Pension Risk Management: Income And Commodity Tax

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Risk management relating to pension plans has been a much-discussed topic among plan sponsors and administrators in recent years, particularly after the market crash in 2008.

Our Pension and Benefits Group has been assisting our clients in addressing different risks regarding their pension plans. The Group is issuing a series of Pension Alerts to discuss the key risks, the strategies to reduce or eliminate such risks and the considerations that an employer needs to take into account in adopting a particular strategy. We have issued Pension Alerts on financial risks, administration risks, investment risks and litigation risks.

This Pension Alert discusses common income and commodity tax risks. Most of these income tax risks are relevant to both defined contribution and defined benefit pension plans although some of them are more important to one type of plan than the other.

Income Tax Risks

Although pension plans, and many associated entities such as pension real estate corporations, pension investment corporations and elected pension master trusts enjoy tax exempt status, there are a number of income tax risks that impact pension plans. Many of these risks can be categorized as tax risks associated with correcting errors (e.g. enrolment errors, contribution errors and erroneous payments of benefits), tax risks associated with pension plan investments and activities and tax risks associated with business transactions such as a merger or sale of a business.

1. Enrolment Errors

Pension plans often mandate enrolment after a certain period of probation. If the enrolment date is missed, the pension plan will be placed in a revocable position as it will not have been administered in accordance with its terms. Although it is unlikely that the Canada Revenue Agency (CRA) would revoke the registration of a pension plan as a result of isolated enrolment errors, systemic errors could be a serious concern. A further tax problem can arise for the affected employee. The employee's pension adjustment (PA) would have been incorrectly reported (or not reported) for the year. This can result in the employee over-contributing to his or her registered retirement savings plan (RRSP) in the following year because the employee's contribution room will be calculated in reliance on the prior year's PA. If the enrolment error is later corrected, the employee's PA for the relevant year(s) will be retroactively corrected. If, as a result, the employee has over-contributed to his or her RRSP, the income tax implications can be significant.

The deduction claimed by the employee in each of the years the RRSP over-contributions were made will be denied, resulting in an income inclusion to the employee for each such year. Affected employees will have a tax and interest liability arising from the reassessment(s). Further, the employee may be assessed tax in respect of the over-contributions under Part X.1 of the *Income Tax Act* at a rate of 1% per month and has an obligation to report the over-contribution each year on a T1-OVP form. The Minister of Revenue has the discretion to waive this tax if the employee demonstrates that there is a "reasonable error". The CRA's administrative position on what constitutes a reasonable error is fairly restrictive. Where the over-contribution occurred as a result of a third party's (i.e. pension administrator's) error there must be clear documentary evidence of the error. Prompt withdrawal of the excess amount from the RRSP is recommended. An employee can withdraw the excess contributions tax free (i.e. free of the normal withholding tax applicable on RRSP distributions), if he or she does so in the year of the CRA reassessment or in the immediately following year, provided the employee had reason to believe at the time of the initial contribution that the amount of the contribution was deductible. The employee will be required to apply for a waiver of withholding tax using form T3012A.

When a pension plan administrator or employer discovers that an error has been made, non-tax implications can include claims from impacted employees. Employees may require assistance if tax filings are required, and, in some cases, may make a claim seeking damages to compensate for any out of pocket costs, interest or penalties that may be triggered.

2. Contribution Errors

Under-contribution errors can trigger similar issues as enrolment errors because the correction will reduce the employee's available RRSP contribution room. Over-contribution errors can be even more difficult to address. If the over-contributions are discovered in the same year it may be possible to refund the contributions in the year and properly report the correct pension contribution and PA on the employee's T4 slip. However, if the error is not discovered until a subsequent year, the pension plan will be in a revocable position and it will be necessary to negotiate the correcting steps with both the CRA and the pension regulator to ensure the funds are removed from the plan in the most efficient manner possible. Corrected tax slips will need to be issued and the employees may be reassessed in the relevant years. Applications can be made to the CRA under its fairness program to request a reduction or elimination of penalties and interest.

