CRA Announces Phaseout of Health and Welfare Trusts

The 2018 federal budget, released on February 27, 2018, included a somewhat surprising announcement regarding the phaseout of the Canada Revenue Agency (CRA) health and welfare trust (HWT) administrative policy, in favour of the employee life and health trust (ELHT) statutory rules. This is a significant development that will affect all employee benefit plans currently organized as health and welfare trusts.

The goal of this article is to provide an overview of the background to this decision, the budget proposal and consultation process, and some of the differences between the two regimes.

Background

HWTs are trusts administratively recognized by CRA to deliver any combination of group sickness or accident insurance plans, private health services plans and group life insurance plans. HWTs are not a recognized trust classification or even mentioned in the Income Tax Act (ITA) (with the exception of the ITA equivalent of a footnote). HWTs have been recognized and governed solely by CRA administrative policy dating back to 1966, and they were most recently updated in 2015 as Income Tax Folio S2-F1-C1 (HWT folio).

In 2010, ITA was amended to create a new statutory scheme for ELHTs. ELHTs are, for the most part, identical to HWTs with respect to the benefits they may provide and the tax treatment of these benefits for employees. However, there are some significant differences, particularly with respect to the prefunding of plan liabilities and multi-employer arrangements.

It was expected that the CRA HWT policy would be revoked after the introduction of ELHT rules. However, CRA continued the HWT policy, allowing trusts established after 2009 to make an election between the two regimes.

The move to harmonize and consolidate these two sets of rules into a single statutory ELHT regime is, for the most part, a welcome one. As discussed below, ELHT rules are preferable for most benefit plans.

Federal Budget 2018

The key aspects of the budget proposal are as follows.

- Amendments will be made to ITA to allow for the conversion of HWTs to ELHTs.
- CRA will no longer apply the HWT folio to...
existing HWTs after 2020 or to any new trusts established after February 27, 2018.

- After 2020, HWTs that have not yet converted to ELHTs will be subject to taxation as a normal inter vivos trust.

There still are many questions with respect to how the conversion process will be implemented. In particular, the budget raises the following three issues as part of the process leading to the development of transitional rules:

- Whether HWTs can continue as ELHTs without the creation of a new trust
- Whether, and under what conditions, a rollover of assets to a new trust will be permitted
- The tax implications for an HWT that does not satisfy the conditions to become an ELHT or where the trustees of an HWT choose not to convert.

These issues indicate that the Department of Finance and CRA are considering whether a wind-up of existing HWTs will be required and/or whether any conditions may be set—perhaps with respect to funding—for a tax-free rollover to an ELHT.

Given the interest in these issues, it is expected that many stakeholders will have made submissions regarding the transitional rules. The Multi-Employer Benefit Plan Council of Canada (MEBCO) submitted a brief (available at www.mebco.org) focusing on issues particularly important for multi-employer plans (MEPs). MEBCO strongly advocates that the conversion process be as simple and low cost as possible. The recommendation by MEBCO is that the conversion process should require no more than a “check the box” election in the annual T3 Trust Income Tax and Information Return. MEBCO argues:

“These plans are established to provide qualifying health and welfare benefits, within a fixed contribution schedule, not to pay unnecessary professional fees.”

MEBCO recommends that no wind-up of existing HWTs be required and that the only conditions for conversion should be to require any amendments to trust and other governance documents that are necessary to avoid any conflict with ELHT rules. MEBCO recommends a curing period of five years to allow HWTs sufficient time to make any changes necessary to avoid conflicts with ELHT rules.

MEBCO also addresses a number of concerns regarding current ELHT rules, including MEP qualifications. The current ITA provision adopts the same test as applicable to specified multi-employer pension plans (SMEPPs), requiring the following conditions to be met.

