THE CANADIAN
BAR ASSOCIATION
L'ASSOCIATION DU
BARREAU CANADIEN

June 7, 2010

Alexandra MacLean
Senior Chief
Tax Legislation Division
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Ms. MacLean:

Re: *Income Tax Act* amendments to Accommodate Employee Life and Health Trusts

I am writing on behalf of the National Pension and Benefits Law Section of the Canadian Bar Association (CBA Section), in regard to proposed *Income Tax Act* (Canada) (ITA) amendments to accommodate employee life and health trusts (ELHTs). The CBA is a national association of over 37,000 members, and our mandate includes improvement in the law and the administration of justice. The CBA Section includes lawyers practicing in different aspects of this area of law from across the country.

The CBA Section appreciates the federal government's initiative to codify and potentially expand the ability of employers and employees to establish new vehicles to deliver group benefits, including post-retirement health and welfare benefits (PRBs). We are pleased to offer comments on the proposed revisions to the ITA in respect of employee life and health trusts.

Deductibility of contributions

The CBA Section is concerned with the deduction provisions set out in paragraphs 144.1 (3) and (4) of the proposed ELHT amendments. These provisions would limit deductions for the year to "the amount [that] may reasonably be regarded as having been contributed to fund designated employee benefits payable in the year." They would permit deduction in future years "in which the related designated employee benefits become payable" to the extent that the contribution in the current year exceeds the amount required to fund the benefits paid in the current year. That approach to deductibility of contributions raises several issues:

1. The proposed limitation on deductibility would be particularly problematic for any multi-employer ELHTs established after 2009. Employer contributions in such arrangements are typically based on a dollar amount per hour worked by an employee, at a rate negotiated between employers and unions and fixed pursuant to a Collective Agreement. Consequently, and for any benefit insurance arrangement, there is no direct link between the contributions required and the benefits paid out in the given year. For some plan members, the benefits payable in a year (or even subsequent years, as would be the case for

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continuing disability payments) would exceed the contributions made in that year. Other members may not receive any benefits at all. Due to the mobile nature of employment, the task of monitoring the employer for which an employee works when the employee submits claims would be difficult and likely very costly. Further, a given employer's ability to take a deduction in a future year for contributions to any ELHT made some years prior may be lost if that employer were to cease participation in a multi-employer ELHT, simply because of practical administration issues. As a minimum, employers in a multi-employer ELHT should be permitted to deduct against income in the year the full amount required to be contributed, where such amounts are contractually fixed through the collective bargaining process.

2. In the CBA Section's view, the deduction provisions would also be problematic in that they limit proper funding of long-term disability and other benefits that may have longer than a one year payout period. The proposed deductibility provisions appear consistent with Finance Canada's position on this matter, at least with respect to long-term disability benefits, as that particular issue has been the subject of some recent scrutiny.

   However, the CBA Section does not support the current approach. To provide adequate funding for long-term disability and other continuing benefits, suitable reserves must be established to support the promised benefit payout period. In addition to providing greater security to those receiving long-term disability and other ongoing benefits, establishing a reserve would be consistent with the way such benefits are provided through insured arrangements. Indeed, an ELHT can simply use its funds to pay premiums for insurance coverage, and the cost of such premiums would be deductible to participating employers. As the cost of such premiums would presumably include a reserve component, we see no reason for an ELHT to be treated differently from a tax perspective if it aims to self-fund long-term disability and other benefits that provide recurring payments, provided that any necessary contributions are actuarially justified.

3. Although the proposed ITA amendments for ELHTs specifically acknowledge coverage for retirees, the CBA Section's concern about PRBs is similar to the issues discussed above concerning long-term disability benefits. Under the current ITA regime it is not possible to pre-fund for PRBs in a tax effective manner, despite the fact that changes to the accounting rules require organizations to account for their future obligations with respect to PRBs. There are several reasons to support pre-funding of PRBs, not the least of which is added security for retirees who could be negatively affected in the event of an employer insolvency. As such, if the deduction of contributions to ELT were matched to the accrual of liability with respect to PRBs (with such liability being actuarially established) the CBA Section believes that pre-funding of post-retirement benefits could be permitted in a reasonable manner.

In light of these shortcomings, the CBA Section recommends that the proposed deduction provisions be re-drafted to reflect that the benefits ultimately provided by contribution to the ELHT are intended to provide "insurance" coverage on both an annual and ongoing basis. This would recognize the actual nature of the benefits and allow greater flexibility for an ELHT to choose between well-funded arrangements and the purchase of insured coverage.

