July 31, 2019

Via email: hwt-consultation-fsbe@canada.ca

Lori Merrigan and Andrew Donelle
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5

Dear Ms. Merrigan and Mr. Donelle:

Re: Draft Legislative Proposals Supporting the Conversion of Health and Welfare Trusts to Employee Life and Health Trusts

The Canadian Bar Association Pension and Benefits Law Section (CBA Section) is pleased to comment on Finance Canada's Draft Legislative Proposals Supporting the Conversion of Health and Welfare Trusts (HWTs) to Employee Life and Health Trusts (ELHTs).[1] Finance Canada's proposals, including a backgrounder, draft legislation and explanatory notes, (collectively, the proposals) facilitate the conversion of existing HWTs to ELHTs and amend some existing ELHT rules under section 144.1 of the *Income Tax Act* (ITA). The CBA Section previously commented on the initial 2018 Federal Budget proposal to discontinue Canada Revenue Agency (CRA) administrative positions on HWTs in favour of the ELHT rules in section 144.1 of the ITA.[2]

The CBA is a national association of 36,000 members, including lawyers, notaries, academics and students across Canada, with a mandate to seek improvements in the law and the administration of justice. The CBA Section contributes to national policy, reviews developing pensions and benefits legislation and promotes harmonization. Our members are involved in all aspects of pensions and benefits law, including counsel who advise pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

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1 Department of Finance, Department of Finance Releases Draft Legislative Proposals Supporting the Conversion of Health and Welfare Trusts.

2 Canadian Bar Association, Discontinuing CRA Administrative Positions on Health and Welfare Trusts, 2018.

The CBA Section generally supports the proposals. We commend Finance Canada for protecting the beneficiaries of HWTs by minimizing the tax and administrative burden for converting to an ELHT. We are also pleased that Finance Canada has acknowledged the wide array of existing HWT arrangements and proposed legislative amendments allowing those arrangements to continue to operate in a similar way under ELHT rules. Below, we offer suggestions on certain transitional aspects of the proposals and the specific legislative changes proposed.

Draft Legislation does not Expressly Address Continuation of an HWT as an ELHT

According to the backgrounder, existing HWTs will be permitted to elect to continue as ELHTs without adverse tax consequences and without having to create a new trust, if CRA is notified in accordance with prescribed requirements. Alternatively, the proposals allow for a tax-free rollover of assets from an existing HWT to a new ELHT.

Many HWTs could satisfy the ELHT requirements under section 144.1 of the ITA once the rule prohibiting trusts established before 2010 from qualifying as ELHTs is removed, or will be able to satisfy the requirements with minor modifications to their trust agreements so that a transfer to a new trust is not necessary. Although the backgrounder states that HWTs may continue as ELHTs without having to create a new trust, the draft legislation does not expressly provide for these trusts to elect to be ELHTs or for the prescribing of regulations to govern such an election.

Draft subsections 144.1(14) and 144.1(15) specify that certain collectively bargained HWTs may elect to become "deemed" ELHTs for a limited time.[3] According to the explanatory notes, the deeming rule would allow HWTs established under collective agreements that generally comply with most ELHT requirements to be deemed to be ELHTs until the changes required to make them fully compliant with the ELHT rules can be negotiated. These deemed ELHT rules do not include a mechanism for non-collectively bargained trusts, or collectively bargained trusts established prior to 2010 that already meet the ELHT requirements, to convert to ELHT status.

One interpretation of the draft legislation is that a trust that otherwise meets the ELHT requirements under section 144.1 of the ITA, but has been operating as an HWT because it was established prior to 2010 or is non-resident, will immediately and automatically qualify as an ELHT when the ITA is amended to remove the requirement that an ELHT be established after 2009 or to permit certain non-resident employee benefit trusts that have Canadian beneficiaries to be ELHTs. If this is the intent, it is unclear why the backgrounder indicates that an HWT must notify CRA in prescribed form of its election to continue as an ELHT, unless the intent of the word "notify" is that the trust will identify itself as an ELHT when it files its next T3.

