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October 27, 2011

EPSP Consultation
Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, ON   K1A 0G5

Dear Sirs:

Re: Consultation on the Tax Rules for Employee Profit Sharing Plans

I am writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU was formed to meet the needs of Advocis members who specialize in advanced applications of life insurance and related financial services, including such areas as employee benefits, wealth accumulation, retirement planning, estate planning and business succession planning.

Advocis is the trade name for The Financial Advisors Association of Canada (TFAAC), which is the largest voluntary professional membership association of financial advisors in Canada, representing more than 10,000 advisors across Canada. Advocis members provide comprehensive financial and retirement planning, employee benefits planning, wealth management, estate and tax planning, risk management products and advice to millions of Canadians.

CALU and Advocis members are often engaged in providing employee benefits and retirement planning advice to small- and medium-size business owners, employees and the self-employed. We are pleased to have this opportunity to respond to your request for input on the consultation paper released on August 30, 2011.

Introduction

The Employee Profit Sharing Plan (EPSP) Consultation Paper (the "Paper") poses a number of questions under the following categories:

1. Eligibility to participate in an EPSP.
2. Role of Minor Children.
3. Limitation on Contributions.
4. Withholding Requirements.

The Paper also asks if there are additional aspects of EPSPs that should be reviewed or taken into consideration to ensure EPSPs remain an effective compensation tool.

We believe there may be a more fundamental question that also needs to be considered as part of this review: Do EPSPs continue to play a useful role in rewarding and incenting employees? We shall start with this question as it lays the groundwork for our response to the other questions that have been posed.

Role of EPSPs in Rewarding and Incenting Employees

The rules governing EPSPs were first introduced over six decades ago. Although we could not find any commentary from the Department of Finance relating to the purpose and intent of these rules at the time these rules were enacted, a paper delivered at the 1960 Canadian Tax Foundation Annual Meeting[1] offers some useful insights:

> One of the basic goals of a profit sharing plan is to create a common interest between the employees and the shareholders; to create an environment or an incentive so that labor and management can work together to produce increased profits through more efficient operation. If this common interest can be created, we can look forward to building up industrial efficiency and production as well as to lessening industrial strife. If employees can see a direct relationship between what they contribute and what they share, they will have a greater interest in the well being of the enterprise.[2]

However, the following concerns with the current EPSP rules were noted:

> The levying of taxes on employees each year based on the book entries credited to their profit sharing accounts, which the employee does not in fact receive at that time, imposes a severe hardship on longer service employees and has been a serious deterrent to the growth of deferred profit sharing plans in Canada.[3]

In the same paper, a speaker from the United States (where profit sharing plans were at the time very prevalent) questioned both the value of EPSPs and proposed legislation governing deferred profit sharing plans:

> For the most part profit sharing plans have been viewed with some misgivings by many trade unionists. If we are correct in our analysis of the proposed amendments to the Income Tax Act (Bill C-84)[4] these misgivings are likely to become more emphatic than they have been in the past.[5]

It is therefore apparent that even a half century ago there were concerns and issues with the long-term viability of EPSPs. As well, since the introduction of the EPSP rule there have been a number of new developments in the design and tax treatment of employee benefit programs which have as their purpose the recognition of employee efforts related to the growth and profitability of the business.

Given the above, we would also suggest that the overall rationale and purpose for EPSPs be discussed with stakeholders. The rules should be reviewed to not only deal with perceived abuses and unintended tax results, but also to ensure such plans remain relevant in aligning the interests of employers and employees in the long-term success of the business.

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[1] E.A Pickering, R.M. Sedgewick, W.F. Cleve Kid, “Profit Sharing Legislation”, Fourteenth Tax Conference, 1960 pp 81-91.
[2] Ibid at page 84.
[3] Supra note 1 at page 83.
[4] Bill C-84 contained the legislation to implement deferred profit sharing plans.
[5] Supra note 1 at page 88.

1. Eligibility to Participate in an EPSPs

We are generally of the view that non-arm's-length employees (including shareholders) should be permitted to participate in employee benefit plans and other employer-sponsored programs on the same terms and conditions as any other arm's-length employee. In other words, we don't believe owner-managers and other non-arm's-length employees should be treated differently from a tax perspective because they are in a position to control the employer in some form or manner, provided the type and level of benefits provided to them are "reasonable" in comparison to benefit programs for other employees within the company and/or benefit packages generally available to employees in the private or public sector.

