



Research Advisory

Hewitt

Canadian Research Group

February 27, 2008

Highlights

There were several key changes contained in Budget 2008 including the introduction of a new tax free savings account and the proposal that over the counter drugs no longer be eligible as a medical expense for income tax act purposes.

Hewitt

The Hewitt Research Advisory is a regular Hewitt newsletter designed to provide a detailed overview of specific legislative and regulatory developments in Canada relating to human resources.

If you have questions or comments, please reply to this message or contact INFOCAN@hewitt.com.

Federal Budget 2008 – A New Hybrid Vehicle...for Savings

There were several key changes contained in Budget 2008 including the introduction of a new tax free savings account and the proposal that over the counter drugs no longer be eligible as a medical expense for income tax act purposes.

Pensions

Tax-free Savings Account

Effective after December 31, 2008, Budget 2008 proposes the introduction of a Tax-free Savings Account (TFSA)—a flexible, registered, general-purpose account that will allow Canadians to earn tax-free investment income. Individuals are permitted to hold more than one TFSA. Features of the TFSA include:

- Canadian residents age 18 or older will be eligible to contribute up to \$5,000 annually to a TFSA, with unused room being carried forward indefinitely;
- contributions will not be deductible;
- capital gains and other investment income earned in a TFSA will not be taxed;
- withdrawals will be tax-free;
- neither income earned within a TFSA nor withdrawals from it will affect eligibility for federal income-tested benefits and credits such as the Canada Child Tax Benefit, the GST credit, the Age Credit, and Old Age Security and Guaranteed Income Supplements benefits;
- withdrawals will create contribution room for future savings;
- contributions to a spouse or common-law partner's TFSA will be allowed, and TFSA assets will be transferable to the TFSA of a spouse or common-law partner upon death;
- qualified investments include all arm's-length Registered Retirement Savings Plan (RRSP) qualified investments;
- the \$5,000 annual contribution limit will be indexed to the Consumer Price Index rounded to the nearest \$500; and

- excess contributions will be subject to a tax of one per cent per month.

Hewitt Comment: *Many group capital accumulation plans (CAPs) have an after tax account for contributions above retirement savings limits. The TFSA may be a more tax effective account for these excess contributions. When considered in conjunction with income splitting introduced in the 2006 Tax Fairness Plan, this change presents an opportunity for plan sponsors to review the structure of their plans to maximize flexibility and tax effectiveness. If this type of account is used within a CAP, there is some question whether the Capital Accumulation Plan Guidelines will apply. Note that since taxpayers are not taxed on gains earned within the TFSA, losses incurred within the account cannot be deducted.*

Organizations could consider establishing a group TSFA allowing employees to contribute through payroll deduction, providing access to institutional investment managers, and lower investment manager and other administrative fees than do individual products. Individuals with no remaining RRSP contribution room could use this new vehicle to promote tax sheltered investment growth on their savings.

As well, the TFSA could provide an account for unused flex credits. A TFSA could for example, be used to:

- create an emergency fund
- fund future medical expenses
- accumulate payments for down payment on a home
- fund private school education

Increased Flexibility for Locked-in Pensions

Budget 2008 proposes to increase flexibility for locked-in pensions by amending the Regulations under the federal *Pension Benefits Standards Act* for holders of Life Income Funds (LIFs). LIFs are funds which have been locked in under pension standards legislation. Currently, LIF holders are permitted to withdraw funds at retirement; however there are strict annual withdrawal limits. Budget 2008 proposes to increase the flexibility for LIF holders by:

- allowing individuals who are 55 or older with LIF balances less than \$22,450 (indexed to the average industrial wage) to wind up their LIF with the option of transferring to another non-locked in, tax-deferred savings vehicle;
- providing individuals who are 55 or older with a one-time conversion option of up to 50 per cent of the balance of the LIF into a tax-deferred savings vehicle with no maximum withdrawal limit; and
- permitting individuals facing financial hardship to unlock up to \$22,450 (indexed to the average industrial wage).

Hewitt Comment: *This proposed change will apply only to individuals who participate in federally regulated pension plans (which are sponsored by employers such as airlines and banks) and whose benefits from such plans are held in a LIF. They reflect a continuing trend toward allowing individuals more access to funds locked-in under pension standards legislation.*

Registered Education Savings Plans

Currently, contributions to a Registered Education Savings Plans (RESPs) can be made for 21 years following the year in which the plan is entered into. An RESP must be terminated by the end of the year that includes the 25th anniversary of the opening of the plan. These limits are extended by an additional four and five years, respectively, for single-beneficiary RESP if the beneficiary qualifies for the Disability Tax Credit (DTC). No contributions may be made to a family plan for a beneficiary who is 21 years of age or older.

To provide additional flexibility to parents who save in RESPs, and to students who later use these savings to help finance their post-secondary education, Budget 2008 proposes to increase each of these limits by an additional 10 years.

Health Care Benefits

The Medical Expense Tax Credit (METC) provides tax relief equal to 15 per cent of eligible medical and disability-related expenses incurred by an individual (including expenses incurred on behalf of a spouse, common law partner or minor children) once the expenses exceed the lesser of 3 per cent of the individual's net income and \$1,962. The *Income Tax Act* defines eligible medical expenses for METC purposes. The same definition applies to expenses eligible under a private health services plan (PHSP).