We recommend clarifying in the draft legislation (or at least in the explanatory notes) how an HWT will elect to continue as an ELHT and notify CRA of its election.

Deadline for Conversion

The proposals set a fixed deadline for an HWT to convert to an ELHT, after which the trust will be subject to tax rules for an Employee Benefit Plan (EBP): either January 1, 2021 or the extended deadline under the deeming rules ending no later than December 31, 2022. We urge Finance Canada to set dates for conversion and end dates for deemed ELHT status only after the supporting

3 These deemed ELHT rules apply only to trusts under which the contributions are determined pursuant to a collective bargaining agreement.

amendments to the ITA come into effect. Restructuring trusteed arrangements cannot begin until all plan sponsors, trustees and other interested parties have confirmation of the final rules.

As we have previously stated,[4] trusteed benefit programs are often complex involving multiple stakeholders and both unionized and non-unionized members, often under the same trust. We anticipate many programs will need more time to determine appropriate future arrangements and complete necessary restructuring. We continue to recommend a minimum three-year transition period for all trusteed programs from the date the final supporting changes to the ITA come into force. We also continue to recommend extending this period to deal with collective bargaining cycles (i.e. three years from the last renewal date following the date the rules are finalized).

Deemed Trust Election

The proposals confirm that to qualify for deemed ELHT status, a trust must elect in prescribed form and manner that subsection 144.1(15) applies as of a particular date "after 2018". The backgrounder confirms that for the 2019 taxation year, the requirement to "file in prescribed form and manner" means that CRA should be notified of the election to be an ELHT in a letter included with the T3 Trust Income Tax and Information Return.

It is unclear from the backgrounder whether existing trusts must file an election for the 2019 taxation year to qualify for deemed ELHT status, or whether an election must be filed only for the period following the end of 2020. We recommend that Finance Canada give guidance on the latest date on which an existing trust must file with CRA to avoid initial EBP status and take advantage of the deemed ELHT status rules. We also recommend that the deadline for filing an election to be a deemed ELHT be set after the legislative changes are final, with at least a three-year transition period.

Composition of the Board of Trustees – Paragraph 144.1(2)(i)

Subsection 144.1(2) of the ITA lists the requirements that an ELHT must meet to be considered an ELHT throughout a taxation year. Paragraph 144.1(2)(i) currently requires that representatives of one or more participating employers must not constitute the majority of the trustees of the trust or otherwise control the trust. The proposals set out that this paragraph will be replaced by a requirement that a majority of trustees must deal at arm's length with each participating employer.

The CBA Section is pleased that the proposals recognize the concern of many HWTs that boards consisting entirely of employer-appointed trustees, or entirely of trustees appointed by an employer association, may not meet the current governance requirement for ELHTs. However, many multi-employer HWT boards are composed of equal numbers of union-appointed and employer-appointed trustees (50-50 Boards). Given their composition, 50-50 Boards should automatically be considered independent from the participating employers. We suggest that paragraph 144.1(2)(i) be revised to state: "Trustees that do not deal at arm's length with each participating employer must not constitute the majority of the trustees of the trust".

Non-Resident Trusts – Paragraph 144.1 (2)(c)

The CBA Section is pleased that proposed subparagraph 144.1(2)(c)(ii) will allow certain non-resident trusts that apply to employees resident in both Canada and another country to qualify as ELHTs, but is concerned that some of these trusts may not qualify as ELHTs if other conditions in

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[4] *Supra* note 2.

subsection 144.1(2) are not met with respect to non-Canadian beneficiaries. The laws of the jurisdiction in which a trust resides may allow it to provide benefits in addition to "designated employee benefits" to non-Canadian participants, or to provide benefits to individuals connected to employee participants who do not qualify as eligible beneficiaries under paragraph 144.1(2)(d), such as former spouses. For example, we understand that American law allows Voluntary Employees' Benefit Association (VEBA) trusts to provide a death benefit and also to provide benefits to former spouses of participating employees. In other respects, VEBAs are very similar to ELHTs. Under the draft legislation, a non-resident trust that complies with subparagraph 144.1(2)(c)(ii) would still need to meet all other requirements in subsection 144.1(2) even in relation to benefits provided to non-Canadian beneficiaries.

