Hewitt Research Advisory

Canadian Research Group

March 19, 2007

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.

Copyright © 2007
Hewitt Associates

Federal Budget 2007: A Budget for the Ages

Background

Federal Budget 2007 was delivered on March 19, 2007. The budget proposes flexibility and tax savings for older workers. There are also further savings incentives for education and disabled dependants. Notably absent were any broad-based changes to inclusion rates relating to capital gains, as was suggested in pre-budget speculation.

Phased Retirement—Pension Payments and Accruals for Older Workers

The Income Tax Regulations currently prohibit phased retirement arrangements by preventing employees from accruing pension benefits under a defined benefit registered pension plan if they receive a pension from the plan of the same or a related employer. This reduces incentives for older workers to remain in the labour force.

Effective 2008, the budget proposes to allow employers to offer qualifying employees up to 60 per cent of their accrued defined benefit pension, while accruing additional pension benefits on a current service basis in respect of their post-pension commencement employment. To ensure that this measure has a positive impact on labour supply, qualifying employees will be limited to those who are at least 55 years of age and who are otherwise eligible to receive a pension without the plan imposing an early retirement reduction. The 60 per cent limit will be based on the amount of pension benefits (including bridging benefits) that would be paid from the plan if the employee were fully retired. There will be no requirement that the partial pension be based on a reduction in work time or that there be a corresponding reduction in salary.

The budget proposals place no restrictions on when, or how often, an employee’s accrued pension amount can be recalculated to take into account the employee’s additional pensionable service and increased annualized earnings (if any)

during a period of simultaneous accrual and pension payment. The prohibition on accruing additional benefits while in receipt of pension payments will continue to apply to designated plans as well as to persons who are connected with their employer.

Hewitt Comment: *The budget opens numerous possibilities for new plan design based on workforce needs to encourage older employees to stay at work. However, note that the new phased retirement provisions apply only in situations where the employee is age 55 and entitled to an unreduced pension; i.e., no early retirement reduction. The notion of phased retirement is not new. In fact, Quebec and Alberta already allow forms of phased retirement. The budget measures will accommodate those phased retirement programs to a greater extent. Applicable pension standards legislation may also require amendment to accommodate these new measures. This may have implications for supplemental plan design; i.e., plans that provide a top-up for eligible employees above* Income Tax Act *limits.*

Increasing the Age Limit for Maturing RPPs and RRSPs

The *Income Tax Act* currently requires that an individual's registered retirement savings plan (RRSP) be converted to a registered retirement income fund (RRIF), or be used to acquire a qualifying annuity, by the end of the year in which the individual turns 69 years of age. Similarly, registered pension plan (RPP) payments must begin by no later than the year in which the pension plan member turns 69 years of age.

Budget 2007 proposes to increase the RRSP/RPP maturation age limit to 71 years of age, effective for the 2007 and subsequent taxation years. There are transition measures for individuals between aged 69 and 71. Existing registered plan annuities can be amended, without adverse tax consequences, to reflect the later conversion age. As well, employers will be allowed to amend their RPPs to allow benefits to accrue, and contributions to be made, in respect of employed members who are 71 years of age or younger at the end of 2007, subject to any otherwise applicable adjustments to pensions in pay.

Hewitt Comment: *The federal government has gone back to the maturity rules in force in 1996 and affords individuals more opportunity to manage their retirement savings. If employers decide to extend the maturity age under their plans, plan amendments may have to be undertaken, unless current plan wording accomodates a change in the maturity age.*

RRSP Qualified Investments

The list of qualified investments that can be held by RRSPs and other registered plans will be expanded to include most investment-grade debt and publicly-listed securities on designated stock exchanges. These changes will apply on or after March 19, 2007, and will provide registered plan investors with greater investment choice and diversification opportunities.

Eliminating Capital Gains Tax on Charitable Donations to Private Foundations

Donations of publicly-listed securities to private foundations will now be eligible for a reduced inclusion rate on capital gains. This measure will be effective as of March 19, 2007.

Tax Fairness Plan
Budget 2007 confirms the Government's intention to proceed with the *Tax Fairness Plan* announced on October 31, 2006 as modified to take into account consultations and deliberations. As announced, the plan dealt with taxation of income trusts, pension income splitting and a $1,000 increase in the Age Credit Amount.

New Tax Measures for Income Trusts
Late last year, the federal government announced a Distribution Tax on distributions from publicly traded income trusts (business trusts and royalty trusts, but excluding real estate trusts, or REITs) also known as specified investment flow-throughs (SIFTs), and limited partnerships. The new taxation measures apply to trusts that began trading after October 31, 2006, beginning with their 2007 taxation year, while all existing trusts will operate under the former system until the 2011 taxation year. Applicable distributions will be subject to tax at corporate income tax rates, and investors in the trusts will be taxed as though the distributions were dividends. As such, the levy will be 34 per cent, and gradually reduced to 31.5 per cent by 2011.

