

Canadian Health Insurance Tax Guide

Employee Life and Health Trusts

September 2021



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INTRODUCTION

An employee life and health trust (ELHT) is a vehicle through which an employer provides life and health benefits for its employees. ELHTs are authorized under section 144.1 of the Income Tax Act (ITA).¹ Generally, employers may deduct contributions to an ELHT as long as those contributions are reasonable business expenses. Employees generally are not taxed on lump sum benefits paid from

¹ Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.

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such plans, but are taxed on benefits paid on a periodic basis (like disability income insurance plan benefits) where the employer has contributed to the plan.²

Currently, employer contributions are not taxed to employees, except for the following

- employer contributions to group term life insurance plans,³
- employer contributions to group sickness and accident insurance plans (GSAIPs) where the benefits paid from such plans are tax-free,⁴ and
- in Quebec, employees must report on their provincial, not federal, tax returns employer contributions to the above plans, and to private health services plans (PHSPs).

Before the February 27, 2018 Federal Budget, employers could choose to provide employee life and health benefits through an ELHT or a Health and Welfare Trust (HWT). Following the Federal Budget of February 27, 2018, and pursuant to proposed legislation released on May 27, 2019 and November 20, 2020 (the proposed amendments), no new HWTs may be established after February 27, 2018. Existing HWTs had to be wound down, transition to become ELHTs, or transfer their assets to new ELHTs by December 31, 2020. This date was later extended to December 31, 2021.⁵ HWTs, where contributions have been determined by a collective bargaining agreement, may elect to be treated as ELHTs, and transition to ELHTs before December 31, 2022. This deadline has not been changed.

WHY ELHTS HAVE BEEN ADDED TO THE ITA

Provide more certainty in the rules governing the delivery of employee benefits through trusts. Before section 144.1 became law, employers could provide life and health benefits for their

² ITA paragraph 6(1)(f).

³ ITA subsection 6(4).

⁴ ITA paragraph 6(1)(e.1).

⁵ Department of Finance Draft Legislative Proposals for Employee Life and Health Trusts, at <https://www.canada.ca/en/department-finance/news/2020/11/draft-legislative-proposals-for-employee-life-and-health-trusts.html>.

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employees through HWTs. The rules governing HWTs were not part of the Income Tax Act (ITA), but were instead based on Canada Revenue Agency (CRA) guidance that the CRA could change, withdraw or choose not to follow.⁶ The rules governing ELHTs are part of the ITA, and can be changed only by an Act of Parliament. The ELHT rules therefore provide a more certain foundation for employee benefits plans than those which governed HWTs.

Reduce the generosity of tax-assisted benefits for business owners and highly compensated employees. The rules governing ELHTs discourage plans that disproportionately benefit business owners and highly compensated employees.

Discourage offshore trusts and tax avoidance schemes. An HWT could have been resident in a different country from Canada without significant restrictions. An ELHT must be resident in Canada, unless it meets certain requirements (discussed below under "Residency Requirements").

REASONS WHY AN EMPLOYER WOULD WANT TO CREATE AN ELHT

Apart from providing employee life and health benefits, an employer could have several reasons for creating an ELHT:

To relieve the employer of responsibility for administering the plan to provide employee life and health benefits. With an ELHT the employer is responsible only for making contributions to the trust; the trustee is responsible for providing the promised benefits.

- To relieve the employer of responsibility for administering the plan to provide employee life and health benefits.

⁶ The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the Income Tax Act and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

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- With an ELHT the employer is responsible only for making contributions to the trust; the trustee is responsible for providing the promised benefits.
- To rely on an expert's skills to administer the plan.
- A trustee may be better equipped to run the plan.
- Lack of time and resources.
- Administering the plan may consume too much of the employer's resources.
- Claims adjudication.
- The trustee adjudicates claims, thereby removing any taint of bias, and allowing the plan to use the trustee's expertise.
- Tax efficiency.
- As discussed below, the employer's contributions are tax deductible in the year made, even if those contributions provide no benefit to employees until a later year.
- An employer's contributions are not taxable income to employees.⁷ There are three exceptions to this rule.
- Contributions paid to provide GSAIP benefits where any GSAIP benefits are paid to employees tax-free. Generally, this means that contributions made to pay premiums for critical illness insurance (CII) and income-style long-term care insurance (LTCI) coverage will be taxable to employees.
- Premiums paid for group term life insurance policies are treated as income to employees.
- All contributions an employer makes to an ELHT for employees living in Quebec are treated as income that the employees must report on their provincial (not federal) tax returns. Throughout Canada, benefits paid from an ELHT are not taxable, except disability income benefits paid on a periodic basis where the employer has contributed to any part of the benefit.
- Common administration.
- An employer can have all the life and health benefits it provides administered using one vehicle.
- Greater security for employees.

⁷ ITA paragraph 6(1)(e.1).