We recommend that subsection 144.1(2) be revised so that non-resident trusts that meet the requirements of subparagraph 144.1(2)(c)(ii) and have substantially similar objects to an ELHT (i.e., are organized to provide employee benefits substantially similar to "designated employee benefits" as defined in subsection 144.1(1)) will qualify as ELHTs as long as they comply with all requirements of subsection 144.1(2) with respect to Canadian beneficiaries.

Deductibility – Subsection 144.1(6)

Subsection 144.1(6) of the ITA accommodates the deductibility of employer contributions to ELHTs that meet certain conditions. It is currently framed in terms of deductibility for multi-employer plans. The proposed replacement removes the multi-employer plan test and reframes the deductibility in terms of collectively bargained trusts.

The CBA Section is pleased that participating employers in many collectively bargained trusts that do not meet the current requirements could meet the requirements for the deductibility provisions under subsection 144.1(6) of the ITA. We also believe that the same deductibility rules should be available to employers participating in non-collectively bargained multi-employer trusts where the employers are contractually bound to pay a set contribution rate. Generally, those contributions are set by an employer association based on actuarial determination of the contribution required to fund the benefits. In turn, the participating employers must make contributions to the trust at the contractually required rate (e.g. a set rate of $ per hour worked). Employers participating in non-collectively bargained multi-employer trusts must, like those participating in a collectively bargained multi-employer trust, make contributions to the trust at the contractually required rate, irrespective of the financial experience of the trust.

We recommend that subsection 144.1(6) be extended to apply to employers participating in non-collectively bargained multi-employer trusts where set contributions are made to the trust under a participation agreement. The CBA Section suggests that this be accomplished by replacing the phrase "or a participation agreement in respect of the collective bargaining agreement" under the proposed paragraph 144.1(6)(a) with the phrase "or a participation agreement".

Mergers – Subsection 144.1(16)

The explanatory notes say that new subsection 144.1(16) of the ITA is designed to permit the transfer of property on a tax-deferred basis, where the Minister has been notified in prescribed form, from "a trust that provides employee benefits substantially all of which are designated employee benefits" (ie an HWT), to an ELHT or "another trust that provides employee benefits substantially all of which are designated employee benefits". According to the explanatory notes, the purpose of the new subsection is to permit the merger of one or more HWTs that choose to continue as an ELHT. Presumably, the subsection is also designed to permit a tax deferred rollover of assets from an HWT to an ELHT if the administrator of an HWT determines it is necessary or desirable to create a new ELHT rather than continue the HWT as an ELHT.

However, the wording of proposed subsection 144.1(16) refers only to a transfer of property from a trust that provides employee benefits substantially all of which are designated employee benefits to an ELHT. It does not refer to the transfer of property from a trust that provides employee benefits substantially all of which are designated employee benefits to another trust that provides employee benefits substantially all of which are designated employee benefits. The wording of new subsection 144.1(16) does not appear to address the merger of HWTs as indicated in the explanatory notes.

We recommend that proposed subsection 144.1(16) be amended so that a "receiving trust" includes both an ELHT and another trust that provides employee benefits substantially all of which are designated employee benefits.

Prohibited Investments – Subsection 207.9(1)

Proposed subsection 207.9(1) introduces a special tax for the acquisition of prohibited investments and related income and capital gains. It is not clear from the definitions in the proposed subsection whether a prohibited investment in a participating employer, or in a person or partnership that does not deal at arm's length with a participating employer, is limited to direct investments made by the trustees of the ELHT or extends to indirect investments made by a pooled fund arrangement in which the ELHT is invested.

