Knowledge & Insights

MORNEAU SHEPELL

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Federal budget: No changes for pension and benefit plans

The 2017 Federal Budget was released on March 22, 2017. There were no changes directly affecting pension plans or employee benefits. However, some changes to Employment Insurance (EI) could eventually result in an impact on some employee benefit plans. Furthermore, it is noteworthy that the tax expenditure review announced in the 2016 Federal Budget did not result in major changes.

Changes to employment insurance

The 2017 Budget proposes to create a new EI caregiving benefit of up to 15 weeks. The new benefit will cover a broad range of situations where individuals are providing care to an adult family member who requires significant support in order to recover from a critical illness or injury. Parents of critically ill children will continue to have access to up to 35 weeks of benefits, with additional flexibility to share these benefits with more family members.

EI parental benefits will become more flexible. Proposed changes will allow parents to choose to receive EI parental benefits over an extended period of up to 18 months at a lower benefit rate of 33 per cent of average weekly earnings. EI parental benefits will continue to be available at the existing benefit rate of 55 per cent over a period of up to 12 months.

Finally, pregnant women will be eligible for EI maternity benefits up to 12 weeks before their due date—expanded from the current standard of 8 weeks—if they so choose.

Results of tax expenditure review

The 2016 Federal Budget announced a review of tax expenditures. There were rumours in 2016 that this review could result in the potential taxation of employee benefit plans. However, the 2017 Federal Budget only included modest changes to tax credits, such as the elimination of the public transit tax credit and the elimination of the deduction in respect of employee home relocations loans, with no direct impact on employee benefit plans.

Healthcare related initiatives

As previously announced and negotiated with the provinces and territories, the Budget promises an additional $6 billion over 10 years to fund home care and $5 billion over 10 years to fund mental health initiatives. The Budget promises better access to mental health support for as many as 500,000 young Canadians under the age of 25.

Conclusion

The 2017 Federal Budget has no direct impact on employee benefit plans, with only a modest indirect impact. It is also notable for the lack of changes to the taxation of employee benefits.

Quebec budget: Compensation tax on insurance premiums

The Quebec government's budget tabled on March 28, 2017 delayed, by five years, the decrease in the compensation tax on insurance premiums, thereby depriving plan sponsors of an expected reduction of 0.18% in this tax.

In December 2014, the Quebec government raised the compensation tax on insurance premiums and on amounts established in respect of an insurance fund from 0.30% to 0.48%. This increase was scheduled to end on April 1, 2017. Some insurers even incorporated the reduced tax in their rate renewal conditions for 2017.

Note that Quebec imposes the heaviest tax burden on group insurance plans in Canada. In addition to the 0.48% compensation tax, the 3% insurance premium tax and the 9% non-refundable sales tax, Quebec is the only province where the employer's contribution to group medical and dental insurance plans is a taxable benefit for employees.

Apart from this, the March 28 budget did not contain any other significant provision that could have an impact on employee benefits or pension plans.

Saskatchewan budget: New tax on insurance premiums

Changes to Saskatchewan's provincial sales tax (PST) were announced in the recent 2017 budget. As of March 23, 2017, the PST increased from 5% to 6% and effective July 1, 2017, the PST will be charged on all insurance premiums as defined in *The Saskatchewan Insurance Act*.

The change applies to premium payments due on or after July 1, 2017 for life, accident and health insurance policies, which includes most insurance premiums for group plans. PST will not apply on reinsurance, self-insurance, annuity contracts, contributions or premiums paid for the Canada Pension Plan, Employment Insurance or Workers' Compensation. This change affects employers with employees in Saskatchewan, even if the organization is headquartered in another province. Further guidance regarding the change is expected from the government in April 2017.

Premium taxes vary provincially so it is important to have correct information regarding employees' province of residence when administering benefits.

The government also announced changes to provincially funded programs and coverage for hearing aids, podiatry services, chiropractic services, and orthotics. These changes may have an impact on plan sponsors and should be considered in light of coverage provided by private plans.

Expanded coverage for hepatitis C drugs

It was recently announced that the pan-Canadian Pharmaceutical Alliance (pCPA) had reached an agreement with several drug manufacturers regarding pricing arrangements for six high cost prescription drugs that treat hepatitis C. The pCPA negotiates drug prices on behalf of government health care programs and has successfully reduced the cost of many generic drugs over the past several years. Up to this point, these hepatitis C drugs have been approved through each province's special access program, which allows provincial funding for drugs not covered under the regular formulary based on certain criteria. Coverage is currently limited to individuals with certain genotypes or severities of hepatitis C.

