Advisory Council’s final report recommends universal, single-payer pharmacare

In June 2019, the Advisory Council on the Implementation of National Pharmacare (the Advisory Council) issued its final report recommending universal public, single-payer pharmacare for all Canadians, with a phased implementation between 2022 and 2027.
Background
The Advisory Council was announced in the 2018 Federal Budget to consider three key questions regarding the implementation of national pharmacare: who will be covered and under what circumstances, what drugs will be covered, and how it will be funded. The Advisory Council released a discussion paper in June 2018 as well as an interim report in March 2019 (see the April 2019 News & Views for more information on the interim report).

Proposed pharmacare model
The Advisory Council recommends the federal government work with provincial and territorial governments to establish a public prescription drug plan to facilitate equal coverage. An initial drug formulary would be established for “essential medicines” by 2022 and then expanded to a “fully comprehensive” formulary by 2027. Out-of-pocket costs for Canadians would be capped at $100 per year for households with copayments of $2 to $5 per prescription.

The Advisory Council does not make any specific recommendations on how to raise revenue to pay for national pharmacare, but acknowledged that this would be a significant challenge. It estimates that an additional $15 billion in public funding would be required in 2027 to pay for the new model. The report recommends “long-term, adequate and predictable” federal funding to provinces and territories, to be financed through general revenue. The report does not recommend a specific tax or levy on employers or employees.

The Advisory Council suggests that universal national pharmacare would lower total drug spending by $5 billion annually from $52 billion in total drug spending estimated for 2027. On an overall basis, it estimates that Canadian households would save an average of $350 per year.

Impact on employer drug plans
Private employer-sponsored plans have been managing prescription drug costs rising at a rate well above inflation for years and prescription drugs typically represent a significant proportion of the overall benefit plan cost. Newer types of drugs such as biologics and other high cost drugs represent a significant risk to private drug plans, and the Advisory Council notes that private drug plans may be attempting to shift costs for high cost drugs to currently available public drug plans.

National pharmacare would represent a shift in spending from private plan sponsors to the public plan. The Advisory Council estimates annual savings of $750 per employee for business owners. Depending on the drugs included on the formulary and coverage for rare diseases, national pharmacare could also mitigate the risk to employers associated with rising drug costs. As there would still be some out of pocket costs from copayments as well as drugs not included in the formulary, the final report also recommends that private insurers be allowed to provide coverage for copayments and/or drugs not covered on the national formulary.

Unanswered questions
The final report is likely to raise the profile of this issue in the upcoming federal election as political parties determine their policy platforms. A number of unanswered issues remain that will affect the perception and viability of national pharmacare including:

- the drugs that will be included on the formulary
- how newly approved drugs will be evaluated and potentially added to the formulary going forward;
- the existing variance in provincial and territorial prescription drug coverage;
- the success of a coordinated approach to prescription drug price negotiation in driving down prices;
- acceptance and coordination amongst provincial and territorial governments;
- the simplicity and efficiency of government administration of a national pharmacare plan;

1 The Advisory Council estimates total drug spending of $28 billion in 2017 net of rebates.
its top priorities as it takes control of pension plan regulation and the regulation of other sectors.

FSRA’s initial priorities

FSRA intends to employ principles-based regulation and permit registrants to determine their own path, providing they achieve the desired regulatory outcome. According to the Newsletter, FSRA’s two over-arching priorities are burden reduction and regulatory effectiveness.

In order to reduce regulatory burdens, FSRA will review inherited guidance, data collection, filing requirements, and service standards to ensure they are relevant, provide value and support its mandate. FSRA intends to review all existing regulatory direction and guidance. However, all existing FSCO regulatory direction will remain in force until FSRA has issued new regulatory direction.

In respect of pension plans, FSRA will establish advisory groups and hold broader consultations in the areas of missing pension plan members, asset transfers and family law matters.

Rule-making authority

FSRA is permitted by legislation to make rules in respect of certain areas over which it has authority. While FSCO issued guidance indicating how it would interpret applicable law and regulation, rules made pursuant to FSRA’s rule-making authority have the force of law.

FSRA’s first official rule, affecting regulatory assessments and fees for regulated sectors including pensions, came into force on June 8, 2019.

