FTR Now

2010 Federal Budget: Highlights for HR Professionals

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On March 4, 2010, the Minister of Finance, the Honourable Jim Flaherty, tabled the Government of Canada's 2010 Budget (the "Budget"), titled "Leading the Way on Jobs and Growth". The Budget represents the second and final phase of the Government's "Economic Action Plan", which was initiated in the 2009 Budget with a view to lifting the Canadian economy out of recession. In this FTR Now, we review the key aspects of the Budget that are of most interest to employers and human resources professionals.

Briefly, as suggested by its title, the Budget outlines several temporary Employment Insurance ("EI") initiatives that will be continued through 2010 to assist workers and employers weather the economic downturn.

In terms of pension and benefit-related tax measures, the Budget contains several items of interest, including the following:

- **Taxation of Employee Stock Options:** The Budget proposes significant changes to the tax rules applicable to stock option plans. Among these changes, new rules will alter the deductions available when stock option rights are paid out in cash instead of exercised for shares. The Budget also proposes to prospectively eliminate the taxable benefit deferral applicable to the exercise of employer-granted stock options to acquire publicly traded shares and to clarify an employer's withholding tax obligations when an employee exercises options.

- **Registered Disability Savings Plans ("RDSPs"):** The Budget proposes changes to allow certain registered retirement accounts to be rolled over on a tax-free basis into the RDSP of a financially dependent infirm child or grandchild upon the account-holder's death.

- **Health and Welfare Trusts:** The Budget confirms the Government's intention to proceed with legislation first announced on February 26, 2010 that will implement new tax rules for employee life and health trusts.

The Budget is largely silent on pension issues and proposes no changes to registered retirement savings plan ("RRSP") and tax-free savings account ("TFSA") contribution limits. The Budget does not propose reductions to public sector pensions. Many in the industry had expected the Budget to signal an intention to address the broader issues of pension reform and, in particular, to call for strengthened pension funding rules and enhanced pension coverage (through, for example, changes to the Canada Pension Plan) – issues which have regularly been in the news of late. It is difficult to predict where these issues will be positioned on the Government's agenda, but it appears that they may not be priority items in the near future.

The following is a detailed summary of the relevant Budget items.

EMPLOYMENT INSURANCE ENHANCEMENTS

The Budget commits the Government to provide $1.6 billion to continue the following enhancements to the EI program first announced in the 2009 Budget:

- **Freeze in EI Premium Rates:** The Budget proposes to continue the existing freeze on EI premium rates at $1.73 per $100 of insurable earnings until the end of 2010. As previously announced in the 2008 Budget, when the temporary freeze ends in 2011, the Canada Employment Insurance Financing Board ("CEIFB"), an independent arm's length Crown corporation, will set EI premium rates on a cost-recovery basis, subject to a 15-cent limit on annual increases.

- **Five Additional Weeks of EI Benefits:** Normally, Canadians eligible to receive EI benefits can receive benefits for a maximum of 45 weeks (depending on the recipient's region of residence). The Budget proposes to continue the temporary 5-week increase to this maximum period introduced in the 2009 Budget (to a maximum period of 50 weeks) until September 11, 2010.

- **Expanded EI Benefits for Long-Tenured Workers:** The Budget proposes to continue to fund expanded EI benefits for long-tenured workers. One key initiative, which continues until September 11, 2010, expands EI benefits for an additional 5 to 20 weeks for workers who have paid EI premiums for many years. Additional EI benefits are also available for long-tenured workers participating in long-term skills training. Intake for this program continues until May 29, 2010.

- **Expanded EI Benefits under Work-Sharing Agreements:** The Work Sharing Program ("WSP") is designed to help employers avoid layoffs by making EI benefits available to qualifying workers willing to work a reduced work week on a temporary basis. Last year, the Government expanded the maximum period to receive EI benefits under the WSP from 38 weeks to 52 weeks. The Budget proposes to temporarily further extend this period to a maximum of 78 weeks for existing or recently terminated work-sharing agreements. The Budget also proposes to increase flexibility in the qualifying criteria for new work-sharing agreements. These proposed enhancements will remain in effect until March 31, 2011.

The Budget also pledges enhanced access to parental and sickness benefits for military families and family members of victims of crime.

EMPLOYEE STOCK OPTIONS

The 2010 Budget proposes significant changes to the tax rules governing employee stock options. To better understand these changes it is helpful to review the current rules.

Generally, an employer-granted stock option will create a taxable benefit for the employee. Where the fair market value of an optioned share when it is granted is at least equal to the exercise price (i.e., the price at which the share can be purchased by the employee), there is no inclusion in the employee's income until the options are exercised and shares are acquired. However, upon exercise, the employee must include in his or her income an employment benefit equal to the fair market value of the shares on the date of acquisition less the amount paid to acquire the shares (subject to the deferral discussed below).