According to the Federal Department of Finance, ongoing conversions, especially those announced or said to have been contemplated by large corporations prior to the government's announcement, would have resulted in billions of dollars in lost revenue to federal and provincial coffers. Another concern was tax leakage. Units of many trusts, especially royalty trusts, were held by foreigners, mainly Americans, which exacerbated the negative tax implications for governments.

By the end of December, the Department had advised that trusts could continue growing within mandated limits. When it announced its intention to tax income trust distributions, the federal government also announced a reduction in the general corporate income tax rate of one-half percentage point, to 18.5 per cent, as of January 1, 2011 designed to further enhance the competitiveness of Canada's corporate income tax system.

Hewitt Comment: *Despite their risky nature, income trusts have proven popular with retail investors and some pension funds because of their high yields combined with capital appreciation potential. Another significant reason income trusts were so popular despite their inherent risks was their beneficial tax treatment when compared to high dividend- paying securities. Immediately after the federal government's October announcement, however, most income trusts suffered losses. In many cases, losses were substantial and, in some instances, approximated one-third of pre-announcement levels. While a portion of these losses have subsequently been recovered, income trusts remain volatile.*

The future of the income trust market remains nebulous. In terms of ensuring appropriate asset selection of their pension fund, plan sponsors should remain vigilant and actively involved in both the selection and ongoing monitoring of their pension fund investments.

Age Credit Amount Increased
The Age Credit Amount was increased by $1,000, to $5,066, effective retroactive to January 1, 2006. Designed to help low- and middle-income seniors, this increase will provide up to $155 ($152.50 for 2006) of federal income tax relief each year, and unused portions of the credit will still be transferable to a spouse or common law partner. For 2006, the Age Credit Amount begins to be phased out at the rate of 15 per cent when net income reaches $30,270, with full phase-out occurring

when net income reaches $57,377. With the $1,000 increase, the age credit will be fully phased out when net income reaches $64,043.

Pension Income Splitting

Beginning in 2007, Canadian residents will be able to split pensions in payment by allocating to their resident spouses or common-law partners up to one-half of their income that qualifies for the existing pension income tax credit. For individuals over age 65, eligible pension income (EPI) includes: lifetime annuity payments under a registered pension plan (RPP), registered retirement savings plan or deferred profit-sharing plan; and payments out of or under a registered retirement income fund. For those under age 65, EPI includes: lifetime annuity payments under an RPP; and certain payments received on the death of a spouse or common-law partner. For income tax purposes, the amount allocated will be deducted in computing the income of the person who received the pension income and included in that of the person to whom some or all of it is allocated. Both parties must agree to the allocation in their tax returns for the year in question. The pension income splitting allocation must be made one year at a time, starting with the 2007 taxation year.

Hewitt Comment: *Current legislation already provides for income splitting for CPP/QPP. Note that the proposed change applies to registered plans only and thereby excludes supplemental arrangements. The proposed budget measure may result in reduced taxes for retired couples receiving pension income and tax planning opportunities.*

New Goods and Services Tax/Harmonized Sales Tax (GST/HST) Rebate for Pension Plan Trusts

A new goods and services tax/harmonized sales tax (GST/HST) rebate for pension plan trusts was also announced in the budget. Currently, employers can only claim input tax credits (ITCs) for eligible expenses incurred in establishing and administering a pension plan (ie: collecting contributions; paying benefits; and maintaining records) but not for investment related expenses (roughly two-thirds of all expenses).

Given current administrative complications and inequalities, the government decided to replace it with a single rebate system, similar to the rebate introduced in 2000 for multi-employer pension plans. The new rebate would generally be available for GST/HST paid on any expenses relating to all employer-sponsored pension trusts, regardless of whether they are administrative or investment related, or incurred by the pension trust itself or by the employer.

Registered Disability Savings Plan (RDSP)

The plan will be available commencing in 2008 and will be based generally on the existing registered education savings plan (RESP) design. An individual eligible for the disability tax credit (DTC), their parent or other legal representative, may establish an RDSP. The DTC-eligible individual will be the plan beneficiary. The plan will consist of three elements:

1. Parents, beneficiaries and others wishing to save will be able to contribute to an RDSP. Contributions to an RDSP for a beneficiary will be limited to a lifetime maximum of $200,000. Contributions will be permitted up until the end of the year in which a beneficiary attains 59 years of age.

2. Annual RDSP contributions will attract Canada Disability Savings Grants (CDSGs) at matching rates of 100, 200 or 300 per cent, depending on family income and the amount contributed, up to a maximum lifetime CDSG limit of $70,000.

3. Canada Disability Savings Bonds (CDSBs) of up to $1,000 per year will be provided to RDSPs established by low and modest-income families, up to a maximum lifetime CDSB limit of $20,000, and will not be contingent on contributions. The maximum annual $1,000 CDSB will be paid to an RDSP where family net income does not exceed $20,883. The CDSB will be phased out gradually for those with family net income between $20,883 and $37,178. These income thresholds are for the 2007 taxation year and will be indexed to inflation for 2008, when RDSPs become operational, and for subsequent taxation years. An RDSP will be eligible to receive CDSBs up until the end of the year in which the plan beneficiary attains 49 years of age.