The Ontario and BC governments followed up on the agreement by announcing that they are expanding provincial coverage for these six specific hepatitis C drugs. Ontario confirmed that effective February 28, 2017, several hepatitis C drugs would be added to the Ontario Drug Benefit (ODB) Program for eligible ODB recipients as limited use benefits. In BC, the PharmaCare program expanded its criteria in March 2017 to provide coverage to more patients living with hepatitis C. Starting in 2018, BC will further expand coverage for any resident living with chronic hepatitis C, regardless of the type or severity of their disease.

BC and Ontario led the negotiations with the drug manufacturers on behalf of the pCPA and were the first two provinces to announce changes to coverage. In the 2017 provincial budget released in March, Saskatchewan announced a similar expansion of coverage effective April 1, 2017. It remains unclear if and when additional provinces and territories will follow suit.

In Quebec, private group insurance plans must cover hepatitis drugs under specific eligibility conditions since the end of 2015. This has already impacted the cost of private group insurance and pooling charges. The Quebec government has mentioned its intention to relax those eligibility conditions progressively in order to reduce the impact on private group insurance plans.

There are estimates that as many as 250,000 Canadians are infected with hepatitis C. Recent advancements in hepatitis C therapies have produced drug success rates of 95% or greater, with fewer side effects than previous options. However these advancements come at a cost, typically ranging from $45,000 to $100,000 per person. Following the release of these new hepatitis C drugs in recent years, many plan sponsors have experienced a significant increase in drug plan costs as well as upward pressure on the premiums required by insurers for pooling and stop loss protection.

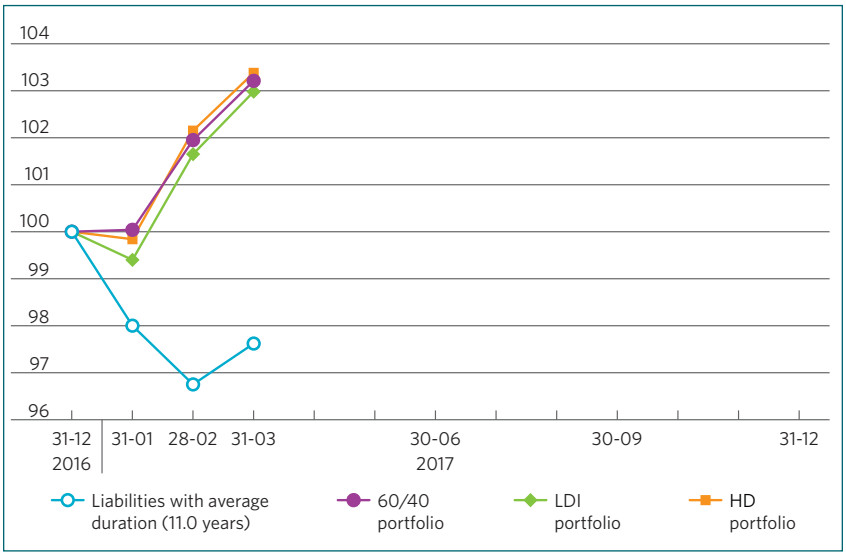
Conclusion

The expansion of coverage for these drugs under several provincial health care programs is favourable news for plan sponsors, though it does not eliminate the risk or impact of claims hitting group plans up to the stop loss limit. In provinces other than Ontario, BC and Saskatchewan, several of these hepatitis C drugs remain available through provincial health care special access programs. Changes regarding prescription drugs occur frequently, underscoring the need for plan sponsors to regularly review their plan.

Tracking the funded status of pension plans as at March 31, 2017

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2016. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2016. The estimate of the solvency liabilities reflects the new CIA guidance published in March 2017 for valuations effective December 31, 2016 or later. The following graph shows the impact of three typical portfolios on plan assets and the effect of interest rate changes on solvency liabilities of medium duration.

The evolution of the financial situation of pension plans since December 31, 2016



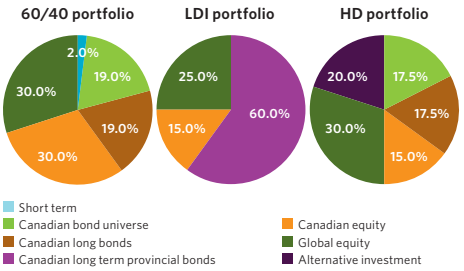
During the month of March, Canadian universe bonds, Canadian long term bonds, Canadian long-term provincial bonds, alternative investments as well as Canadian and global equity markets showed positive returns. With a return of 1.3%, the low volatility portfolio (LDI[1]) outperformed the 60/40 portfolio (1.2%) and the highly diversified portfolio (HD) (1.2%). The outperformance of the LDI portfolio is explained by a larger weight in Canadian long-term provincial bonds. The prescribed CIA rates used in the calculation of solvency liabilities slightly decreased during the month, increasing the solvency liabilities by 0.9% for a medium duration plan. For this type of plan, an investment in either of the 60/40, the LDI or the HD portfolio resulted in a solvency ratio increase.