Although a pooled fund must be invested in accordance with its investment policy or mandate, the specific investments made by a pooled fund change from time to time and are entirely outside of the control of its investors. A prohibited investment under proposed subsection 207.9(1) of the ITA should not extend to pooled fund investments, and we recommend that Finance Canada clarify this in the explanatory notes.

Subsection 207.9(1) is proposed to apply to 2014 and subsequent taxation years. We recommend that Finance Canada clarify how the retroactive date will apply in the explanatory notes. For example, will it apply during the "deeming" period and does CRA intend to go back and review potential tax on existing ELHTs?

Consequences of being an EBP/Revised Definition of EBP

The backgrounder states that an HWT that is not converted to an ELHT (or wound up) by the end of 2020 will generally be an EBP. For this determination, Finance Canada proposes an amendment to the definition of EBP in subsection 248(1) of the ITA. Under the proposed paragraph 248(1)(a.1), an EBP would not include any portion of an arrangement that is a plan (other than a plan that is administered or provided by a trust) that is a group sickness or accident insurance plan (GSAIP), a group term life insurance policy (GTLIP) or a private health services plan (PHSP). Put differently, the proposed EBP definition excludes a portion of an arrangement that is a GSAIP, GTLIP or PHSP <u>except if "the plan is administered or provided by a trust"</u>.

The backgrounder indicates that, because an HWT that is not converted to an ELHT or wound up by the end of 2020 will generally be an EBP, designated employee benefits offered to an employee will continue to be taxed in generally the same manner as if the benefits were provided through an HWT or an ELHT. We are concerned that under the proposed definition of EBP, the tax nature of a GSAIP, a GTLIP or a PHSP may be lost with respect to designated employee benefits simply because a trust is interposed.

There are a number of differences between how benefits are taxed under an EBP and how they are taxed under a GSAIP, a GTLIP or a PHSP. If the GSAIP, GTLIP and PHSP tax treatment of designated employee benefits is lost, an employer whose HWT cannot be converted to an ELHT, and who wishes to preserve the tax nature of the benefits, may be forced to terminate the trust and offer the GSAIP, GTLIP or PHSP directly. The employer would have to do this in order to be able to do directly what it could not do indirectly.

The taxation of benefits under an EBP, GSAIP, GTLIP, and the proposed change to the definition of EBP, are discussed in more detail in Appendix A to this letter.

Although a trust may be dealt with as an EBP trust, we believe the benefits paid to beneficiaries from the trust should be dealt with, not as EBP benefits, but rather, as benefits provided under a GSAIP, a GTLIP, or a PHSP. The characterization as an EBP should determine how the trust is to be taxed, but not the tax treatment of the benefits themselves.

We trust that our comments are helpful and would be pleased to offer further clarification.

Yours truly,

(original letter signed by Nadia Sayed for Sonia Mak)

Sonia Mak
Chair, CBA Pensions and Benefits Law Section

Appendix A

Taxation of EBP, GSAIP, GTLIP and PHSP Contributions and Benefits

Taxation of a payment under an EBP is different from taxation of a benefit under a GSAIP, GTLIP or PHSP.[5] For EBPs:

- Contributions are not taken into income by the employee. (See clause 6(1)(a)(ii).)
- Amounts received constitute employment income, except for a death benefit.
- A death benefit, defined at subsection 248(1) as an amount received after the death of an employee in recognition of the employee's service in an office or employment minus up to $10,000 where the recipient taxpayer is the employee's surviving spouse or common-law partner, is taxed to the recipient. (See paragraph 6(1)(g) and clause 56(1)(a)(iii), and paragraphs 6 and 7 of IT-502 *Employee Benefit Plans and Employee Trusts*.)