We also believe it is important to differentiate between the tax treatment of EPSPs and Deferred Profit Sharing Plans (DPSPs), or other employer-sponsored programs where special rules currently apply to non-arm's-length employees. In the case of EPSPs, at least conceptually, the tax rules for these plans are designed to be "tax neutral." All employer contributions to an EPSP are to be allocated to participating employees and treated as salary and wages, and similarly all income earned in the trust is to be allocated to employees and taxable on an annual basis according to specific rules.

There are specific situations where EPSPs do not appear to be "tax neutral" and they are discussed in following sections. We would note, however, that the Income Tax Act (the "Act") already contains a number of general provisions[6] that apply or could be modified to apply in order to deal with planning techniques involving EPSPs that are considered to be abusive.

2. Role of Minor Children

As noted above, we are of the view that non-arm's-length employees should generally be treated in a similar way to arm's-length employees in terms of participation in employee benefit programs, and this view also extends to employees who are minors. However, we also recognize that Finance has a valid concern that EPSPs are being used to avoid the various income-splitting rules applicable to minors under the Act.

We would therefore be supportive of rules that are designed to prevent the use of EPSPs for this purpose. This could be an extension of the tax on split income regime to "unreasonable" allocations or reallocations of EPSP benefits to a minor child that is related to the employer or is a specified shareholder of the employer. Another approach would be to limit the amount that could be allocated to any minor children to a percentage amount of the salary paid to that minor child in the year. Under this latter approach, if the salary paid to the minor child was subsequently determined to be "unreasonable," the tax on split income relating to EPSP benefits would be re-determined based on the "reasonable" amount of salary.

3. Limitation on Contributions

As noted above, if there was true tax neutrality in the rules governing EPSPs, there should be no concern if an amount is received directly by an employee as salary or indirectly as an allocation or reallocation under an EPSP. In these circumstances there is no reason to place a limit on the amount of contributions other than those that currently exist under the Act.

[6] Such as section 15 (shareholder benefits), subsection 56(2) (indirect benefits) and section 67 (limitation on expenses).

4. Withholding Requirements

As discussed in the consultation paper, EPSPs are being used to avoid the payment of Canada Pension Plan (CPP) and Employment Insurance (EI) premiums as well as defer the payment of income taxes on salary and wages. This is a valid concern not only for the government, but also for any participating employees who are not otherwise maximizing benefits under the CPP or making full contributions for EI.

The difficulty arises with the fact that amounts allocated under an EPSP may not actually be received by the plan participant. While there is a mechanism for claiming a refund of income taxes paid on such amounts,[7] there continues to be the issue of the plan participant funding such taxes as they may not actually be in receipt of such allocations.[8] As there is currently no obligation to pay CPP or EI premiums, there is no mechanism for reimbursing and reallocating these amounts between different employees.

Where the plan includes non-arm's-length employees, the potential for reallocations of amounts to another employee is significantly reduced. Also, as they presumably have some influence or control on the initial allocations under the EPSP, they are in a better position to fund the taxes and payroll costs associated with such allocations.

Based on the foregoing discussion, we would be in favor of extending the requirement for income tax withholding to EPSP allocations made to non-arm's-length employees. We would also be supportive of similar rules applying for purposes of CPP and EI withholdings.

There is also an argument for extending the withholding rules to arm's-length employees in situations where it appears that the EPSP is being used as a "flowthrough" vehicle to avoid withholding requirements.

Concluding Comments

In summary, we believe the initial review should be in relation to the policy objectives which can be served by Employee Profit Sharing Plans in the current environment. The next step would be to determine if the tax rules can be modified to enhance the overall objectives of these plans while dealing with the perceived abuses as discussed above.

Thank you for the opportunity to provide input on the EPSP consultation paper and we'd be pleased to play a continuing role in the development of any new rules relating to EPSPs.

Respectfully,

Susan St. Amand, CFP, CLU, CH.F.C., TEP
Chair, CALU

[7] Subsection 144(9) of the Act.
[8] This funding requirement becomes even more onerous where contributions are retained by the EPSP for investment purposes and earnings are annually allocated to plan members.