Revised
June 12, 2013

City of Winnipeg Group Life Insurance Plans
Financial Implications of Proposed Restructuring

1. Background

The proposed restructuring of the City's group life insurance plans effective January 1, 2014 involves the following:

- Freezing the existing fund (the "Old Fund") and treating it as tax-paid employee contributions.

- Establishing a new fund (the "New Fund") to be held by a newly constituted municipal corporation.

- Loaning the assets of the Old Fund (currently about $130 million) to the New Fund on an interest-free basis, so that all future investment income will be earned in the New Fund. This investment income will be tax-sheltered as the New Fund is held by a municipal entity.

- Using the Old Fund to pay a portion of future insurance premiums. The loan to the New Fund would be repaid as necessary to finance these premium payments. As the source of these premiums is tax-paid employee contributions, this portion of the premiums will not give rise to taxable benefits for the Plan members.

- Directing all future employee, pensioner and employer contributions to the New Fund.

- Using the New Fund to pay the balance of the future insurance premiums.

The proposed structure assumes that premiums for pre-retirement insurance are financed firstly out of employee contributions to minimize or eliminate the taxable benefits allocated to employees. The taxable benefits for retirees will be based on the premiums paid from the New Fund for post-retirement insurance coverage less the amounts of the pensioners' own contributions.

2. Allocation of Insurance Premiums Between the Old and New Funds

We propose that the future payments of insurance premiums be allocated between the Old Fund and New Fund as follows:

	Old Fund	New Fund
Pre-retirement insurance	None.	Total premium for pre-retirement insurance.
Post-retirement insurance:		
Existing pensioners (at 1/1/14)	Excess of total premium over pensioner's own contribution.	Amount equal to pensioner's own contribution.
Future pensioners	(Premium - pensioner's own contribution) x $\frac{OS}{TS}$ where OS ("old service") is service before 1/1/14 and TS ("total service") is total service under Plan prior to retirement.	Total premium - portion paid from Old Fund.

For this purpose, premiums would be calculated using:

- a single blended rate for employees' pre-retirement insurance, and
- a single blended rate for pensioners' post-retirement insurance.

Any experience refunds would be reflected in these calculations as an offset against the following year's premiums.

Example

As an example of the allocation of premiums, if we assume that a pensioner has $30,000 of post-retirement insurance coverage, the pensioner's contribution rate is 0.25% of the insurance coverage per year and the blended premium rate for pensioners is $20 per $1,000 of insurance:

- the annual premium is $600;
- the pensioner's annual contribution is $75, which would be paid to the New Fund;
- if the pensioner retired in 2013 or earlier, the $600 premium would be allocated as follows: Old Fund – $525; New Fund – $75; and

- if the pensioner retired on December 31, 2014 and had 25 years of service at retirement, the $600 premium would be allocated as follows: Old Fund − $504 (= ($600 - $75) x 24/25); New Fund − $96.

3. Calculation of Taxable Benefits

Based on the proposed allocation of premiums, the calculation of taxable benefits each year under the new structure would be as follows:

Category of Member	Formula for Calculating Taxable Benefit
Employee	(Insurance coverage x blended premium rate for pre-retirement insurance) - employee's contribution for year. Note: If the aggregate premiums (net of refunds) for pre-retirement insurance are equal to or less than the aggregate employee contributions for the year, no taxable benefits would be attributed to employees. Also, to the extent that an employee's contributions for a year exceed the premium for pre-retirement insurance, the "excess contributions" will be carried forward to offset against future years' taxable benefits.
Pensioner	Portion of premium paid from New Fund (based on blended rate for post-retirement insurance) - pensioner's contribution for year.

Examples

1. Employee

Salary: $60,000
Insurance coverage: $120,000
Employee contribution rate: 0.5% of salary
Blended premium rate for pre-retirement insurance: $2.00 per $1,000 per year.