This amount is taxed as regular employment income. However, where certain conditions are met, the employee is entitled to a deduction equal to 50% of the employment benefit (the "stock option deduction"). The stock option deduction has the effect of causing taxable stock option benefits to be taxed at capital gains tax rates.

Stock Option Cash-Outs
An employer stock option plan may permit an employee to exercise option rights and receive a cash payment instead of shares. Currently, if a plan is properly designed, an employee can claim the 50% stock option deduction whether option rights are exercised for shares or for cash. Where stock option rights are exercised for cash, the employer can also claim a full deduction for the cash payment. In that event, the same employment benefit is deducted one-and-a-half times (i.e., a full deduction by the employer and a one-half deduction by the employee).

The Budget proposes to prevent the double deduction so that, when an employee elects to receive a cash payment upon exercising stock option rights, the employee will only be able to claim the stock option deduction if his or her employer has elected not to deduct the cash payment. The stock option deduction remains available to the employee where he or she acquires shares pursuant to the exercise of stock option rights.
Elimination of Deferral Election
The Budget also proposes to repeal provisions of the Income Tax Act (Canada) ("ITA") that, since 2000, have enabled

eligible employees to defer tax on stock option benefits in certain circumstances.

As noted, when an employee exercises an employer-granted stock option and acquires shares, the employee must recognize a taxable employment benefit equal to the fair market value of the acquired shares less the amount paid to acquire the shares. Subsequent changes in the market value of the acquired shares will, upon disposition, result in a capital gain or loss that is dealt with separately for tax purposes.

Starting in 2000, for qualifying acquisitions of publicly traded shares, the ITA allowed an eligible employee and his or her employer to jointly elect to defer recognition of the taxable employment benefit until the shares were disposed of, subject to a limit of $100,000 per year. This deferral was intended to allow employees to retain more of their shares instead of being forced to sell a portion of them to pay the tax triggered by the exercise. However, taking advantage of this deferral election could cause difficulty for the employee if the value of the shares fell and the proceeds of the later disposition were insufficient to cover the employee's deferred tax liability for the employment benefit.

The Budget proposes to repeal the deferral election for employer-granted stock options exercised after 4:00 p.m. (EST) on March 4, 2010. In addition, the Budget proposes tax relief for employees with "underwater" shares who elected to defer recognition of the employment benefit arising from shares acquired under an employer stock option plan and whose shares are now worth less than the deferred tax liability on the underlying benefit. The proposal would allow a taxpayer to elect to pay a special tax which, in effect, limits his or her tax liability to the proceeds of disposition of the shares (after taking into account the benefit of being able to offset the related capital loss against capital gains from other sources). Shares must be disposed of before 2015 for this special tax relief to apply. A special election is available to employees who disposed of their shares prior to 2010.

The Budget also proposes to clarify the provisions of the ITA that require an employer to withhold and remit income tax in relation to the taxable benefit that arises when an option is exercised (other than for eligible shares of Canadian-controlled private corporations). These amendments, which are proposed to be effective after 2010, will require employers to withhold and remit income tax as if the benefit was paid as a cash bonus. The proposed rules will allow the 50% stock option deduction to be taken into consideration when calculating how much should be withheld.

Finally, the Budget proposes to amend the ITA to clarify that, when an employee disposes of rights under a stock option plan to a non-arm's length person, this triggers a taxable employment benefit in the employee's hands at the time of disposition.

EMPLOYEE LIFE AND HEALTH TRUSTS

Prior to the release of the Budget, the Government issued a proposal for the creation of a new employee benefit trust that will be of significant interest to employers who currently provide employee benefits through a Health and Welfare Trust ("HWT") or may be considering implementing a trust vehicle to assist with the funding of employee benefits.

The Budget confirms the Government's intention, first announced on February 26, 2010, to introduce the employee life and health trust ("ELHT"). The ELHT is a new type of taxable trust for purposes of providing certain employee benefits. The ELHT will replace the HWT, which is not specifically addressed in the ITA and which has been governed predominately by the policies of the Canada Revenue Agency ("CRA").

The proposed amendments codify many aspects of the HWT regime but also introduce some important administrative changes. As well, the proposed amendments provide clarity and certainty with respect to the treatment of employer contributions where the employer wishes to pre-fund future benefits.

Under the proposed rules, an ELHT is defined as a trust, established by one or more employers, that provides "designated employee benefits" to employees or former employees (including retirees and former employees of a company that has been subsequently acquired in a sales transaction). Designated employee benefits are those benefits provided under group sickness or accident plans, private health services plans or group term life insurance plans. The tax treatment of designated

employee benefits received from an ELHT will be as if the benefits were received directly from the employer. For example, if an employee receives employer-paid long term disability benefits from an ELHT, the disability benefits remain taxable when received by the employee. On the other hand, where the employee receives benefits from an extended health plan (that qualifies as a private health services plan) through an ELHT, the benefits will not be taxable when received by the employee.

