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Employee Life and Health Trusts and Health and Welfare Trusts

Introduction

Employers and Benefit Plan Administrators are faced with a relatively new choice in determining the appropriate vehicle for providing certain employee benefits: should benefits be structured through an Employee Life and Health Trust ("**ELHT**") or the historic Health and Welfare Trust ("**HWT**")? What are the distinctions and why are they relevant?

The relatively recent introduction of ELHTs resulted in significant uncertainty in the pension benefits industry in Canada. Specifically, much of the concern arose from a lack of clarity as to how the ELHT regime would impact existing trusts operating as HWTs. After commentary from the pension benefits community, legislation from the Department of Finance ("**Finance**") and interpretive positions being released by the Canada Revenue Agency ("**CRA**"), the dust has mostly settled and many concerns have subsided. Accordingly, it is a suitable time to revisit the basic features of an ELHT and a HWT, consider the most recent statements of the CRA and compare the tax and other advantages and disadvantages of using an ELHT versus a HWT.

Background

When the proposed ELHT legislation was first released some concern arose that the administrative positions of the CRA set out in IT-85R2 (the "**Bulletin**") may be rescinded. The positions set out in that Bulletin are the basis for the existence of HWTs. That is, it could have been that the ELHT legislative rules replaced the HWT administrative rules. However, CRA has now clearly stated that there are no immediate plans to retract the Bulletin or disallow HWTs from forming after the date on which ELHT regime was implemented.

Accordingly, a trust that is established after 2009 (the earliest year in which a trust may be an ELHT) to provide group sickness, accident insurance, group term life insurance or a private health services plan, may be formed as either an HWT or an ELHT. Generally, then, an employer or benefits administrator is free to select whichever of the two is more preferable. It should be noted, however, that CRA has stated that it remains unsatisfied with certain aspects of HWTs and intends to revise the Bulletin. However, the CRA has not yet provided a timeframe for doing so. As a result, one factor that administrators and employers may consider is that an HWT remains subject to the administrative discretion of the CRA, whereas the rules in respect of ELHTs are arguably more predictable in that they are legislative.

Before reviewing some of the distinctions between an ELHT and an HWT it will be helpful to first describe some of the key features of each form of trust.

Key Features of an ELHT

Initially, the ELHT regime was designed and implemented to allow major automotive manufactures to find a method for rearranging employee benefit obligations during their 2008 restructurings. This is an unusual history for a large body of legislative rules that may apply generally across the economy.

The key features of an ELHT are as follows:

- the trust must be resident in Canada;
- the trust must be organized for the purpose of providing the limited forms of benefits and assistance set out above;
- the trust has a legal right to enforce payment of contributions to the trust; and
- employer agents or representatives constitute only a minority of the trustees of the trust.

Notably, an ELHT should incorporate many of these terms specifically in its governing trust document. Also of import is the fact that if a trust ceases to qualify as an ELHT at any time in a taxation year, it will be disqualified for the entire taxation year.

ELHTs also have an anti-avoidance concept of a "key employee" which is a high income employee or those that hold significant shareholdings. Benefits cannot accrue more favorably to such employees than to other employees. Additionally, at least once class of beneficiaries of an ELHT must contain more than 25% of all employees and at least 75% of that class must not be a key employee. This rule may prove to be problematic for some employers.

One area that Finance did not see eye to eye with industry on is the timing of deductions to an employer making contributions. The making of a contribution does not, necessarily, create a deductible expense for tax purposes. Instead, the contributor can take a current year deduction only in an amount equal to the sum of:

- benefits paid out of an ELHT;
- life insurance premiums paid by the trust in the year; and
- pre-paid life insurance coverage.

Non-deductible contributions in a current year can however, be carried forward to a future year in which benefits are paid. However, in the interim the contributor has lost the time value of the money contributed without corresponding tax recognition of this fact. Interestingly, there is specific legislative codification of a rule that allows a contributor to deduct contributions to the extent that they meet an arm's length actuarial report of expected disability benefits to be paid out in a year.

A payment to a beneficiary is tax free if it would have been tax free had it been received directly from the employer. Correspondingly, if an employee beneficiary were to receive an amount directly from an employer as a taxable benefit, paying that amount through the ELHT would not change the tax treatment of the amount.

An ELHT will be subject to tax on its net investment income (which will not include contributions made to the ELHT). In computing its income the ELHT will able to deduct all amounts paid or payable to employee beneficiaries, as well as administrative costs of operating the ELHT including insurance premiums. If the amount so paid in a year exceeds income, the ELHT will be entitled to "carry forward" any unused portion of the deduction.

