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Canada-United States Law Journal

Volume 16 | Issue

Article 17

January 1990

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Recommended Citation

Donald A. McGrath, *Human Resources: A Comparative Look at the Legal and Tax Environment for Motivating and Compensating People in the United States and Canada (ESOP's, Profit Sharing, Pensions and Other Fringe Benefits, etc.)--Balance Sheet and Profit/Loss Sheet Effects of*, 16 Can.-U.S. L.J. 125 (1990)
Available at: https://scholarlycommons.law.case.edu/cuslj/vol16/iss/17

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Human Resources: A Comparative Look at the Legal and Tax Environment for Motivating and Compensating People in the United States and Canada (ESOP's, Profit Sharing, Pensions and other Fringe Benefits, etc.)—Balance Sheet and Profit/Loss Sheet Effects of Same; Current Status and Future Trends

*Donald A. McGrath**

Bill Napoli has set the stage reasonably well with regard to demographic change and plan objectives. Those matters are very similar in Canada and in the United States. We are going to have the same kind of demographic changes and the same kind of human resource management strategies. But, we do have somewhat different traditions and aspirations thus, some differences will be noted. I know you will understand this when I tell you that the Canadian athlete of the year is an ice fisherman!

Canadians are thought to be somewhat more reserved and security conscious. Our three major political parties might be described as being center-left, left and left-left. It is often been said that, whatever happens in the United States will happen in Canada ten years later. That is probably true, but at least in two areas we seem to have preceded you: One has been the complexity of pension regulation; the other is medicare. As with the United States, we have a three-tier retirement income system, including, basic government benefits, employer-sponsored plans and individual savings, some of which are tax supported and some of which are not.

Let us start with our social security system, which is really founded on two different schemes of income benefits during retirement. The first is Old Age Security ("OAS"), based solely on residence. It is currently running about $4,000 a year.

The second scheme is the Canada (or Quebec) Pension Plan, which is a contributory occupational-type scheme that relates benefits to amounts of earnings and to years of contributions. At maximum level, it is currently running about $7,000 per year. The sum of these two amounts currently is approximately $11,000 a year, which is about 40% of our average industrial wage.

I should point out that, because OAS is a universal benefit, it is also paid to the spouse of the employee. So, for those people now retired, representing the older type of lifestyle — the male employee with a wife

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Published by Case Western Reserve University School of Law Scholarly Commons, 1990

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who has not worked outside of the home — there would be another $4,000 paid to the family because of the universality of OAS.

The other aspect of security in retirement is our medicare program. Medicare, both pre- and post-retirement, provides for virtually all hospital and doctor's care, diagnostic tests and so on. After age sixty-five, it also covers most prescription drugs. We in Canada do not have quite the same problem with retiree medical care as you do in the United States.

Bill Napoli talked a bit about pension adequacy and replacement ratios. There is a range of final earnings, and the government benefits as a percentage of those earnings. Also, there is what I call a Registered Pension Plan ("RPP"), which is Canadian lingo for a qualified pension plan. It is based upon information in our TPF&C Benefits Data Bank, which contains the plan characteristics of over 300 major Canadian employers. In combination, those plans will produce a gross replacement ratio between 76% of total earnings at the $30,000 level, up to about 58% of earnings at the $120,000 earnings level.

Basically, a target replacement ratio in Canada is going to be about 60 to 65% of final pay, less government offsets. We are not permitted to directly integrate OAS into a formula, but we are permitted to integrate the Canada Pension Plan. OAS is implicitly integrated by setting the target level of benefit desired. In other words, you can lower the target because you know of the existence of OAS, but you cannot specifically offset it in the formula.

These figures, by the way, ignore any OAS payable to the spouse. If I take my final earnings after they have been reduced by tax and other payroll deductions, and after I make an adjustment for savings that I no longer have, these kind of replacement ratios, at least in the initial year of retirement, will give me a 100% replacement of disposable income, except at the higher earnings levels where personal saving is important. That is the goal to which most of our benefit planning is directed.

Now we come to the regulatory scene. We do not have one regulator; we have two. In the beginning there was Ottawa. And Ottawa sets limits on contributions to plans and limits on benefits that may be derived from plans. This concerns the tax treatment of registered pension plans and other tax-supported means of saving.

The provinces, however, have a separate and different role to play. It is almost a consumer watchdog king of role and, with the exception of British Columbia, every province has, or is close to having, such pension standards legislation. First of all, this legislation deals with solvency. It sets funding standards that promote plan solvency, thereby providing benefit security. In addition, the provinces' role addresses all the consumer issues such as, eligibility, vesting, inflation protection, death benefits, and so on, which are included in a plan.

The vehicles commonly used to provide for retirement income are the RPPs of the two types that Bill Napoli described, defined benefit plan and defined contribution plan, the latter sometimes called money purchase. We may also use a deferred profit share plan. This is about the only area in which we can have a tax effective profit sharing plan. It is possible to have a profit-linked RPP, but these are rare. As you will see later, because of some of the rules, it is virtually impossible to have both a good RPP and deferred profit sharing plan.

