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Employee Life and Health Trusts

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Canada's Department of Finance recently released proposed amendments to the *Income Tax Act* (Canada) (the "Act") relating to employee life and health trusts. The proposals will be of interest to employers who provide, or are considering providing, health and welfare benefits to their employees through trust arrangements. To date, trusts of this nature have not been specifically provided for in the Act. Instead, "health and welfare trusts" have been subject to administrative requirements established by the Canada Revenue Agency ("CRA") which are currently set out in its Interpretation Bulletin IT-85R2.

The Act will be amended to add new section 144.1 which will provide for a new type of trust called the "employee life and health trust" ("ELHT"). Consequential changes will be made to numerous other provisions of the Act. The amendments will apply to trusts established after 2009.

The new rules codify some current CRA administrative practices and modify others. Over the years, the CRA has taken issue with certain employer-established trusts on the basis that they do not meet the conditions to qualify as health and welfare trusts. Some of the arrangements challenged by the CRA have involved trusts established offshore for the benefit of non-arm's length employees where the contribution to the trust was viewed as unreasonably high. In its Technical News No. 25, the CRA has also expressed concerns regarding perceived over-funding of benefits through lump sum payments to health and welfare trusts. The new rules include provisions which appear to be intended to address these concerns.

Qualification as an ELHT

A trust established for the benefit of the employees of one or more employers will qualify as an ELHT in a taxation year if throughout that year all of the following conditions are satisfied:

- The trust's objects are limited to providing "designated employee benefits" (any combination of group sickness or accident insurance benefits, private health services plan benefits or group term life insurance benefits) and to paying out any remaining surplus on wind-up. For this purpose, the investment and management of funds and administration of arrangements for benefit payments are generally considered to be activities performed in furtherance of the object of providing designated employee benefits.

- The trust is resident in Canada.
- Each beneficiary of the trust is an employee of a participating employer, an individual related to an employee, or another ELHT. For this purpose, "employee" includes both current and former employees as well as individuals for whom an employer has assumed the responsibility of providing benefits as a result of a business acquisition.
- The trust is not maintained primarily for the benefit of beneficiaries who are "key employees". In general, a key employee means either a significant shareholder or a high income employee (i.e., earnings exceed five times the Year's Maximum Pensionable Earnings).
- Where key employees are beneficiaries of the trust, they are treated no more advantageously than a group, at least 75% of the members of which are not key employees and representing at least 25% of all of the beneficiaries of the trust.
- Neither the employer nor any person not dealing at arm's length with the employer has any rights to distributions under the terms of the trust. There is a limited exception which would allow designated employee benefits to be provided to a non-arm's length person who is an employee of the employer, e.g., a controlling shareholder of the employer.
- The trust is administered in accordance with its terms.
- The trust has a legal right to enforce payment of contributions to the trust.
- Employer representatives do not form a majority of the trustees of the trust.

Income Tax Implications

The income tax implications for the employee, the employer and the trust are described below.

Employee

The tax treatment to an employee of designated employee benefits received from the ELHT will depend on the nature of the benefit. Benefits which would be taxable in the hands of the employee if received directly from the employer (e.g., certain disability insurance benefits) will be taxable when received by the employee from the ELHT, while other benefits which would be non-taxable when received directly (e.g., medical and dental benefits) will be non-taxable when received by the employee from the ELHT. In other words, the existence of the ELHT will not change the tax treatment to the employee of benefits received.

Contributions by the employer to the ELHT will not result in any taxable benefit to the employee. An exception is where the ELHT provides group term life insurance coverage.

Amounts received by the employee from the ELHT which do not qualify as designated employee benefits (e.g., a distribution of residual surplus on wind-up) will be taxable.

Generally, employee's contributions to the ELHT will not be eligible for a deduction or tax credit. However, a look-through rule provides that to the extent that any contribution would receive particular tax treatment if made directly rather than through the ELHT (e.g., eligibility for the medical expense tax credit), the same tax treatment will apply if the contribution is made through the ELHT.

Employer

The timing of deductions by the employer for contributions made by it to the ELHT will be subject to specific rules. The employer will be entitled to deduct ELHT contributions made in a year to the extent they relate to designated employee benefits that are payable in that year. If the contributions relate to liabilities to make benefit payments in future years, they will not be deductible until the later year(s) to which they reasonably relate. Accordingly, to the extent that benefits are pre-funded, the employer's deduction will be delayed.

Trust

An ELHT will generally be subject to tax on its net income. However, in computing its income the ELHT will be entitled to deduct all amounts payable by it in the year as designated employee benefits. Where the amount of designated employee benefits payable in a year exceeds the trust's income for that year, the excess will be treated as a loss (rather than as a distribution from trust capital) and will be deductible against income in any of the three preceding years or three following years so long as the trust retains its status as an ELHT.

ELHTs will not be subject to alternative minimum tax or to the 21 year deemed disposition rule applicable to most trusts.

Where benefits are administered on behalf of employees of more than one employer, an election may be made for the ELHT to be treated for tax purposes as two or more separate trusts.

Employee Life and Health Trusts

If you have any questions on this topic or would like to know how these rules will apply to a particular corporation or transaction or would like to discuss any other tax matters, please do not hesitate to contact one of the professionals in the **Tax Group.**

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