Tax treatment of ELHTs

The purported tax treatment of ELHTs also raises concerns. To provide benefits such as short and long-term disability coverage and benefits for future retirees, a multi-employer ELHT would typically receive contributions from employers and then invest those contributions to provide adequate funding for future promised benefits. If the investment income of an ELHT is subject to tax, as currently proposed, the assets available for benefits could be reduced. The CBA Section recommends that the investment income be exempt from taxation in a manner similar to the exemption of investment income for registered pension plans. The rationale for doing so is also similar to that applicable to registered pension plans in that the income earned is intended to provide funding for future promised benefits.

Existing health and welfare trusts

The proposed ITA amendments for ELHTs apply only to trusts established after 2009. However, numerous health and welfare trusts have been established pursuant to Interpretation Bulletin 85R2 (IT-85R2). IT-85R2 has been refined over the years by a series of Technical Interpretations issued by the Canada Revenue Agency. As a result, and in the absence until now of any governing legislation, there is likely to be a wide array of approaches to such health and welfare trusts taken across Canada. Some health and welfare trusts could potentially benefit from a switch to an ELHT structure. However, no transition rules have been provided in the proposed ITA amendments, nor has there been any statement from the Department of Finance as to the future of existing health and welfare trusts. Accordingly, the CBA Section encourages the Department of Finance to address what we view as necessary transitional provisions.

Post-retirement benefits – broader issues

The CBA Section wrote to the Ministry of Finance on August 7, 2009 (a copy of our letter is attached) with respect to pre-funding of PRBs. Although the introduction of ELHTs through the proposed ITA amendments goes some distance to addressing the CBA Section's concerns, they do not go far enough. Media coverage has suggested that the ELHT concept was developed as a specific response to arrangements in support of continued operation of certain industries that confronted extreme financial difficulty following the economic downturn in 2008. Although ELHTs may provide a vehicle for the funding of benefits, including PRBs, with broader applicability, the CBA Section is concerned about the general inability of organizations in Canada to pre-fund PRBs in a tax effective manner, especially in a single-employer environment. The creation of ELHTs, on their own, is unlikely to halt organizations wishing to amend or terminate their PRB plans, especially given the current ELHT deduction restrictions. The CBA Section therefore suggests that Finance Canada engage in broader consultation on the issue of funding of pre-retirement benefits. We would be pleased to be involved in such extended consultation.

Thank you for considering our views.

Yours truly,

(original signed by Gaylene Schellenberg for Hugh Wright)

Hugh Wright
Chair, National Pensions and Benefits Law Section

Enclosure

THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

August 7, 2009

The Hon. James M. Flaherty, P.C., M.P.
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Minister,

Re: Pre-funding post-retirement benefits

I am writing on behalf of the National Pension and Benefits Law Section of the Canadian Bar Association (CBA Section) to urge you to consider a more tax effective way for employers to pre-fund post-retirement health and welfare benefits (PRBs). The CBA is a national association of over 37,000 members, and our mandate includes improvement in the law and the administration of justice. The CBA Section includes approximately 600 lawyers from across the country practising different aspects of pension and benefits law.

The CBA Section is concerned by the general inability of organizations in Canada to pre-fund PRBs in a tax effective manner, particularly given existing constraints under the *Income Tax Act* (Canada) (ITA) and the administrative policies of the Canada Revenue Agency with respect to health and welfare trusts that militate against pre-funding. ITA amendments are required, and for policy reasons, tax effective pre-funding of PRBs should be available to all employers and not limited to any particular sector.

Some factors that call for immediate attention to the issue include:

- increasing costs of PRBs, in part driven by rising health care costs combined with the erosion of provincial medicare coverage;
- changes to accounting rules requiring disclosure of liabilities with respect to PRB obligations;
- increasing number of retirees;
- limited options to discharge PRB obligations, especially in contrast to pension benefits which can, for example, be annuitized;
- negative impact of PRB obligations on the ongoing operations of industries facing economic challenges (e.g. manufacturing); and

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- need for a more level playing field with employers in the United States, who can reduce the costs and accounting impact of PRB liabilities through the establishment of Voluntary Employees' Beneficiary Associations (VEBA).

Employers' inability to pre-fund for PRBs in a tax effective manner has already led to organizations amending or even terminating their PRB plans to manage costs and accounting liabilities. The amendment or termination of PRB plans will have negative implications for current and future retirees and may lead to costly and time-consuming litigation.

The CBA Section would be pleased to be involved in any consultations you may arrange in connection with this issue, and to provide written comments on any proposed changes to the ITA to address the funding of health and welfare benefits.
Thank you for considering our views.

Yours truly,

(Original signed by Gaylene Schellenberg for Barbara Austin)

Barbara Austin
Chair, National Pension and Benefits Law Section