Initial solvency ratio as at December 31, 2016	Evolution of the solvency ratio as at March 31, 2017 for three different portfolios		
	60/40 portfolio	Low volatility portfolio (LDI)	Highly diversified portfolio
100%	105.7%	105.5%	105.9%
90%	95.2%	94.9%	95.3%
80%	84.6%	84.4%	84.7%
70%	74.0%	73.8%	74.1%
60%	63.4%	63.3%	63.5%

[1] Liability driven investment

Comments

1. No consideration has been made for contributions paid to the plan or for benefits paid out of the plan.
2. Solvency liabilities are projected using the rates prescribed by the Canadian Institute of Actuaries (CIA) for the purpose of determining pension commuted values.
3. The underlying typical defined benefit plan is a final average plan with no pension indexing, including active and inactive participants representing 60% and 40% of liabilities, respectively.
4. Assets are shown at full market value. Returns on assets are based on three typical benchmark portfolios.



The table shows the impact of past returns on plan assets and the effect of interest rate changes on solvency liabilities of a medium duration plan, based on the plan's initial solvency ratio as at December 31, 2016, as well as the asset allocation of the three typical portfolios. Since the beginning of the year, driven by strong returns in the global equity markets, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 3.2%, 3.0% and 3.4% respectively. The solvency liabilities decreased over that same period between 2.3% and 2.4% depending on the duration of the group of retirees. The variation in the plan's solvency ratio as at March 31, 2017 stands between 3.3% and 5.9%.

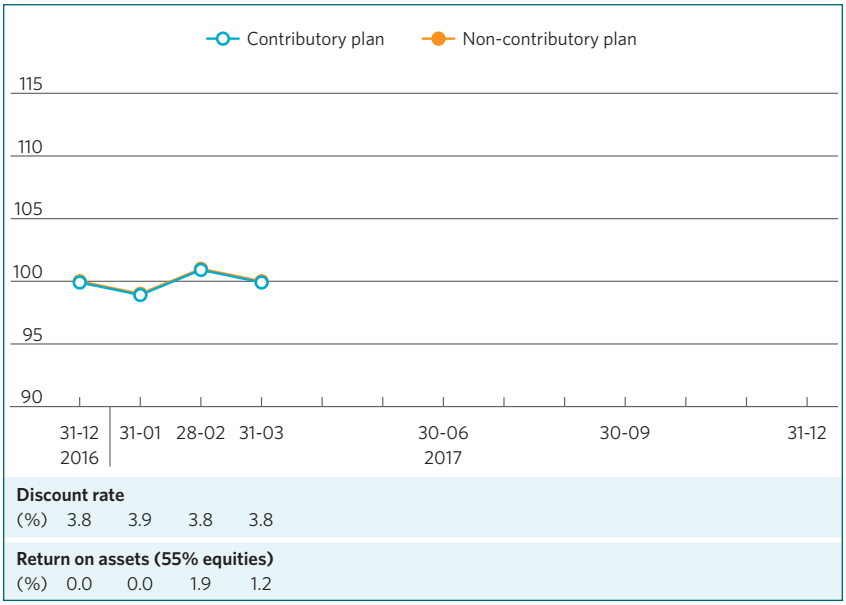
Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.

Impact on pension expense under international accounting as at March 31, 2017

Every year, companies must establish an expense for their defined benefit pension plans.

The graph shows the expense impact for a typical pension plan that starts the year at an arbitrary value of 100 (expense index). The expense is influenced by changes in the discount rate based on high-quality corporate and provincial (adjusted) bonds and the median return of pension fund assets.

Expense Index from December 31, 2016



The table below shows the discount rates for varying durations and the change since the beginning of the year. A plan's duration generally varies between 10 (mature plan) and 20 (young plan).

Discount rate

Duration	December 2016	March 2017	Change in 2017
11	3.66%	3.59%	-7 pbs
14	3.81%	3.77%	-4 pbs
17	3.90%	3.89%	-1 pbs
20	3.96%	3.96%	0 pbs

The discount rate has increased slightly in the last month, which had the effect of reducing the pension expense. Since the beginning of the year, the slight decrease in the discount rate has been offset by good returns, reducing the plan expense to the same level as the one determined at the beginning of the year.

Comments

1. The expense is established as at December 31, 2016, based on the average financial position of the pension plans used in our *2016 Survey of Economic Assumptions in Accounting for Pensions and Other Post-Retirement Benefits report* (i.e. a ratio of assets to obligation value of 94% as at December 31, 2015).
2. The return on assets corresponds to the return on the Morneau Shepell benchmark portfolio (55% equities and 45% fixed income), which reflects the average asset mix in our 2016 Survey.
3. The actuarial obligation is that of a final average earnings plan, without indexing (two scenarios: with and without employee contributions.

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