Background

The creation of FSRA was recommended by an expert panel in 2015 and included in Bill 70 in 2016 (see the December 2015 and December 2016 News & Views). The creation of FSRA was intended to provide operational flexibility to the regulator, encourage a flexible and consumer-oriented regulatory approach and clarify and streamline the regulator’s mandate.
FSRA is a self-funded Crown corporation created by statute. FSRA is governed by a Board of Directors comprised of directors who are appointed on the recommendation of the Ontario Minister of Finance. FSRA’s Chief Executive Officer, who is appointed by the Board of Directors, is responsible for the management and administration of FSRA.

While FSRA has new executive leadership, many employees of FSCO who were involved in pension plan regulation on an operational basis have been hired by FSRA.

**New $200,000 deduction limit for employee stock options**

Provided certain conditions are met, employees are currently permitted to claim a deduction for 50% of employee stock option benefits when they exercise the option, which effectively results in the employee stock option benefit being taxed at half of the normal income tax rate (i.e., the same rate as capital gains).

The motion would put a $200,000 annual limit on the value of the employee stock options that may vest in a year and continue to qualify for the stock option deduction. This limit will be calculated based on the fair market value of the underlying shares at the time the option is granted. With respect to the portion of the stock option that exceeds the above limit, upon exercise the difference between the price paid and the fair market value of the stock will be treated as a taxable employment benefit, with no 50% deduction.

The limit will apply to all stock options granted by the employer and any non-arm’s length corporation or mutual fund trust, so multiple option agreements with the same employer or options from two non-arm’s-length corporations that vest in the same year will count towards a single $200,000 limit. However, employees with multiple arm’s-length employers will enjoy a separate $200,000 limit for each employer.

**Exempted employers**

The cap will not apply to options granted by Canadian-controlled private corporations (CCPCs), and non-CCPCs that meet prescribed conditions, such as start-ups, emerging or scale-up companies.

The stated purpose of the proposal is to limit the preferential tax treatment of options for employees of large, long-established and mature firms while still allowing younger and growing companies to continue to use stock options to attract talent. However, it remains to be determined what will constitute “start-ups, emerging or scale-up companies.” The government will be accepting input on what characteristics will be used to define this category until September 16, 2019.

**Employee stock option deduction limits to take effect January 1, 2020**

On June 17, 2019, the federal Minister of Finance tabled a Notice of Ways and Means Motion that would limit the availability of deductions with respect to shares issued under certain employee stock options granted starting January 1, 2020. This follows an announcement in the 2019 federal budget in which the government signaled its intention to limit the use of the current employee stock option tax regime for employees of large, established companies (as discussed in the March 2019 News & Views).

**Comment**

For the time being, FSCO’s website continues to operate and existing FSCO guidance continues to be in force. Over time, FSCO’s operations will migrate to the FSRA website and FSRA can be expected to put its own stamp on pension regulation. Ontario pension plan administrators and others in the Canadian pension sector will be interested to see how FSRA alters pension plan regulation to achieve its stated goals of burden reduction and regulatory effectiveness.
Draft employee life and health trust legislation released

In May 2019 the federal Department of Finance released draft legislation with respect to employee life and health trusts (ELHTs). The draft legislation implements proposals announced in the 2018 Federal Budget. The legislation sets out the process for conversion of existing health and welfare trusts (HWTs) to ELHTs, amends the existing ELHT rules to accommodate some stakeholder concerns and addresses a number of technical issues.

Background

A HWT is a trust established to provide health and welfare benefits to employees. HWTs are not codified in the Income Tax Act, but are subject to administrative positions published by the Canada Revenue Agency.

Since 2010, the Income Tax Act has included rules relating to ELHTs. The rules for ELHTs are similar to those for HWTs but are generally more accommodating with respect to certain issues such as surpluses and pre-funding of benefits.

It was announced in the 2018 federal budget that the rules relating to HWTs will cease to apply after December 31, 2020. Existing HWTs will have the option to convert to ELHTs or be subject to the usual taxation rules relating to trusts.

Proposed rules for converting HWTs

The current ELHT rules will be extended to apply to trusts created before 2010. Existing HWTs will be permitted to elect to continue as ELHTs without any adverse tax implications and without having to create a new trust. A tax-free rollover of assets is permitted where a new trust is created or two or more existing stock option grants will be termed “non-qualified securities”.