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- Once an employer makes a contribution to an ELHT it cannot get its money back. Any money in an ELHT must be spent solely to provide designated employee benefits for the plan beneficiaries, according to the trust language and ITA subsection 144.1(2). If the employer suffers a financial reversal, money in the trust generally is not subject to the claims of the employer's creditors.
- The employee relies on the trustee's judgment as to whether a claim should be paid, not the employer's.

REQUIREMENTS FOR CREATING AN ELHT

GENERAL

The ELHT rules apply to all trusts created after 2009 that satisfy the ELHT rules. ITA subsection 144.1(2) contains the requirements that a trust must meet to be considered an ELHT. A trust that fails to qualify as an ELHT will be treated as an employee benefit trust (EBT), with less beneficial tax treatment for the parties. Proposed amendments to the ELHT rules originally announced on May 27, 2018 apply retroactively to February 27, 2018, the date of the 2018 Federal Budget.

SPECIFIC REQUIREMENTS FOR CREATING AN ELHT

ITA subsection 144.1(2) sets out the specific requirements for creating an ELHT. We discuss those requirements below.

WHO MAY BE A BENEFICIARY OF AN ELHT

An ELHT's only purpose is to provide "designated employee benefits" for the following people:

- Employees of a participating employer or former participating employer,⁸

⁸ Throughout this article we will use the term, "employer" to mean a "participating employer or former participating employer" unless stated otherwise.

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- Individuals who are, while the employee is alive, or who were at the employee's death:
- Their spouses or common law partners, and
- People who are related to the employee, and are either a member of the employee's household or are dependent on the employee for support,⁹ and
- Her Majesty in right of Canada or a province.

The wording in ITA paragraph 144.1(2)(d) is exclusive: "the trust may not have any beneficiaries other than..." those listed above.¹⁰ Appendix A contains a chart summarizing the various beneficiaries who can receive designated employee benefits.

Employees

ITA subsection 144.1(1) defines an "employee" as a current or former employee. A former employee may be someone for whom the employer continues to provide benefits after that person has left, after retiring, for example. An "employee" is also an employee of a business that the employer has acquired, and by so doing may have assumed the former employer's obligations to provide health and welfare benefits for its employees.

Spouse or common law partner

The term "spouse or common law partner" means a person of the same or opposite sex to whom the employee is married or in a common law relationship (same or opposite sex), and the spouse or common law partner of an employee who has died.¹¹

⁹ ITA subsection 144.1(2).

¹⁰ ITA paragraph 144.1(2)(d).

¹¹ ITA clause 144.1(2)(d)(ii)(A).

Related persons

The third class of beneficiaries includes members of the employee's family, whether living with the employee or not. An individual can be a beneficiary if they are "related to the employee" and either "a member of the employee's household" or "dependent on the employee for support".

RELATED

ITA section 144.1 does not define the phrase, "related to the employee", but ITA subsection 251(2) describes "related persons" or "persons related to each other" as "individuals connected by blood relationship, marriage or common-law partnership or adoption." ITA subsection 251(2) applies to the entire Act, and therefore controls who ITA section 144.1 treats as related to the employee.

The phrase, "a member of the employee's household", is not defined in the ITA, but should include family members like children, at least until they leave the employee's home to pursue independent lives as adults.

DEPENDENT

The phrase, "dependent on the employee for support", could apply to children and former spouses not living with the employee (possibly because of marriage breakdown), but still related to the employee, and dependent on the employee for support. The phrase could also include elderly relatives who don't live with the employee but who still depend on the employee for support (like long-term care and medical expenses). Finally, the phrase could include adult children living away from home, but still dependent on the employee because they are pursuing post-secondary education.

ITA section 144.1 does not specify the degree of support needed for someone to be considered "dependent on the employee for support". But the CRA has considered the question in its guidance

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on the medical expense tax credit (METC). We discuss this issue in our article, "The Medical Expense Tax Credit".

To qualify as a dependent according to CRA guidance on the METC, someone must depend on the taxpayer on a regular and consistent basis¹² for the basic necessities of life, such as food, shelter and clothing.¹³ It does not matter whether support is provided voluntarily or pursuant to a legal requirement.¹⁴ A dependent can be dependent on more than one taxpayer.¹⁵ Whether someone depends on another for support is a question of fact in each case.¹⁶

Still considering the METC, ITA subsection 118(6) also defines a dependent as:

- A child or grandchild of the individual or individual's spouse or common law partner.
- A parent, grandparent, brother, sister, uncle, aunt, niece or nephew, if resident in Canada at any time in the year, of the individual or individual's spouse or common law partner.

