Employee Life and Health Trusts - Where do they Fit?*

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Introduction

On February 26, 2010 the Department of Finance (Finance) released tax proposals to create a special type of trust called an "employee life and health trust", effective for trusts established after 2009. It first appeared that this legislation was designed to give statutory effect to the administrative guidelines in IT-85R2 governing Health and Welfare Trusts.[1] An ELHT, like a HWT, is an arrangement that allows an employer to make contributions to a trust that will provide benefits under a group sickness or accident insurance plan, a private health services plan or group term life insurance.

However, a closer examination of the draft legislation indicated there were a number of differences in the tax rules governing the two types of employee benefit trusts. For example, conditions imposed by the ELHT legislation will make it difficult for certain small employers to utilize an ELHT where a significant percentage of employees are shareholders or highly paid employees.

A number of organizations including the Society of Trust and Estate Practitioners (Canada)("STEP Canada") and the Conference of Advanced Life Underwriting ("CALU") made representations to Finance on the draft legislation, noting among other things their concerns with the proposed rules as they apply to small businesses and their employees. Unfortunately, the revised draft legislation released on August 27, 2010 did not address these concerns. The ELHT legislation contained in Bill C-47 received Royal Assent on December 15, 2010 as S.C. 2010 c. 15.

The purpose of this article is to review the policy intent of this legislation, the terms and conditions that must be met to qualify as an ELHT, contrast the tax rules for ELHTs with those applicable to HWTs and provide an overview of discussions with Finance relating to ELHTs and HWTs.

Overview of the Administrative Rules for HWTs

Under a HWT, the employer is generally permitted to deduct contributions to the trust in the year the legal obligation to make the payment to the trust arises, to the extent they are reasonable and are laid out to earn income from business or property.[2] The CRA has indicated that if the required contributions exceed the amount needed to provide current benefits to employees, the deduction to the employer will be denied under paragraph

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[1] "Health and Welfare Trusts for Employees", dated July 31, 1986.
[2] Ibid, paragraph 8.

18(9)(a)(iii) of the Income Tax Act, (which denies the deduction of prepaid insurance costs).[3]

From the employee perspective, no taxable benefit is received upon the employer making a contribution to the HWT. Benefits under the plan are taxable in the same way as if the benefits were provided directly by the employer. To summarize, premiums for group term life insurance coverage are taxable to the employee in the year paid by the HWT and any death benefit is tax-free to the beneficiary. Premiums or contributions for group disability benefits will not result in a taxable benefit, while the receipt of such benefits by the employee is fully taxable. Premiums and benefits paid under a private health services plan are not taxable.[4]

The trust itself is considered to be an *inter vivos* trust and will be taxable to the extent it has investment earnings in excess of the following amounts: expenses incurred to earn the trust income, expenses related to the normal operation of the trust, and premiums/benefits payable out of the trust income in the current year pursuant to paragraph 104(6)(b) (trust income distributed to a beneficiary). Benefits that are paid out of the proceeds of an insurance policy are not deductible to the HWT.[5] The IT also indicates that "contingency reserves" are not deductible by the trust.[6]

The CRA has several concerns with the current administrative rules governing HWTs and in 2005 it released draft IT-85R3 with a view to making changes and providing clarification on the application of the administrative guidelines. This attempt to modify the rules applicable to HWTs was greeted with significant push-back from the tax community[7], relating in particular to proposed limitations on an employer's deduction of contributions that are required under the HWT arrangements.[8] The CRA did not proceed with releasing the revised Interpretation Bulletin and the status quo was maintained.

Tax Rules Governing ELHTs

[3] This requirement may arise where benefits such as long term disability are "self-funded", and there is an actuarial determination requiring a lump sum contribution to cover the future costs of incurred or expected claims. See CRA Technical Interpretation 2004-0094771I7 and Income Tax Technical New No. 25 dated October 30, 2002.

[4] Supra note 1, paragraph 9. Note that in Quebec, at the provincial level, the contribution paid by an employer for the benefit of an employee may be included in the employee's income as a taxable benefit (Article 37 Taxation Act, R.S.Q c. I-3. .

[5] Supra note 1, paragraphs 11-13. Note that employer contributions to a HWT are not considered to be income of the trust.

[6] Supra note 1, paragraph 14.

[7] The CICA-CBA Joint Committee on Taxation made a submission to the CRA challenging a number of proposed administrative changes, including the linking of an employer's deduction for contributions to benefits that may reasonably be expected to be paid out in the year. CALU also sent in a submission supporting the comments made by the Joint Committee.

[8] The CRA had previously made its position known that it would challenge the deductibility of employer contributions to "pre-fund" benefits in a number of Technical Interpretations, as well as commentary on HWTs contained in Income Tax Technical News No. 25 dated October 30, 2002.

