the problems were identified through an IRS audit.

© Towers Perrin 2005. All rights reserved.