Taxable benefit = annual premium − employee contribution
= $240 - $300
= nil
("excess contribution" of $60 carried forward to offset against future years' taxable benefits)

2. Pensioner retired before 1/1/14

Insurance coverage: $30,000
Annual premium (based on blended rate for post-retirement insurance):
$525 paid from Old Fund
$75 paid from New Fund

Taxable benefit = annual premium paid from New Fund − pensioner contribution
= $75 - $75
= nil

3. Pensioner retired on 31/12/14

Insurance coverage: $30,000
Annual premium (based on blended rate for post-retirement insurance):
$504 paid from Old Fund
$96 paid from New Fund
Pensioner contribution: $75

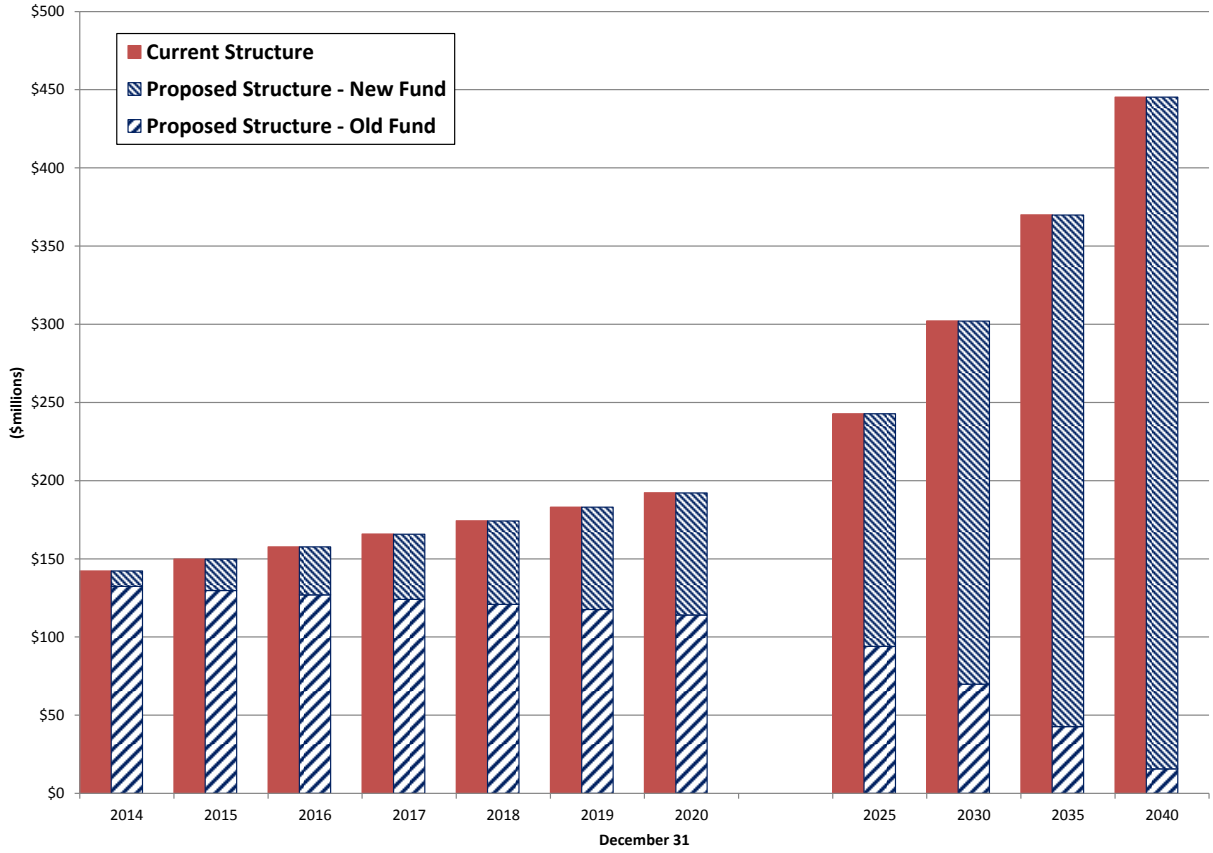
Taxable benefit = $96 - $75
= $21

4. Projections

We have carried out a series of projections to illustrate the financial operation of the proposed structure and the calculation of taxable benefits.

The results of the projections are summarized in the following graphs:

Figure 1 – Fund Projections



This illustrates the projected evolution of the Old Fund and New Fund under the proposed structure, based on a reasonable set of assumptions (including 5% per year investment returns and 3% per year growth in employee payroll).

Note that, if the Old Fund and New Fund are exempt from tax, the aggregate of the two will be the same as the projected fund under the current Plan structure if the status quo is maintained.