(a) Conditions to Qualify as an ELHT

The conditions that must be satisfied for an employee benefit trust to qualify as an ELHT may be summarized as follows[9]:

- The trust objects must be limited to the provision of designated employee benefits;[10]
- On wind-up or reorganization, the property of the trust may only be distributed to employees and certain family members (other than key employees and related persons), another ELHT, or in certain circumstances to her Majesty in right of Canada or a province;[11]
- It must be a Canadian resident trust determined without reference to section 94 of the Act;[12]
- All beneficiaries must be employees of a participating employer, certain dependants of those employees, another ELHT or Her Majesty in right of Canada or a province;
- The trust must be maintained primarily for the benefit of "non-key employees" (discussed in more detail below);
- The trust must not make a loan to, or an investment in, a participating employer or a person or partnership who does not deal at arm's length with the participating employer;[13]
- Employers generally may not have any rights to distributions from the trust; and Employer representatives may not constitute a majority of the trustees of the trust or otherwise control the trust.[14]

(b) Tax Rules Applicable to the Employer

An employer may deduct contributions to the ELHT to the extent that such contributions:

(i) enable the trust to pay premiums to a Canadian licensed insurance company for insurance coverage for the year or a prior year in respect of designated employee benefits for specified beneficiaries, or

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[9] Subsection 144.1(2) of the Income Tax Act (herein referred to as the "Act').

[10] A designated employee benefit means a benefit from a group sickness or accident insurance plan, a group term life insurance policy or a private health services plan (see definition in subsection 144.1(1) of the Act).

[11] Informally Finance was asked by CALU if it would consider allowing a registered charity to be an eligible recipient in similar circumstances to Her Majesty in right of Canada or a province. It was indicated that registered charities might be added to the list of eligible recipients a later date.

[12] This requirement would appear to address CRA's concerns involving the use of non-resident trusts to provide benefits for employee/shareholders.

[13] The Explanatory Notes released with the legislation indicate this provision is intended to prevent trust capital from reverting, directly or indirectly, to an employer. However, an ELHT could hold a promissory note issued by an employer as evidence of the employer's indebtedness for unpaid employer contributions. As well, an ELHT could accept shares of the employer as contributions in some circumstances. This might arise where the employer is in financial difficulty and its only assets are shares issued from treasury. This must be consistent with the terms of the trust and the trustees' fiduciary duties.

[14] The phrase "or otherwise control the trust" is intended to prevent a situation where the employer may through the terms of the trust or other contractual provisions exercise control over the trust.

(ii) Otherwise allow the trust to provide group term life insurance or any designated employee benefits payable in the year or a prior year for specified beneficiaries.[15]

To the extent that a contribution is not deductible in a current year, it may be deducted in future years where the designated employee benefits become payable to, or for the benefit of, specified beneficiaries.[16]

The legislation provides that the portion of the contribution that an independent actuarial report indicates to be the amount the ELHT can be expected to pay to provide employee benefits to beneficiaries for a taxation year is presumed to have been contributed to enable the trust to provide those benefits for the year. Such report must be prepared using accepted actuarial principals prior to the contribution by the employer to the ELHT.[17]

The total amount that may be deducted by an employer in all taxation years in respect of contributions made to an ELHT may not exceed the total amount contributed by the employer to the ELHT.[18] This is to prevent an employer from claiming a deduction in respect of amounts relating to income earned by the trust or to higher than anticipated benefit payments which are facilitated by strong investment performance within the trust.

It appears to be the intent of the legislation that where benefits are "self-insured" through the ELHT (as opposed to paying a premium to insure those benefits), the employer cannot deduct any contributions that are not required to fund benefits in the year. A number of submissions have argued against this approach on the basis that if the self-insured plan is established using actuarial principles and the employer is contractually obligated to make contributions to ensure there are sufficient funds to cover off incurred claims, such contributions should be deductible in that year and not deferred to a subsequent year. Also, given that the ELHT is an inter vivos trust, the ELHT would presumably pay tax at the top marginal rate in respect of the income earned on accumulated contributions that are available to fund benefits in a future year.

(c) Tax Consequences to the Employee Beneficiaries

The tax consequences to the employee of participating in such a plan are similar to being the beneficiary of a HWT as discussed above.[19] To the extent that an employee receives a payment that is not a designated employee benefit, this amount has to be included in the income of the recipient.[20] It should be noted that generally, employee contributions to an ELHT will not be deductible by the employee. However, there is a special look-through

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[15] Paragraph 144.1(4)(a) of the Act. See also paragraph 18(1)(o.3) and paragraph 20(1)(r). Note that separate rules governing deductibility of premiums apply to certain multi-employer ELHTs pursuant to subsection 144.1(6) of the Act.
[16] Paragraph 144.1(4)(b) of the Act.
[17] Subsection 144.1(5) of the Act. It should be noted that provision does not allow the employer to deduct contributions required to cover claims incurred in the year where benefits are payable in a subsequent year.
[18] Subsection 144.1(7) of the Act.
[19] Paragraph 6(1)(a) and (f) of the Act.
[20] Paragraph 56(1)(z.2) and subsection 144.1(11) of the Act.