- No more than 95% of beneficiaries can be employed by a single employer or a related group of employers.
- At least 15 employers must contribute to the trust, or at least 10% of beneficiaries will be employed in the year by more than one participating employer.
- Employers must contribute pursuant to a collective agreement with a contribution rate that does not vary based on the financial experience of the plan.
- Contributions must be determined by reference to a number of hours worked or other measures specific to each employee.

MEBCO argues that these SMEPP conditions are not relevant and should not be imposed with respect to ELHTs. MEBCO recommends that the MEP rules be extended to any contribution made pursuant to a collective bargaining agreement or other participation agreement where the contribution is based on a measure specific to the employee.

**Key Differences for ELHTs**

While we highlight some of the key differences in the rules, the primary eligibility conditions for ELHTs are the same as the HWT requirements. Generally speaking, if an HWT has been administered in compliance with CRA administrative rules, it likely will qualify as an ELHT under the existing rules.

Where the ELHT rules differ, they generally are more favourable to employee benefit plans, particularly to qualifying multi-employer benefit plans. Some of the advantages of the ELHT regime include the following.

**Clear Ability to Prefund Benefit Liabilities on a Tax-Deductible Basis**

For qualifying multi-employer ELHTs, all contributions remitted by employers pursuant to a collective agreement are permissible and deductible without limit. For single em-
employer plans, contributions to an ELHT in excess of amounts required to fund benefits in the current year are deductible by the employer in subsequent tax years. Also, though it will not be deductible, there can be funding by way of promissory notes. Alternatively, contributions based on actuarial advice with respect to annual benefit costs are deductible.

This is in contrast to the HWT folio surplus restrictions for HWTs, which may have disqualified all collectively bargained plans and did not clearly permit funding benefit liabilities on an actuarial basis.

No Restrictions on Surplus Accumulations or on Deductions for MEP Contributions

There are no surplus rules for ELHTs. Contributions to MEPs are permissible and deductible, provided that the contributions are made pursuant to a collective agreement, the contributions comply with a negotiated contribution formula that does not vary based on the financial experience of the trust, and the contributions are based on the number of hours an individual works or some other measure specific to the employee.

In contrast, the HWT folio made no accommodation for multi-employer plans where contributions were fixed by a collective agreement, and they could not be altered based on the financial experience of the trust. Under the HWT folio, an HWT that maintains a permanent surplus or that generated a surplus because of the terms of its funding mechanism may be disqualified as an HWT and/or could be denied deductions for contributions.

Ability to Deduct the Cost of All Benefits From the Taxable Income of the Trust

In addition to deductions for reasonable administrative expenses, an ELHT also may deduct the cost of all benefits paid during the year from taxable income. In contrast, HWTs are only permitted to deduct the cost of taxable benefits paid from the trust.

Ability to Carry Forward and Back Noncapital Losses for Three Years

Administratively, CRA has denied HWTs the ability to claim a loss and carry back or carry forward any noncapital loss generated where expenses exceed income. In contrast, for an ELHT, if expenses (including all eligible benefits and reasonable administrative expenses) exceed income in a year, the excess is treated as a noncapital loss that may be carried back or forward for three years. In the majority of circumstances, these rules should allow ELHTs to avoid income tax.

Tax-Free Transfers Between ELHTs

ELHT rules explicitly allow for tax-free transfers between ELHTs. CRA policy does not permit or contemplate transfers between HWTs. CRA has been reluctant to confirm that such transfers are permissible.

Next Steps

HWT trustees do not need to take any immediate action as a result of the announcement and generally should wait to see the transitional rules before taking any steps. Trustees should consult their professional advisors and consider where any administrative or governance changes may be required to comply with ELHT rules. Submissions on issues of importance were accepted during the consultation period that ended on June 29, 2018. It is not expected that the Department of Finance and/or CRA will release draft transitional rules prior to reviewing submissions and engaging in an informal consultation process.

Endnote

1. The announcement was included in the “Tax Measures: Supplementary Information” document released with the budget (see page 28).