Registered Retirement Savings Plans ("RRSP") are individual vehicles like the U.S. IRA, but have higher contribution limits. Some stock purchase plans are also found. People often ask me, particularly from U.S. parent corporations, if this can be done in Canada as in the United States. And the answer to that is invariably, yes, but it will not be as tax effective. Some of these items have substantial plan design differences. I think it is critical with the increasing transfer of people, particularly senior people, across the border, that we realize the impact on executive compensation. You are going to see some considerable differences.

Retiree Medical Plans

I have already mentioned that liability is essentially taken care of by our medicare program. At the moment, the Province of Ontario has committed one third of its provincial spending to medicare. And the system is still considerably underfunded.

Previously in Ontario, there was a direct premium payable by residents for medicare, which, for a couple, was $720 a year. Those contributions in the aggregate amounted to about 14% of the total cost of the scheme. As of January 1, 1990, Ontario replaced the direct premiums with an employer payroll tax of just under 2%. That magically increased the direct funding to 16% of the total cost. So, 84% of the cost of the program has to come from other taxation.

When medicare was introduced in Ontario, the Premier at the time, John Robarts, said that he wanted the scheme to have a direct contribution paid by residents because he wanted the citizens to know that socialism was expensive. He obviously was a conservative.

Very few companies extend dental benefits to retirees. Furthermore, less than 30% in our survey extend any dental benefits at all. I do not think that is a deficiency. If people have retired after a number of years of service under a good dental plan, they are either going into retirement with fairly good teeth and only need maintenance, or they have no teeth at all and it does not matter.

The only catastrophic health risk a Canadian faces is taking ill outside of the country. Medicare responds to expenses outside of Canada, but only to the Canadian level in most cases. Most of our plans, both pre-retirement and post-retirement, make special provisions for out-of-country care.

Bill Napoli talked about the FASB accounting standards as they apply to pension plans in the United States. We have similar rules

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promulgated by the Canadian Institute of Chartered Accountants ("CICA"). The rules are fewer, less specific and the applicable disclosure rules are less onerous. Canadian subsidiaries of U.S. corporations, or Canadian companies which trade on public stock exchanges in the United States, are going to have to conform to FASB accounting. And there are some differences.

This is handled by the Canadian subsidiary going through its CICA calculation, then passing it to the corporate office which either recalculates the numbers to conform to FASB, or just includes the Canadian results on the basis that any difference is not material.

When it comes to the FASB rules for post-retiree medical, we do not have any in Canada, yet. The CICA has simply said, on the balance sheet, please tell us what benefits you provide and how you are funding them. The way most are being funded is on a pay-as-you-go basis.

We have no tax effective way of pre-funding non-pension benefits. We used to informally permit the group insurance benefits to build up a surplus with the insurance company, which would then be used to finance post-retirement benefits. Unfortunately, Revenue Canada discovered what we were doing. Another aspect of tax reform is to now tax those funds held by the insurance company at such a rate that it is no longer financially attractive to indirect funding.

Funding Requirements

I mentioned that the provincial pension authorities are concerned with solvency and, therefore, minimum funding standards have to be met. In Ontario, for example, solvency deficiencies in a pension plan must be funded not over five years. Solvency deficiencies are deficiencies which would have existed had the plan been closed at date of measurement. Unfunded liabilities in excess of solvency deficiencies must be funded for not over fifteen years. Contributions (both employer and employee, if any) must be remitted monthly. And, of course, there are federal limits on tax deductions.

We, too, in Ontario, have a pension benefit guarantee assessment. It is a basic premium of only one dollar per participant, but we also have a variable premium based upon funded status. If there is a solvency deficiency, then there is an increase in the basic premium.

Tax Support

This subject is a little difficult because we are in transition from one regime to another, with regard to the tax support that goes to our pension vehicles. At the moment, there is considerable difference in the amount of tax support that goes to any one of the ways of providing for retirement income. If you take a defined benefit pension plan, for example, the maximum pension which can be accrued is subject to two formulae: Two percent of average final earnings times thirty-five years — a maximum of seventy percent — not more than an annual accrual of $1,715; that means salaries above about $86,000 cannot be protected under the formula at the maximum, which is the two percent. The employer's contribution to the defined benefit plan is consequently only restricted to the amount necessary to fund the benefit.

If I am in a defined benefit plan, and I want to make a contribution to an RRSP, then I am able to make a contribution of $3,500, less any contributions that I might personally have made to the employer's sponsored plan. If I am not in an employer sponsored pension or deferred profit sharing plan, I can make a contribution of up to $7,500 to an RRSP.

You can see from this example, and there are others, that the tax support has not been equally applied to the different vehicles. So we have had some very imaginative people in Ottawa spending some years coming up with an elegant but almost unintelligible new system, which endeavors to balance out some of those inequities. It starts with the premise that the government will permit tax supported contributions of up to eighteen percent of earned income, to a maximum of $15,500 in 1995 (lower limits apply in the years prior to 1995). And if you work that through, not surprisingly, it covers about an $86,000 salary. The difference is that the $15,500 will be indexed to wage changes in the future, commencing from 1995. So you start with the ability to contribute, either personally or by the employer, up to $15,500.