Figure 2 – Projected Tax Revenues to CRA



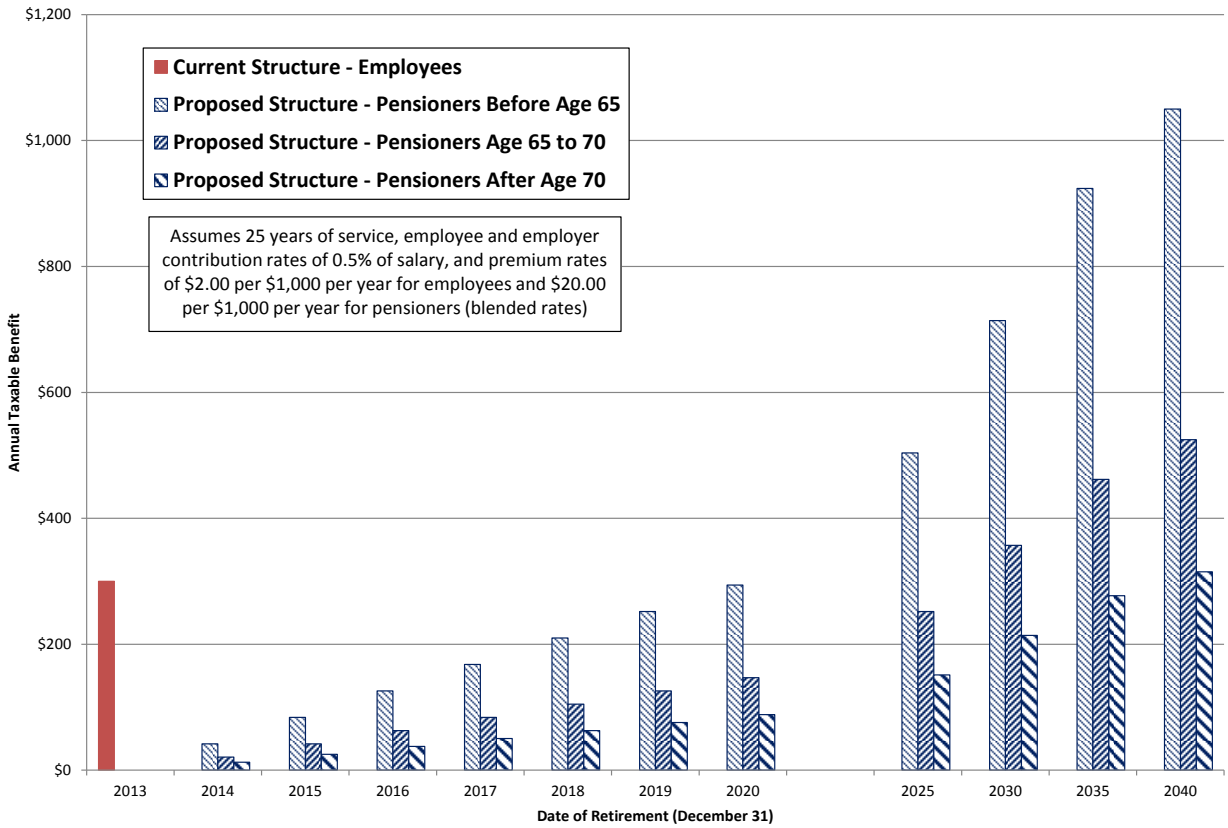
Tax revenues to CRA include:

- tax on employees' and pensioners' earnings used to pay (after tax) employee and pensioner contributions to the Plan,
- tax on taxable benefits allocated to employees and pensioners, and
- tax on fund investment income (assumed to be nil under both current and proposed structures).

Note that tax revenues to CRA would immediately drop by approximately $1 million per year under the proposed structure as a result of eliminating the taxable benefits allocated to employees (provided that premiums for pre-retirement insurance coverage do not exceed the employees contributions).

Ultimately (although potentially 30+ years in the future), tax revenues to CRA under the proposed structure will exceed those projected under the current structure, once taxable benefits allocated to pensioners (in respect of premiums paid from the New Fund, i.e. in respect of service after January 1, 2014) exceed those that would have been allocated to employees in respect of employer contributions under the current structure.