Employer contributions to an ELHT will be deductible, but only to the extent that the contributions relate to the designated employee benefits provided in that year. If an employer wishes to pre-fund benefits, any amount relating to future benefits not payable in the tax year may be deducted in the future when those benefits are in fact paid out. However, the employer may not deduct an amount in excess of the contributions actually paid to the ELHT over the life of the trust. The proposal also specifies the treatment of an employer's contribution that is satisfied through the issuance of a promissory note. Employees may also contribute to an ELHT. These contributions would not be deductible by the employees but may qualify for the medical expense tax credit.

An ELHT will be permitted to treat benefit payments as expenses. Where an ELHT's expenses exceed income and revenue in a tax year, the ELHT will be permitted to treat the excess as a non-capital loss that may be carried forward or back three years to reduce the taxation of the trust.

In order to maintain its status as an ELHT in any tax year, the trust must meet a number of specific conditions. Of particular note, the employer may not have any right to distributions from the ELHT, including surplus, and the trustee must be independent of the employer, such that employer representatives cannot constitute a majority of the trustees. The proposed amendments also place restrictions on the ability of an ELHT to provide benefits to "key employees". As a result, the majority of beneficiaries of an ELHT cannot be significant shareholders and high income earners of the employer.

Employers will be permitted to establish an ELHT for any tax year after 2009. The Government is inviting comments on the proposals until April 30, 2010 and appears to anticipate the passing of the proposed amendments by the end of 2010.

ELIMINATION OF TAX CREDIT FOR COSMETIC PROCEDURES

Effective March 4, 2010, the Budget proposes to eliminate purely cosmetic procedures from eligibility for the medical expense tax credit ("METC"). Although these types of services are already commonly excluded from coverage under insured benefit plans, they often are covered under health care spending accounts sponsored by employers.

CRA's policy is that amounts that are not METC-eligible cannot be reimbursed under a health care spending account or other private health services plan without jeopardizing the tax-free status of the plan. The types of procedures that are to be eliminated from eligibility include liposuction, hair replacement procedures, botox injections and teeth whitening. The exclusion does not apply if the procedures are for medical or reconstructive purposes. Cosmetic procedures will now also be subject to GST/HST.

REGISTERED DISABILITY SAVINGS PLANS

The Budget builds on measures introduced in 2007 to provide for the financial security of people with severe disabilities by allowing contributions of up to $200,000 to be invested and accumulate tax-free in a registered disability savings plan ("RDSP").

The Budget proposes to allow tax-free rollovers from RRSPs, Registered Retirement Income Funds ("RRIFs") and registered pension plans into an RDSP established for a disabled child or grandchild upon the death of the RRSP or RRIF annuitant or pension plan member. This rollover is expected to apply to registered plan death benefits made to a disabled child (or grandchild) of the plan member as well as to death benefits paid to the deceased's estate if the disabled person is a beneficiary of the estate. We anticipate that the CRA will provide further guidance as to the circumstances in which registered plan administrators may transfer death benefits on a tax-deferred basis to an RDSP. The provision will apply

retroactively back to 2007 under special transitional rules.

PENSION PLAN EXCEPTION FROM NON-RESIDENT TRUST TAXATION

The Budget outlines new proposals to address foreign investment entities and non-resident trusts. The proposals will be the subject of public consultation until May 2010. Proposed amendments to the current non-resident trust provisions have been under consideration for a number of years. The Budget provides clearly that investments in non-resident trusts made by registered pension plans and other tax-exempt entities will not be subject to the non-resident tax provisions. This exception for pension plans is consistent with a Department of Finance comfort letter issued in respect of prior proposals relating to non-resident trusts.

GST EXEMPTION FOR INVESTMENT MANAGEMENT FEES

The Budget reiterates a proposal first announced on December 14, 2009 to limit which financial services qualify as GST-exempt. Under the proposal, asset management fees will be subject to GST or HST, as applicable. The proposed legislation broadly characterizes a number of services as “asset management”, including management or administration of another person’s assets or liabilities (regardless of whether the service provider has discretionary authority to deal with the assets); research, analysis, reporting or advice relating to those assets or liabilities; and acts to meet performance targets with respect to those assets or liabilities. This proposal will impact employers who use investment managers to invest the assets of a registered pension plan.

The proposed legislation will be retroactive to 1990 (the year in which the GST was introduced) but will effectively exempt payments made to service providers on or before December 14, 2009.

QUESTIONS?

If you have any questions arising out of this FTR Now, please contact one of the members of our Pension & Benefits Group, or your regular Hicks Morley lawyer

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