



TAX NOTES

March 23, 2020

SUPPLEMENTAL UNEMPLOYMENT BENEFIT PLANS

I. INTRODUCTION

As a result of the COVID-19 pandemic, many businesses have been forced to temporarily lay-off employees. Although many of these employees will qualify for employment insurance (EI) or may be covered by the recently-announced supplemental benefits for non-EI-eligible employees, the \$573 per week maximum EI benefit may be inadequate to allow laid-off employees to cover living expenses. For various reasons, employers may want to top-up EI benefits, including as part of an agreement whereby the employee agrees to not sue the employer for wrongful dismissal, out of a sense of moral obligation or to increase the likelihood that employees will return to work after the layoff ends.

For businesses that desire to supplement EI benefits for laid-off employees, a straightforward way in which to do so is to create a supplementary unemployment benefit (SUB) plan. Benefits under qualifying SUB plans will **not** reduce a laid-off employee's EI benefits, thereby allowing the employer and the government to split the cost of providing the employee with up to 95% of their average weekly earnings during the layoff.

II. EI TREATMENT

In order to qualify as a SUB plan, the plan must be registered with the Canada Employment Insurance Commission prior to its effective date and must meet, among others, the following requirements:

- The plan documentation must identify the covered employees, although the covered employees need not have vested rights in the plan except to receive benefits under the plan as and when entitled.
- The plan must cover any period of unemployment by reason of temporary work stoppage, training, illness, injury or quarantine.
- Employees covered under the plan must be required to apply for and receive EI benefits in order to receive benefits under the plan, subject to exceptions for employees who may not have enough hours to qualify for EI benefits or who have exhausted their EI benefits.

- The plan must provide that the maximum weekly benefit payable to an employee under the plan plus the employee's EI benefits cannot exceed 95% of the employee's normal weekly earnings.
- The plan must be entirely funded by the employer, and the employer must be entitled to receive all remaining assets of the plan (if any) on the termination of the plan.
- During its existence, the plan must maintain accounts separate from the employer.

Distributions from a registered SUB plan to a laid-off employee are deemed not to be insurable earnings, and therefore do not result in a reduction of the EI benefits to which a laid-off employee may otherwise be entitled. This contrasts with most other forms of remuneration from an employer to a laid-off employee, which would generally reduce EI benefits and therefore may be of lesser value to the employee.

III. INCOME TAX TREATMENT

For income tax purposes, employers must choose between an unfunded and a funded SUB plan. An unfunded SUB plan is usually advantageous where the plan is being created after the need for the plan has arisen or where the employer would prefer to fund the plan from operating revenues. A funded SUB plan can be advantageous if the employer is creating the plan in a taxation year before any material benefits will be paid under the plan, since the employer can deduct the contributions to the funded SUB plan in that earlier taxation year rather than waiting until benefits are paid to laid-off employees.

If the plan is an unfunded SUB plan, the employer generally should be entitled to deduct payments to laid-off employees under the plan in computing its income from business for the taxation year that payments are made, in accordance with ordinary income tax principles. Individuals receiving benefits under the unfunded plan will be required to include the benefits in their income from employment for the taxation year in which benefits are received.

A funded SUB plan must be organized as a trust and must be registered with the Canada Revenue Agency (CRA). The CRA will not register a funded SUB plan until it has been registered by the Employment Insurance Commission, meaning that the funded SUB plan must comply with both the requirements of the *Employment Insurance Act*, the *Income Tax Act* and the CRA's administrative requirements for registration.

In addition to documentation requirements, the CRA has imposed minimum standards for funded SUB plans including, but not limited to, the following:

- Contributions must be made to, and benefits paid from, a trust with a December 31 fiscal year-end.
- Consistent with the first requirement, payments must not be made out of the plan from an operational revenue fund or the general operating revenues of the employer (although there is no restriction on funding contributions to the SUB plan trust from such sources).

- The plan must not be a superannuation, pension, retirement savings, deferred profit-sharing, or an employees' profit-sharing plan.
- The funds of the trust must be used only for the payment of periodic amounts to eligible employees who are laid-off because of a temporary work stoppage, sickness, accident, disability, training or parental leave.
- Benefits may not be paid for vacation leave, termination pay, retiring allowances, or to maintain earnings of an employee transferred to a lower-paying position for technological reasons.
- The plan must state the classes of employees covered and the eligibility requirements. Employees cannot be covered unless they are entitled to receive EI benefits and cannot be persons who control the business or who are related to a person who controls the business.
- The plan must establish the timing and level of the employer's contributions and the maximum funding level for the trust.
- The employees must be told promptly of the terms of the plan and must be provided periodic updates as to their entitlements under the plan.

Once a funded SUB plan is registered, it is exempt from Part I tax on its income. Contributions to the SUB plan by the employer are deductible, while amounts received by the laid-off employees as periodic benefits under the plan are included in income. If the employer receives an amount on the amendment or termination of the plan that must be included in the employer's income.

Regardless of whether a SUB plan is funded or unfunded, benefits paid to employees should be subject to withholding. If the SUB plan is unfunded, the employer should be required to withhold tax from the benefits paid in the same manner as any other remuneration from employment. If the SUB plan is funded, the trustee of the SUB plan will have the withholding obligation.

IV. CONCLUSION

Since it is necessary to register a SUB plan with the Employment Insurance Commission (and also with the CRA in the case of a funded SUB plan), employers who may wish to top-up EI benefits generally should start the process of creating SUB plans as soon as practicable in order to meet employee needs that may still exist by the time the plan is registered.

Please contact any of the lawyers of Felesky Flynn LLP if you would like further information on establishing a SUB plan, or if we can be of assistance with any other tax matter that may arise during the difficult time ahead.