Figure 3 – Projection of Taxable Benefits (in 2013 Dollars)

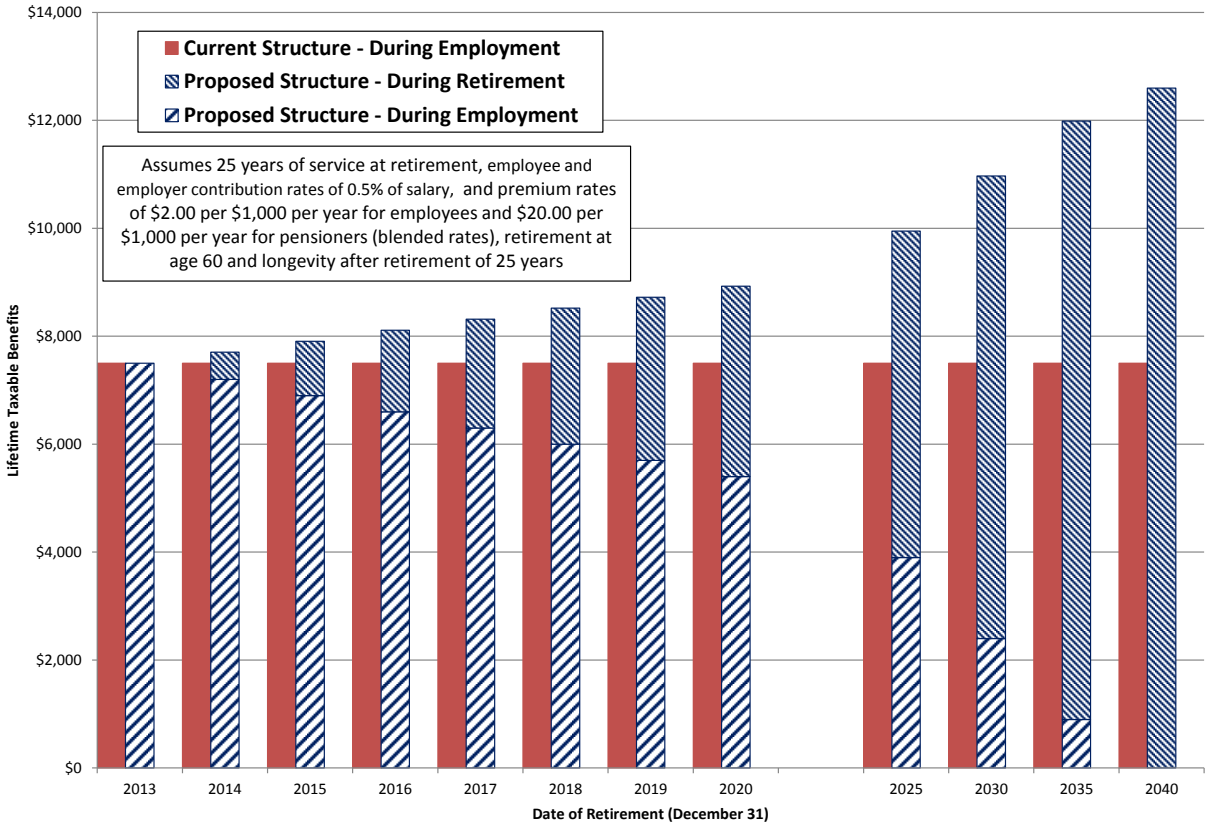


This illustrates how the taxable benefit allocated to a Plan member under the proposed structure is expected to compare with the taxable benefit allocated under the current structure.

Note that under the current structure only employees are allocated taxable benefits (in respect of the employer's contributions). Under the proposed structure, it is likely that:

- the taxable benefits allocated to employees will be eliminated,
- pensioners who retired before January 1, 2014 will have no taxable benefit, and
- pensioners who retire after January 1, 2014 will have a taxable benefit pro-rated on the basis of the proportion of their service after January 1, 2014.

Figure 4 – Comparison of Total Lifetime Taxable Benefits (in 2013 Dollars)



This illustrates the total amount of the taxable benefits an employee (and ultimately as a pensioner) can expect to have allocated over his or her entire lifetime.

This shows that pensioners who retired before January 1, 2014 would be unaffected by the change in structure; pensioners who retire after January 1, 2014 can ultimately expect to have greater taxable benefits (and, hence, pay more tax), with the taxable benefits allocated during their retirement years being only partially offset by the reduction in taxable benefits during their pre-retirement service after January 1, 2014.

In this regard, it is important to note that the taxes payable on taxable benefits allocated after retirement will be paid much later than the taxes that would otherwise have been payable on taxable benefits allocated during employment.

Conceptually, provided that the investment income on the funds under the new structure is exempt from tax and the Plan members' marginal tax rate is the same after retirement as it was during employment, the present value of the taxes payable under the new structure will be exactly equal to the present value of the taxes payable under the current structure.