rule that will allow certain contributions to an ELHT to qualify for the same tax treatment as if they were made directly by the employee.[21]

(d) Tax Rules Applicable to the Trust

The tax rules applicable to the ELHT are also closely aligned with those applicable to a HWT. The ELHT will be able to deduct amounts payable by it in a year as designated employee benefits.[22]

However, no amount may be deducted by an ELHT if in a particular taxation year the trust is not operated in accordance with the terms and conditions specified in subsection 144.1(2) of the Act[23], or it is operated or maintained primarily for the benefit of one or more key employees or their family members (see discussion below on key employees).[24] In discussions with Finance it has indicated that if more than 50% of the employees in the ELHT are "key employees", the CRA could find the plan is being operated "primarily" for the benefit of key employees and deny the deduction of amounts paid by the ELHT for designated benefits.

To the extent that such deductions exceed the ELHT's income for the year, the excess amount will be treated as a non-capital loss that can be carried forward or back for up to three years to offset income in those years.[25] However, the trust may not deduct a non-capital loss from another taxation year where the trust "was not an employee life and health trust in the year."[26] As well, an ELHT cannot deduct non-capital losses from another taxation year if the trust is not operated in accordance with the terms and conditions specified in subsection 144.1(2) of the Act.[27]

An ELHT is specifically excluded from the application of alternative minimum tax (AMT)[28] as well as the 21-year deemed disposition rules.[29]

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[21] Subsection 144.1(10) of the Act. This would permit, for example, an employee to claim the medical expense tax credit for qualifying contributions to an ELHT.
[22] Paragraph 104(6)(a.4) of the Act.
[23] Paragraph 144.1(3)(a) of the Act. Finance has confirmed this is intended to catch situations where the ELHT is being operated in such a way that it is in breach of the terms of the trust. It is hoped that the CRA will not take too strict an interpretation of this provision and will excuse any "inadvertent" breach of the trust terms. Finance has confirmed this denial of a deduction is "permanent" – there is no catch up of deductions if the breach of trust is cured at a later date.
[24] Paragraph 144.1(3)(b) of the Act.
[25] Subsection 144.1(13), subsections 111(7.3)–(7.5), and amendments to the definition of non-capital loss in subsection 111(8) of the Act.
[26] Paragraph 111(7.5)(a) of the Act. Finance has indicated this provision is designed to capture the situation where the terms of a validly constituted ELHT are subsequently modified and no longer meet the requirements of subsection 144.1(2) of the Act.
[27] Paragraph 111(7.5)(b) of the Act. Also refer to footnote 23.
[28] Amendments to add subparagraph 127.55(f)(iv) of the Act. The CRA has taken the position that a HWT is subject to AMT as there is no specific exception contained in the Act (see TI 9903747 dated June 14, 1999 and TI-2004- 0093641E5 dated November 26, 2004).
[29] Amendments to definition of "trust" in subsection 108(1) of the Act. The CRA has taken the position that a HWT is subject to the 21-year deemed disposition rule as there is no specific exception contained in the Act (see TI 9813645).

There are also new rules that govern the tax treatment of an ELHT if it becomes non-resident of Canada. If an ELHT goes "off-shore", its property is deemed to be inventory with a nil cost base, and such property is deemed disposed of at its fair market value.[30] This tax treatment would appear to be appropriate where the employer received a full deduction for its contributions to the ELHT and it has accumulated assets with those contributions. However, where the employer contribution have not been fully deducted (i.e., due to part of the contribution relating to future benefit payments) this would appear to result in double tax. Finance is aware of this concern and indicated that the employer could deal with this issue by specifying in the trust arrangements that the ELHT must remain a resident in Canada.

An ELHT is exempt from Part XII.2 tax on distributions by Canadian resident trusts to non-residents as it is a trust described in paragraph (a) of the revised definition of "trust" in subsection 108(1) of the Act.

(e) Provisions Governing Key Employees

A key employee is defined under the legislation as:[31]

- a "specified employee" of the employer. A specified employee is essentially an employee that owns not less than 10% of the issued shares of any class of the employer corporation or related corporation, and any persons who do not deal at arm's length with the corporation);[32] or
- any employee whose employment income from the employer in any two of the five preceding years exceeded five times the Year's Maximum Pensionable Earnings (YMPE) for the year. In 2010 the YMPE is set at $47,200, which equates to an employee earning in excess of $236,000 (in 2011, 5 x $48,300 = $241,500).