3. Pension Plan Investments

The *Income Tax Act* (Canada) restricts the pension plan from investing in debt or equity of an entity which is related to the sponsoring employer, except where the securities are publicly listed. If the pension plan invests via a pension real estate corporation or a pension investment corporation (both of which are entitled to a tax exemption on investment income), the investments and activities of these corporations are further restricted.

Pension plans are not able to grant security and are only able to borrow in very limited circumstances. Only borrowings on an unsecured, short term (i.e. less than 90 days), or borrowing to acquire real property provided the only security is real property itself are permitted.

Where a pension plan invests in other jurisdictions, it is necessary to review the relevant tax treaties to determine if the pension plan is eligible for a reduction or elimination of withholding tax on income earned in the foreign jurisdiction. Further, pension plans must be cognizant of foreign reporting obligations which could be triggered by foreign investments. Often special purpose entities – established for the purpose of addressing these issues – are created to facilitate the investment by Canadian pension plans.

4. Transfer of a pension plan on a merger or acquisition.

Where employees are transferred in connection with the sale of a business, the purchaser sometimes assumes the obligations of accrued pension under the seller's pension plan for both transferred employees and retirees of the vendor under the vendor's pension plans. However, in order for the purchaser to be permitted to contribute to the plan and deduct the pension contributions (and to ensure the pension plan is not placed in a revocable position), it is imperative that the vendor be considered a predecessor employer. The definition of predecessor employer requires that “all or a significant number” of the employees of the vendor have become employees of the purchaser. We understand that the CRA's administrative positon as to what constitutes "a significant number" is applied on a case-by-case basis, having regard to the particular circumstances.

GST/HST Risks

In addition to income tax considerations, pension plan administrators face complex and ever changing GST/HST compliance obligations. The latest of these changes was released on July 22, 2016. Most of the new provisions are applicable to fiscal years starting after July 22, 2016, but some are retroactive to September 23, 2009. The new rules revise the treatment of master trusts and certain pension corporations (referred to as "master pension entities"). The overall intent of the changes is to treat pension plans with an interest in a master pension entity in a similar fashion to those plans which hold investments directly.

Pension plans are entitled to claim a rebate equal to 33% of the GST/HST they pay or are deemed to have paid. Under the prior rules, that rebate was not available to master pension entities. Under the proposed amendments, those entities will be able to designate a participating pension plan which is then deemed to have paid all of the GST/HST paid by the master pension entity and therefore entitled to claim the rebate. If there is more than one pension plan participating in a master pension entity, an election must be made between one such plan and the master pension entity to have that plan designated as the designated pension entity. Without an election, no participating pension plan will be able to claim the rebate.

Under the pre-amendment rules, double taxation could occur when an employer made a supply to a master pension entity and collected GST/HST from that entity. The employer would also be deemed to have made a supply to the pension plan(s) and to have collected GST/HST on that deemed supply. Relieving provisions were available where both an actual and deemed supply was made directly to a pension plan, but not where the actual supply was made to the master pension entity. This has been corrected through new relieving provisions which are retroactive to September 23, 2009. Where an employer has been assessed with respect to the tax deemed collected on a supply made to a master pension entity in these circumstances, it can request a reassessment within one year of the date on which the new legislation receives Royal Assent. To the extent a rebate was claimed with respect to that tax, the rebate will also be reassessed.

The new rules also extend the availability of certain elections in some circumstances to master pension entities. Employers should review their pension plan structures to determine which elections may be beneficial.

Overall, while the new rules make the imposition of the tax on pension plans somewhat fairer, they do little to alleviate the compliance complexity and may, to some degree, exacerbate it.

See our previous issues Pension Risk Management: Financial Risks, Pension Risk Management: Investment Risks, Pension Risk Management: Administration Risk and Litigation Risks of De-Risking.

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