Key Features of an HWT

An HWT, like an ELHT, must be restricted to providing prescribed group benefits, being disability, medical, dental and group life insurance. Like an ELHT, an HWT cannot be controlled by the funding plan sponsors, and cannot make direct investments in the plan sponsor entity. Notably, the "key employee" test for ELHTs does not apply to an HWT.

An HWT otherwise provides similar benefits to an ELHT. That is, like an ELHT, the purpose of the trust must be limited to providing the permissible benefits describe above.

A HWT is, like an ELHT subject to tax as a trust (e.g. at the highest marginal rate) on its investment income. Often HWTs are not in tax paying positions because the trusts are able to deduct taxable benefits paid to beneficiaries.

Distinguishing Features

The following are the most important differences between an ELHT and HWT.

One of the key distinctions between an ELHT and a HWT is that an ELHT is arguably more tax efficient to the trust (though not necessarily the employer making contributions to the trust). The reason an ELHT is notionally more tax efficient than an HWT is that the HWT is only able to deduct taxable benefits it pays out, whereas an ELHT is able to deduct all benefits, whether taxable or non-taxable in the hands of a beneficiary. An ELHT is also able to deduct all costs related to providing eligible benefits, including insurance premiums, claims and administrative costs. Practically speaking it is rare for an HWT to be in a tax paying position due to the deductions it may be in a position to take, however the arguably improved tax sheltering available for an ELHT may in some cases make it a more attractive structure.

One of the key distinguishing features of ELHTs when compared to HWTs is the presence of the "qualified multi-employer" rules. These rules provide that an ELHT with at least 15 employers under a collective bargaining agreement will, provided certain technical conditions are met, be able to claim a full current year deduction for all contributions made. However, qualifying for such status will in many cases prove to be impractical.

A contribution to an HWT can be deducted in the year in which there is a legal obligation to make payment to the extent that the contribution is reasonable in the circumstance. Many employers may thus prefer an HWT, so that they can obtain a deduction.

Notably the "carry forward" and "carry back" provisions applicable to an ELHT do not apply to an HWT (the "carry forward" rule applies only for three years).

One distinction between the two forms of trust is who gets the amount of any excess funds on wind-up. Under the HWT regime it is permissible for excess funds to be delivered to a charity. On wind-up of an ELHT funds may only pass to beneficiaries, another ELHT or the Crown.

Conversion from a HWT to an ELHT

One area of continued uncertainty is whether or not a tax-deferred "rollover" or conversion of an HWT into an ELHT can be achieved. It is clear that there is no express rule that provides for such a conversion within the *Income Tax Act* (Canada)(the "**Tax Act**"). Specifically, section 107.1 of the Tax Act provides a mechanism for a "rollover" of trust property from an ELHT to another ELHT. Notably absent from this rule is an HWT. That such a specific rule was required, and that such a rule does not exist for an HWT, suggests that a conversion may not be available. It is noted that the CRA's position is that material variations to the terms of a trust can constitute the settlement of a new trust which will result in a taxable event. Accordingly, without a clear mechanism for tax deferral (such as section 107.1) simply modifying the terms of the trust to comply with the conditions set out for ELHTs is likely to trigger tax. There may be planning opportunities for engaging in a tax free conversion transaction, but to date CRA has not explicitly endorsed any particular method and many methods may contain some technical tax risk.

Concluding Remarks

Benefit plan administrators seeking to establish new trusts for the provision of benefits in the future have two very similar options for consideration: an ELHT or an HWT. While there does not appear to be a consensus in the industry, it is expected that given the greater comfort offered by the legislative rules surrounding ELHTs it is more likely that ELHTs will be the preferred vehicle for many benefit administration programs, however plan administrators and employers should carefully consider whether in their particular circumstance an HWT might be preferable.

Organizations that do not require the tax deduction on contribution to an ELHT but are concerned that an HWT may be subject to tax may find an ELHT to be the more attractive funding mechanism.

Each of the ELHT and the HWT regimes are complex to implement, maintain and administer. CRA and Finance have provided flexibility but additional complexity in providing for two separate yet similar regimes.

Overall, given the relative administrative uncertainty as to potential further review by CRA of the HWT system; it is likely that ELHTs will be the most common trust mechanism utilized in this sector.

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