Employers that are subject to the new employee stock option rules will be permitted to designate shares granted under employee stock options as ineligible for the 50% employee stock option deduction. Under certain conditions, the employment benefit generated with respect to those ineligible shares will be deductible to the employer. Employers that are not subject to the new rules will not be able to opt-in in order to designate shares as non-qualified.

Employers will be required to notify their employees in writing upon the grant of a stock option for non-qualified securities, as well as the Canada Revenue Agency in a prescribed form filed with the employer’s income tax return for the grant year.

Comment

The proposed limits on the preferential tax treatment of employee stock options could have a significant impact on the appeal of employee stock options as a compensation vehicle for executives. Some organizations may wish to consider alternative forms of incentive-based compensation beginning in 2020 when the new regime comes into force, either on their own or in conjunction with stock option grants falling below the annual limit.

Morneau Shepell’s compensation consulting practice, with its extensive experience in incentive program design and stock option administration, can assist clients in updating incentive programs to achieve their goals.
Changes to current ELHT rules
Several changes to existing ELHT rules have been proposed based on feedback in the stakeholder consultation process:

• The requirements for an employer to be allowed to deduct contributions required by a collective agreement have been simplified by removing the test for a minimum number of employers.

• Employer representatives currently cannot constitute a majority of ELHT trustees. This requirement will be replaced by one that requires that a majority of trustees deal at arm’s length with all participating employers (i.e., they must exercise independent judgment).

• Mergers of HWTs and ELHTs will be allowed without any adverse tax consequences.

• ELHTs will not be considered to have breached their terms with respect to the participation of non-eligible beneficiaries if the trustees could not reasonably have known that the beneficiaries were ineligible.

• The existing ELHT rules provide that benefits may only be paid to employees of participating employers, and certain individuals related to those employees. The rules will be expanded to include employees of former employers, and certain related individuals.

• The draft legislation allows an ELHT to be resident outside Canada if it provides employee benefits to Canadian residents and non-Canadian residents, if at least one participating employer is resident outside Canada and if the trust is required to be resident in a country in which a participating employer resides.

• An ELHT currently cannot make a loan to, or an investment in, a participating employer or a person not dealing at arm’s length with that employer. That rule will be repealed and a new tax will be levied on an ELHT that acquires a prohibited investment as defined in a new Part XI.5 of the Income Tax Act.

Consequences if a HWT does not convert
The Canada Revenue Agency has announced that it will cease to apply its HWT rules after 2020. HWTs that do not convert to ELHTs by the end of 2020 will become employee benefit plans, with negative tax consequences.

Future considerations
The Department of Finance indicated that several issues were identified in stakeholder feedback and continue to be considered:

• The types of benefits that currently qualify as “designated employee benefits” under an ELHT and whether other benefits should be considered;

• Expanding the scope of the Private Health Services Plan component of designated employee benefits;

• The use of ELHTs to provide benefits to “key employees”; and

• The rules related to carry back and carry forward on non-capital losses under ELHTs.

Comment
These changes provide more flexibility than the existing ELHT rules and the simplified conversion process for a HWT to become an ELHT is welcome. The management of trust funds is complex and trustees should be in close contact with their advisors to review these changes and govern their plans successfully.

As an advisor to many trustees of HWTs and ELHTs, Morneau Shepell made a submission to the Department of Finance in the 2018 stakeholder consultation on behalf of clients. Further comments on the draft legislation can be submitted to the Department of Finance by the end of July 2019 and Morneau Shepell intends to make another submission.
FSCO suggests that former members who are considering unlocking the commuted value of a deferred pension should be encouraged to obtain independent legal and tax advice regarding the tax consequences of such a decision.

Comment
The introduction of non-residency unlocking for Ontario pension plan members is likely to affect only a small number of Ontario former members who have moved outside of Canada. However, it is a useful option for pension plans to provide. Employers with Ontario members in their pension plans may wish to amend their pension plan texts to provide this option.

British Columbia introduces critical illness or injury leave and domestic or sexual violence leave
Effective May 30, 2019, British Columbia employment standards legislation has been amended to introduce critical illness or injury leave and domestic or sexual violence leave. These new forms of leave must be provided to British Columbia employees who meet legislative requirements, with implications for employers who offer pension and benefit plans in British Columbia.