The rights of key employees are restricted by the following conditions:

- The ELHT must contain at least one class of beneficiaries under which:
    - members of the class represent at least 25% of all the beneficiaries of the trust who are employees of the participating employer
    - at least 75% of the members of the class are not key employees of the participating employer, and
    - the rights under the trust of each key employee of a participating employer are not more advantageous than the rights of the class of beneficiaries defined above.[33]

[30] Subsection 128.1(4) of the Act.
[31] Definition of "key employee" in subsection 144.1(1) of the Act.
[32] A specified employee is defined in subsection 248(1) of the Act.
[33] Paragraphs 144.1(2)(e) and (f) of the Act.

Put in simpler terms, where key employees are members of the ELHT, the benefits provided to this group under the trust cannot be “more advantageous” than the rights of a class of beneficiaries representing at least 25% of all the beneficiaries of the trust and where at least 75% of the members of the class are not be key employees.

Also, as noted above, even if these conditions are met the ELHT may be denied a deduction where it is determined that it is being operated primarily for the benefit of one or more key employees or their family members.[34]

This will impact small employers with a high percentage of shareholder-employees or high income employees. For example, if an employer has 10 employees of which 4 are key employees, the employer could not implement an ELHT with only one class of employees. This is because less than 75% of the class consists of non-key employees. This situation could be resolved by putting all four key employees into one class, and the six non key employees in a separate class. As long as the rights available to both classes under the trust were exactly the same, the ELHT would meet the requirements of the legislation.[35]

There is also the question of how the phrase “more advantageous” will ultimately be interpreted by the CRA. Presumably, if in the above example the benefits for the two separate classes are determined in accordance with a reasonable formula, this would meet the test. For example, if the trust provides group insurance benefits, and the insurance amount is determined by a formula based on five times the employees’ earnings, the fact that the key employees would have more insurance coverage than non-key employees would not in itself mean the “rights were more advantageous” to the key employees. On the other hand, if the formula creates an additional advantage for higher income employees that are also key employees, this may not meet the test.

Smaller employers could instead establish a non-trusteed plan for key employees, with the cost of such program deductible to the extent the benefits are ‘reasonable’ and received in the capacity of employees and not shareholders. This creates additional complexity, compliance costs and other expense to the small employer.

In discussions with Finance about the impact of these rules on small employers, it was indicated that the ELHT legislation was designed primarily to deal with the potential financial insolvency of several large public companies. Finance wanted to create a workable set of rules that would allow these employers to establish a funded and trusteed employee benefit program to protect current and retired employees. While it was also contemplated that smaller employers may want to establish an ELHT, Finance wanted to ensure that such plans were not used primarily for the benefit of shareholder/employees, family members and highly paid employees.[36]

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[34] Supra footnote 24.

[35] Again subject to the possible denial of a deduction for benefit payments under paragraph 144.1(3) of the Act.

What is the Impact of this Legislation on Current HWTs?

One must also consider the impact this legislation will have on existing HWTs. Given the fact that the ELHT legislation reflects much of the CRA's current assessing practices for HWTs, and deals with some perceived problems that they wanted to address in their 2005 revisions of IT-85R2, there was a concern that the CRA would withdraw this Bulletin once the ELHT legislation is enacted.

The explanatory notes to the legislation indicate that the CRA currently has no plans to withdraw or modify IT-85R2. It would therefore appear that employers have the choice of setting up an employee benefit plan as a HWT or ELHT, assuming the applicable criteria and conditions can be met. However, there are more recent indications that the CRA will be undertaking a review of IT-85R2 in order to update it to reflect current CRA assessing practices. The CRA has previously indicated that if any such modifications were contemplated they would first be discussed with the tax community and appropriate consideration would be given to existing plans.

In Summary

The ELHT rules bring greater clarity to the tax rules governing employee benefit trusts and unlike HWTs, the rules will be expressly sanctioned by legislation rather that being creatures of administrative policy. However, the conditions for establishing and maintaining the status of an ELHT will prevent their use by a number of smaller employers and they must continue to rely on the use of HWTs.

Given the above, the industry must remain watchful of the CRA and resist any attempts on its part to migrate the ELHT requirements relating to key employees into the HWT administrative regime.

We will keep members advised of any further dialogue we have with either Finance or the CRA on this matter.

*This article is a joint initiative of the Conference for Advanced Life Underwriting (CALU) (www.calu.com) and the Society of Trust and Estate Practitioners (STEP) Canada (www.step.ca).

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[36] For an indication of the type of abuses Finance was concerned with refer to the case of Labow v. The Queen, 2010 TCC 408 (under appeal) which involved an offshore HWT that was established for the benefit of shareholders and/or their spouses. See also Kevin Wark, "Health and Welfare Trusts Under Challenge by the Canada Revenue Agency, (2010) 4 Insurance Planning 1036.

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