Registered Education Savings Plan (RESP)
Budget 2007 proposes changes that will provide additional flexibility and encourage greater savings in these plans by:

- eliminating the $4,000 limit on annual RESP contributions;
- increasing the lifetime limit on RESP contributions, for the first time since 1996, to $50,000 from $42,000;
- increasing the maximum annual amount of CESG that can be paid in any year to $500 from $400 (and to $1,000 from $800 if there is unused grant room from low contributions made in previous years); and
- each child will continue to be eligible to receive up to $7,200 in CESGs.

Cervical Cancer Vaccine *(HPV)*
The Government will provide funding to the provinces and territories to support the launch of a national program for the HPV vaccine that will focus on protecting women and girls from cancer of the cervix. Budget 2007 proposes to put $300 million into a third-party trust in 2007–08 for the benefit of provinces and territories, allocated on a per capita basis. Provinces and territories will have the flexibility to draw down funding, as they require, over the next three years.

***Hewitt Comment**: This new funding could lead to the addition of the HPV vaccine to provincial drug formularies and coverage under the provinces' immunization programs. In a survey conducted by Hewitt in December, 2006, we found that only 20 per cent of employers cover the HPV vaccine under their drug plans. An additional 10 per cent said they plan to cover the HPV vaccine in the future. By adding the HPV vaccine to the provincial immunization programs, employers who cover the vaccine today will see a small reduction in their claims experience.*

Helping Employers Meet Immediate Skills Shortages
Budget 2007 proposes a series of improvements to the Temporary Foreign Worker Program designed to reduce processing delays and more effectively respond to regional labour and skill shortages. New measures such as expanding the online application system, maintaining lists of occupations where there are known shortages of workers, and processing work permits more rapidly will ensure that the process of hiring skilled foreign workers for not only large, but also small and medium-sized enterprises, is easier, faster and less costly for employers. At the same time, the Government will

ensure that these improvements do not result in reduced employment opportunities for Canadians. Budget 2007 provides $50.5 million over the next two years to support these improvements.

The Government announced its intention to establish an office to help qualified foreign-trained professionals become accredited to practise in their chosen fields in Canada. Facilitating the adoption of labour mobility agreements amongst Canadian provinces and territories was also announced as a government priority in the years ahead.

Working Income Tax Benefit
Also announced in the Budget was the introduction of a new Working Income Tax Benefit (WITB) of up to $500 for individuals and $1,000 for families.

The WITB will provide a refundable tax credit equal to 20 per cent of each dollar of earned income in excess of $3,000 and net income less than $12,833 to a maximum credit of $500 for single individuals without dependants. Single individuals with earnings of $5,500 or more and net income less than $9,500 will receive the full $500 amount. For families (couples and single parents) the maximum credit amount will be $1,000. For the purpose of computing the WITB, earned income for a taxation year means the total amount of an individual's or family's income for the year from employment and business, and is determined without reference to any losses arising or claimed in that year.

Fairness for Single-earner Families
Currently, taxpayers who have low-income spouses, or single taxpayers who support dependants such as a child or elderly parent, receive a tax-free amount of up to $7,581 in 2007. The tax relief for the supporting person is reduced as the spouse's or dependant's net income increases, and is fully phased out once it reaches $8,340.

Budget 2007 proposes to increase the credits for low-income spouses and dependants of single individuals by raising the amounts to the same level as the basic personal amount ($8,929) from their current level ($7,581), effective January 1, 2007. These amounts will grow with currently legislated future increases in the basic personal amount, meaning that they will reach at least $10,000 by 2009, $1,500 higher than previously legislated.

This measure will provide up to $209 in additional tax relief, so that single-earner families will receive the same tax relief as that already provided through the basic personal amount to two-earner families.

New Child Tax Credit
Budget 2007 proposes to introduce a new non-refundable child tax credit for parents based on an amount of $2,000 (indexed) for each child under the age of 18 years at the end of a taxation year. The tax credit will be calculated by reference to the lowest personal income tax rate for the taxation year; i.e., 15.5 per cent in 2007. This new tax credit will take effect beginning in 2007, and will provide personal income tax relief of up to $310 per child.

About Hewitt Associates

With more than 65 years of experience, Hewitt Associates (NYSE: HEW) is the world's foremost provider of human resources outsourcing and consulting services. The company consults with more than 2,300 organizations and administers human resources, health care, payroll and retirement programs on behalf of more than 340 companies to millions of employees and retirees worldwide. Located in 33 countries, including Canadian offices in Toronto, Montreal, Vancouver, Calgary and Regina, Hewitt employs approximately 24,000 associates. For more information, please visit www.hewitt.com.