Critical illness or injury leave
This type of leave entitles employees to take an unpaid leave in order to care for or support a family member (defined as being in the employee’s immediate family or any other individual in a prescribed class) if they obtain a certificate from a medical or nurse practitioner. This certificate must state that the family member has experienced a change to the baseline state of health that puts...
An employee is not entitled to leave respecting an eligible person if the employee is the one who commits the violence against that person. If the employer requests proof that the employee is entitled to leave then the employee must provide reasonably sufficient proof as soon as practicable.

The statutory maximum length of critical illness or injury leave is 36 weeks if the family member is a minor or up to 16 weeks if the family member is an adult. The period can begin at the earlier of the first day of the week in which the certificate is issued and the first day of the week where the family member’s condition significantly changes and their life is at risk.

Domestic or sexual violence leave

This type of leave applies to an employee or an eligible person in respect of an employee. An eligible person is defined as a minor child of the employee, an adult child who is under the care of the employee, or another prescribed person.

In order for the leave to be taken, the employee or eligible person must have experienced physical abuse by an intimate partner or family member, sexual abuse by any person, or psychological or emotional abuse by an intimate partner or family member. The same provisions apply if the violence or abuse was attempted. A child is also considered to have experienced domestic violence if the child is exposed, directly or indirectly, to domestic or sexual violence by an intimate partner or family member of the child.

Domestic or sexual violence leave may be taken for one or more of the following purposes: physical or psychological medical attention, to obtain victim services related to domestic or sexual violence, to obtain counselling, to relocate, to seek legal or law enforcement assistance in either a civil or criminal proceeding or any prescribed purpose.

An employee is entitled to up to 10 days of unpaid leave in units of one or more days and, additionally, a single period of 15 weeks of unpaid leave taken all at once. The employer may also consent to dividing the single 15 week period into smaller periods.

Comment

These two new types of leave build upon the most recent expansion of employment leaves in British Columbia, which was summarized in the June 2018 News & Views. Employers in British Columbia are required to continue any pension and benefits coverage during employment leaves required by law, subject to the employee making any required contributions. Employers should therefore be prepared to administer these new leaves with respect to their pension and benefits plans. Pension plan amendments may be required if a registered pension plan sets out all forms of employment leaves available to employees.

These new forms of leave became effective immediately as of May 30, 2019.

Quebec issues draft regulation affecting the stabilization provision

On July 3, 2019, a draft regulation amending the Regulation respecting supplemental pension plans was published in the Gazette officielle du Québec. The regulation would affect the determination of stabilization contributions and increase annual information return filing fees, among other changes.

The draft regulation revises the scale used to determine the target level of the stabilization provision that must be established by the payment
of stabilization contributions. To determine the target level of the stabilization provision, the draft regulation allows for non-rated private debts to be taken into account as fixed-income investments if certain conditions are met.

Generally, the revised chart will increase the stabilization provision for defined benefit plans with a significant proportion of assets allocated to variable-income securities and decrease the stabilization provision for those with less exposure to variable-income securities. In addition, plans that use bond overlay strategies would see a more significant increase in their stabilization provision.

The draft regulation increases and adjusts annually the upper limit of fees required when filing the annual information return so that it better reflects the expenses incurred by Retraite Québec for the administration of the Supplemental Pension Plans Act, and the upper limits of certain fees required, as when filing an application for the registration of a plan termination report, among others.

Finally, the draft regulation proposes various forms of relief regarding in particular the content of partial valuations in relation to plan amendments and the additional fees payable for a delay to file a document, and some technical or consequential amendments to correct some outdated provisions, to use more adequate terminology and to ensure better consistency between the French and English versions of the legislation.

Comment

Two of the measures proposed by the draft regulation would have financial consequences on pension plan sponsors. Those measures are the increase of the upper limit of fees payable and their adjustment thereafter, which will have an impact on plans with a significant number of members, and the proposed scale to determine the target level of a stabilization provision, which could entail an increase or a decrease in contributions depending on the degree of risk in the plan’s investment policy. The proposed measures regarding the content of partial valuations of amendments and the additional fees payable for a delay in filing a document relax certain administrative rules for enterprises.

The regulation will come into force on the 15th day following the date of its publication in the Gazette officielle du Québec, except for certain provisions that will come into force on December 31, 2019, namely the revised scale used to determine the target level of the stabilization provision, and January 1, 2020, namely the adjustment of the upper limit of fees.