In fact, the employer contribution to a defined benefit plan is not subject to a dollar limit. If you are a participant in a defined benefit plan, you must subtract from that $15,500, a factor called the Pension Adjustment, which is the amount of pension accrued in the year, multiplied by a factor of nine less $1,000. Why nine, you ask? Since we do not have all week, just accept that it is nine. So, if I earn a benefit of $1,000 this year, nine times that is $9,000 less $1,000, or $8,000, which I subtract from my $15,500; bingo! I have $7,500 left to put into some other vehicle, such as an RRSP.

If I am in a defined contribution plan then, of course, the Pension Adjustment is actually the amount of the contribution made by the employer or by the employer and myself.

One reason that this is going to be complicated is the Pension Adjustment cannot be calculated until the year after it has occurred, while the government promises us that these calculations will be completed and mailed to every resident. As I said earlier, it is a fairly elegant solution to an intellectual problem.

Other Changes

You recall I said that we have a limit of thirty-five years on the accrual. Under the new agreement, there will be no limit on the accrual,

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but there will still be a maximum amount of around $1,700 that you can earn in any year.

Now, these numbers are important because as we saw from Bill Napoli's presentation, in the United States, under a qualified plan, you are providing something in excess of $100,000. We are providing a maximum of about $60,000. Think about executive transfers in that context.

Non-discrimination issues are important in pension planning in both countries. Although, I think I am right in saying that they are somewhat less onerous in Canada than they are in the United States, particularly those which deal with questions of equity.

Our working conditions are governed by the various provinces' Employment Standards Acts. These Acts prohibit discrimination in employment by gender, age, marital status, and so on. The provincial pension rules also address discrimination. We are able to have completely different benefit levels, different shapes to our plans for defined classes of employees. We do not have any tests that say, if this class gets this much, then it has an impact on another class. So you can have distinct classes of employees, each having its own unique benefit formula.

All of this leads to "top hat" plans being permitted in Canada. This is where you can solve the problem of the executive transfer. Top hat plans, a regular part of executive compensation, are provided in one of two ways. The simpler, and probably the more common, is merely to protect the executive against the Revenue Canada maximum which, I said, currently peaks at $1,715 a year. That is as much as you can fund, and represents a salary of about $86,000. But if one is earning $100,000, then you can say, "What I'm going to do for you is continue the benefit formula on the salary in excess of $86,000." But you cannot fund it. You cannot fund it in a registered plan. You can fund it externally, but only by suffering severe tax consequences. So, most of these are not externally funded.

The other thing that is sometimes done for executives is to grant a better benefit formula than the plan for the rank and file. Employees might have one-and-a-half percent; executives, might receive two percent. And, again, the executive can be saved against the Revenue Canada maximum benefit.

There are other factors, some quite worrisome, some quite controversial. One thing that dispirits Canadian plan sponsors is that all this regulation applies to plans which are, in the first instance, voluntarily provided. Currently, in Ontario we have legislation that may, when the next piece comes down, require the mandatory indexing of deferred vested benefits, as well as pensions in the course of payment. For years, most Canadian employers, particularly the larger ones, have been doing some kind of *ad hoc* increasing when the plan could afford it, and when the time was right to do so.

This kind of regulation will force the indexing of benefits in payment. The basic proposed formula is 75% of the change in the consumer price index ("CPI"), minus 1%. That means that if CPI went up 10% it is 7.5% minus 1%. So you have to index at 6.5% (the highest required increase in any year is 5% per annum). But you will have to index the benefit only up to 60% of the wage ceiling under Canada Pension Plan. All of this asks the questions: "Why am I doing this;" "Why am I providing generous benefits for my employees?" The employers who are hit the hardest are those with the most generous pension plans. People without pension plans are not at all hurt by this.

On, now, to fund asset surplus ownership. In the past, under defined benefit plans, unless the plan text or collective agreement said otherwise, it had been presumed that surplus funds belonged to the employer. What is wrong with that? The employer took all the risk, promised a benefit and funded it, and did so conservatively. When a surplus arose, the balance had changed. The presumption was that because the pension was for employees, then it must somehow have been employee money. So, a lot of legal action is expected to determine this question of surplus ownership.

Employee Representative

Some provincial authorities now seem to be moving towards the concept that they will oversee plan administration, and delegate this function to employees. Also, in some provinces, a pension plan must have a committee, if requested by the employees, which includes employees to deal with the monitoring of administration of the pension plan but not, as yet, to deal with financing, funding or investment. Nevertheless, it is still an employee committee.

A few other differences are that pension payments are made from age seventy-one, in contrast to the U.S. situation, which provides for distributions from age seventy-and-a-half. In Canada, we cannot transfer assets from a RPP to a retiree medical plan. There is no direct way to do that.