In contrast:

- Employer contributions to a GSAIP or a PHSP are excluded from the employee's income, and employer contributions to a GSAIP are included in the employee's income only to the extent that the contributions are not in respect of a benefit payable on a periodic basis. (See clause 6(1)(a)(i) and subsection 6(e.1), and paragraph 1.33 of the HWT Folio.)
- Periodic benefits paid under a "sickness or accident insurance plan", a "disability insurance plan" or an "income maintenance insurance plan" (which are not defined but can be taken to refer to GSAIP benefits) to which an employer contributes, are included in income when received. (See paragraph 1.34 of the HWT Folio.)
- Coverage of an employee during a year under a GTLIP generates an income inclusion equal to the term insurance and prepaid benefits for the year. (See subsection 6(4), and sections 2701, 2702 and 2703 of the regulations.)
- Benefits paid under a PHSP are not taxable to the employee. (See paragraph 1.35 of the HWT Folio.)

A GSAIP or a PHSP may be insured or self-insured, a GTLIP may only be insured, and all may be provided <u>directly</u> by an employer, or <u>indirectly</u> by one or more employers through a trust.

Direct arrangements (insured and self-insured)

Where an <u>insured</u> GSAIP, PHSP or GTLIP is provided directly:

- The employer enters into the insurance contract and remits contributions in the form of premiums to the insurance company, which is engaged by the employer to pay GSAIP, GTLIP or PHSP benefits.
- Once the contributions are remitted, they belong to the insurance company which then owes a debt. The insurance company is the debtor, the employer is the creditor, and the insurance company owes GSAIP, GTLIP or PHSP benefits to the employees.

Where a <u>self-insured</u> GSAIP or PHSP is provided directly, the employer adjudicates and pays GSAIP or PHSP benefits itself. However, typically the employer engages an insurance company, resulting in:

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[5] For the sake of brevity and simplicity this discussion assumes that no employee contributions are made.

- The insurance company adjudicating and paying GSAIP or PHSP benefits on the employer's behalf (pursuant to what is commonly referred to as an Administrative Services Only or ASO contract), as the employer's paying agent.
- A reconciliation method being used to deal with the fact that contributions may be more or less than what is actually required to pay the benefits.

Pursuant to the revised definition of EBP, since there is no trust there is no question of GSAIP, GTLIP or PHSP benefits being characterized as EBP benefits.

Indirect arrangements (insured and self-insured)

Where a trust is interposed between the employer (or employers) and the insurance company:

- The trustees collect the contributions in respect of the GSAIP, GTLIP or PHSP, and enter into the insurance contract.
- While the contributions are in the trust, the trustees have legal title to them.
- The trustees remit the contributions (in the form of premiums) to the insurance company.
- Once the contributions are remitted, they belong to the insurance company which then owes a debt. The insurance company is the debtor, the trust is the creditor, and the insurance company owes GSAIP, GTLIP or PHSP benefits to the employees.

Where an <u>insured</u> GSAIP, PHSP or GTLIP is provided indirectly:

- The trustees enter into the insurance contracts and remit the contributions (in the form of premiums) to the insurance company engaged by the trustees to pay GSAIP, GTLIP or PHSP benefits.
- Once the contributions are remitted, they belong to the insurance company which then owes a debt. The insurance company is the debtor, the trust is the creditor, and the insurance company owes GSAIP, GTLIP or PHSP benefits to the employees.

Where a <u>self-insured</u> GSAIP or PHSP is provided indirectly, the trustees adjudicate and pay GSAIP or PHSP benefits. However, typically the trustees engage an insurance company, resulting in:

- The insurance company adjudicating and paying GSAIP or PHSP benefits on the trustees' behalf pursuant to an ASO contract as the trustees' paying agent.
- A reconciliation method being used to deal with the fact that contributions may be more or less than what is actually required to pay the benefits.

Pursuant to the revised definition of EBP, since there is a trust GSAIP, GTLIP or PHSP benefits may be characterized as EBP benefits. We recommend that the characterization as an EBP come into play in determining how the trust is taxed, but not how the benefits themselves are taxed.