OTC Drugs No Longer Eligible Medical Expenses

Budget 2008 proposes that effective February 26, 2008, over-the-counter (OTC) drugs will no longer be eligible medical expenses under the *Income Tax Act*, even in circumstances where they are prescribed by a physician. As a result, individuals will no longer be able to claim OTC drugs under the METC. In addition, PHSPs, which include medical plans and health care expense accounts, will no longer be permitted to reimburse these expenses.

Hewitt Comment: *Currently, OTC drugs prescribed by a physician have been interpreted to be eligible medical expenses under the Income Tax Act. Budget 2008 proposes to "clarify" this provision, since covering OTC drugs "goes beyond the policy intent of the Medical Expense Tax Credit". Therefore OTC drugs may no longer be eligible expenses, even with a prescription provided by a medical practitioner.*

Although this is described as a "clarification", many medical plans and health care expense accounts include some coverage for OTC drugs or medications, either broadly or in special circumstances.

Plan sponsors should seek to:

- understand exactly what coverage in all of their benefit plans is affected by this change;*
- ensure their claims adjudicators no longer reimburse plan members for these expenses;*
- modify their insurance contracts to reflect this change;*
- review employee communications to clarify these new provisions;*
- review union collective bargaining agreements for potential conflicts with the new provisions; and*
- seek to understand the legal implications of removing this coverage from union or retiree groups.*

Even though benefits plans may not cover OTC drugs broadly, there are certain OTC products that are more commonly covered under medical plans, such as epinephrine auto-injectors (e.g. "EpiPen") and diabetic supplies. It is unclear at this point whether these types of over-the-counter products will also no longer be eligible medical expenses under the Income Tax Act.

Additional Eligible Medical Expenses

In addition, the proposed changes to the METC would add to the list the cost to purchase, operate and maintain the following devices, provided they were prescribed by a medical practitioner:

- altered auditory feedback devices for the treatment of a speech disorder;
- electrotherapy devices for the treatment of a medical condition or a severe mobility impairment;
- standing devices for standing therapy in the treatment of a severe mobility impairment; and
- pressure pulse therapy devices for the treatment of a balance disorder.

Budget 2008 also proposes to expand the METC to recognize certain expenses in connection with service animals specially trained to assist individuals severely affected by autism or epilepsy.

Hewitt Comment: *This proposed change expands what an individual may be able to claim as a METC. Similarly, it expands the scope of eligible expenses that may be reimbursed to an employee under a PHSP (including Health Care Spending Accounts).*

Investment

Private Foundations - Excess Corporate Holdings

As a result of consultations with private foundations, the federal government has reviewed its excess corporate holdings rules (introduced in Budget 2007) in order to provide relief in respect of unlisted securities held on March 19, 2007. Budget 2008 proposes that certain holdings of shares (“unlisted shares”) that were held on March 18, 2007 by foundations will be “exempt” shares in the excess corporate holdings calculation and applicable transitional divestiture rules.

General HR

Targeted Initiative for Older Workers

The Targeted Initiative for Older Workers (TIOW) is a federal-provincial employment program that provides a range of employment activities for unemployed older workers who live in vulnerable communities and helps them stay in the workforce.

Budget 2008 proposes extending the TIOW until March 2012 to help more older workers remain active and productive participants in the labour market.

Improved Management and Governance of Employment Insurance

To enhance the independence of premium rate setting and to ensure that EI premiums are used exclusively for the Employment Insurance (EI) program, the government is creating a new, independent Crown corporation, the Canada Employment Insurance Financing Board (CEIFB). It will have the following key responsibilities:

- **managing a separate bank account.** Any annual EI surpluses going forward will be held and invested until they are needed for EI program costs.
- **implementing an improved EI premium rate-setting mechanism.** Starting in 2009, the new rate-setting mechanism will take into account any surpluses or deficits that arise on a go-forward basis, to ensure that EI revenues and expenditures break even over time. To provide rate stability, the maximum annual change in the premium rate set by the CEIFB will be 15 cents.
- **maintaining a cash reserve.** The Government will provide \$2 billion to establish a reserve in the CEIFB’s bank account. In the event of a downturn where the projected break-even rate would result in a premium rate increase greater than the 15-cent limit, the difference would be funded from the reserve in that year, which would be replenished in subsequent years through the premium rates. In the event of an economic upturn, any surplus beyond the desired reserve level would be used to reduce EI premiums in future years.

Copyright © 2008
Hewitt Associates

About Hewitt Associates

For more than 65 years, Hewitt Associates (NYSE: HEW) has provided clients with best-in-class human resources consulting and outsourcing services. Hewitt consults with more than 3,000 large and mid-size companies around the globe to develop and implement HR business strategies covering retirement, financial and health management; compensation and total rewards; and performance, talent and change management. As a market leader in benefits administration, Hewitt delivers health care and retirement programs to millions of participants and retirees, on behalf of more than 300 organizations worldwide. In addition, more than 30 clients rely on Hewitt to provide a broader range of human resources business process outsourcing services to nearly a million client employees. Located in 33 countries, including Canadian offices in Toronto, Montreal, Vancouver, Calgary and Regina, Hewitt employs approximately 23,000 associates. For more information, please visit www.hewitt.com.