Plan sponsors should review the impact of the proposed changes to the stabilization provision on their plan contributions and consider whether there is a need to revisit their investment and funding policies.
Tracking the funded status of pension plans as at June 30, 2019

This graph shows the changes in the financial position of a typical defined benefit plan with an average duration since December 31, 2018. For this illustration, assets and liabilities of the plan were each arbitrarily set at $100 million as at December 31, 2018. The estimate of the solvency liabilities reflects the new CIA guidance for valuations effective March 31, 2019 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, 2018

During the month of June, Canadian long-term bonds, Canadian long-term provincial bonds, Canadian equity markets, global equity markets (CAD) as well as alternative investments showed positive returns. With a return of 2.5%, the low volatility portfolio (LDI\(^1\)) outperformed both the highly diversified portfolio (HD) (2.2%) and the 60/40 portfolio (2.2%).

The prescribed CIA Annuity purchase rates and the commuted value rates used in the calculation of solvency liabilities decreased during the month. As a result, the solvency liabilities increased by 2.4% for a medium duration plan. For this type of plan, an investment in the 60/40 or in the HD portfolio resulted in a decrease of the solvency ratio while an investment in the LDI portfolio resulted in an increase of the solvency ratio.

\(^1\) Liability driven investment
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, 2018.

The graph shows the asset allocation of the three typical portfolios.

<table>
<thead>
<tr>
<th>Initial solvency ratio as at December 31, 2018</th>
<th>Evolution of the solvency ratio as at June 30, 2019 for three different portfolios</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>60/40 portfolio</td>
</tr>
<tr>
<td>100%</td>
<td>100.0%</td>
</tr>
<tr>
<td>90%</td>
<td>90.0%</td>
</tr>
<tr>
<td>80%</td>
<td>80.0%</td>
</tr>
<tr>
<td>70%</td>
<td>70.0%</td>
</tr>
<tr>
<td>60%</td>
<td>60.0%</td>
</tr>
</tbody>
</table>

Since the beginning of the year, driven by strong positive returns in the Canadian equity markets, global equity markets as well as the alternative investments, the 60/40 portfolio, the LDI portfolio and the HD portfolio returned 11.9%, 13.2% and 11.2% respectively. The solvency liabilities fluctuated over that same period from 11.3% to 12.4% depending on the duration of the group of retirees. The variation in the plan’s solvency ratio as at June 30, 2019 stands between -0.6% and 1.2%.

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

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 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.
Impact on pension expense under international accounting as at June 30, 2019

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, 2018

<table>
<thead>
<tr>
<th>Discount rate (%)</th>
<th>3.8%</th>
<th>3.6%</th>
<th>3.6%</th>
<th>3.3%</th>
<th>3.4%</th>
<th>3.1%</th>
<th>3.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on assets (55% equities, %)</td>
<td>0.0%</td>
<td>4.2%</td>
<td>1.8%</td>
<td>2.5%</td>
<td>1.8%</td>
<td>-1.3%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Duration</th>
<th>December 2018</th>
<th>June 2019</th>
<th>Change in 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>3.72%</td>
<td>2.88%</td>
<td>-84 bps</td>
</tr>
<tr>
<td>14</td>
<td>3.81%</td>
<td>2.97%</td>
<td>-84 bps</td>
</tr>
<tr>
<td>17</td>
<td>3.87%</td>
<td>3.02%</td>
<td>-85 bps</td>
</tr>
<tr>
<td>20</td>
<td>3.90%</td>
<td>3.06%</td>
<td>-84 bps</td>
</tr>
</tbody>
</table>

Since the beginning of the year, the pension expense has increased by 32% (for a contributory plan) due to the decrease in the discount rates, despite the good returns on assets (relative to the discount rate).

Please contact your Morneau Shepell consultant for a customized analysis of your pension plan.
Morneau Shepell is the leading provider of technology-enabled HR services that deliver an integrated approach to well-being through our cloud-based platform. Our focus is providing everything our clients need to support the mental, physical, social and financial well-being of their people. By improving lives, we improve business. Our approach spans services in employee and family assistance, health and wellness, recognition, pension and benefits administration, retirement and benefits consulting, actuarial and investment services. Morneau Shepell employs almost 5,000 employees who work with some 24,000 client organizations that use our services in 162 countries. Morneau Shepell is a publicly traded company on the Toronto Stock Exchange (TSX: MSI). For more information, visit morneaushepell.com.