CRA guidance is helpful, but not binding, and ITA subsection 118(6) applies to dependents under ITA subsection 118(1) with respect to the METC. The courts and the CRA may decide that definitions of a dependent developed to assist in administering the METC do not apply to ELHTs. In particular, since non-resident ELHTs are allowed to provide benefits to non-resident employees, and since it's reasonable to expect such employees to have non-resident dependents, it may not be helpful to rely on guidance developed to interpret a part of the Act that specifically excludes non-residents.

PROVINCIAL LAW

Provincial law also adds some complexity to the question of who is a dependent. For example, Alberta's Adult Interdependent Relationships Act¹⁷ describes and sets rules for common law

¹² CRA Document 2004-0063331E5, May 3, 2004.

¹³ CRA Document 2009-032672117, November 9, 2009.

¹⁴ CRA Document 9725807, May 15, 1998.

¹⁵ Ibid.

¹⁶ Ibid, note 12.

¹⁷ S.A. 2004, c. A-4.5.

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marriages, though the Act uses the term, “adult interdependent relationship”. But the Act also allows people related by blood or adoption to enter into a relationship of interdependence. Since such an arrangement contemplates interdependence between parents and children, and between siblings, it cannot be a common law marriage. Yet, depending on the arrangements they create, parents, children and siblings could owe to each other many if not all of the obligations that common law spouses owe to each other. While provincial law does not control the interpretation of federal statutes, the arrangements contemplated in the Alberta Act recognize the diversity and complexity of the living arrangements people are creating, suggesting the need for an open and generous interpretation of the beneficiary provisions in ITA clause 144.1(2)(d)(ii)(B).

DESIGNATED EMPLOYEE BENEFITS

ITA subsection 144.1(1) confines “designated employee benefits” to those benefits allowed under ITA subparagraph 6(1)(a)(i):

- Group Sickness or Accident Insurance Plans (GSAIP). These include disability insurance, critical illness insurance, some types of long-term care insurance, and accidental death and dismemberment insurance. We discuss GSAIPs in our article, “Group Sickness or Accident Insurance Plans”.
- Group term life insurance policies. We discuss group term life insurance policies in our article, “Group Sickness or Accident Insurance Plans”.
- Private health services plans (PHSP). We discuss PHSPs in our article, “Private Health Services Plans.”

Under the proposed legislative amendments the following additional benefits also will be treated as “designated employee benefits”:

- Counselling services for the mental and physical health of the employee or dependent, or the employee’s re-employment or retirement (see ITA subparagraph 6(1)(a)(iv)), and

- The first \$10,000 of benefit provided on the death of a taxpayer in respect of that taxpayer's employment.¹⁸

A trust that provides benefits other than those listed above will fail to qualify as an ELHT.

CLASSES OF BENEFICIARIES

Under proposed amendments to ITA paragraph 144.1(2)(e) the trust must meet one of the following requirements:

- It must have at least one class of beneficiaries, although it could have more. Each member of a class must have rights under the trust identical to every other member of the class.¹⁹ The beneficiaries in at least one class must represent at least 25% of all beneficiaries of the trust who are employees.²⁰ Either at least 75% of the class cannot be "key employees"²¹ or the trust contributions in respect of key employees who deal at arm's length with the employer are determined in connection with a collective bargaining agreement.²² We discuss key employees later in this article.²³ This latter requirement for trust contributions to have been determined by a collective agreement is new. Otherwise, this requirement has been mostly carried over from the original legislation.
- Alternatively, PHSP benefits for key employees (and their spouse or common-law partner,²⁴ and relatives or dependents of the key employee who are members of the key employee's household) cannot exceed \$2,500 per person.²⁵ This requirement is new.

¹⁸ ITA paragraphs 144.1(1)(d) and (e).

¹⁹ ITA subsection 144.1(1), c.f. "class of beneficiaries".

²⁰ ITA clause 144.1(2)(e)(i)(A).

²¹ ITA subclause 144.1(2)(e)(i)(B)(I).

²² ITA subclause 144.1(2)(e)(i)(B)(II).

²³ ITA subparagraph 144.1(2)(e)(i).

²⁴ ITA clause 144.1(2)(d)(ii)(A).

²⁵ ITA clause 144.1(2)(d)(ii)(B).

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An example may help make the requirements in the first bullet point clearer. Consider ABC, Ltd., a company with 96 employees. 16 of those employees are “key employees”. Half of them are non-owner employees who deal with ABC at arm’s length. The other half are shareholder/employees who do not deal with ABC at arm’s length.

ABC creates an ELHT for its employees with one class of beneficiaries. The members of that class must comprise “at least 25% of all the beneficiaries of the trust who are employees of [ABC]”. If the class contains at least 24 employees, the trust satisfies this requirement. There is no upper limit on the number of beneficiaries a class may have, so the class could comprise all 96 employees.

A second requirement is that “at least 75% of the members of the class are not key employees of [ABC],”²⁶ or alternatively, the contributions to the ELHT in respect the arm’s length key employees in the class are determined in connection with a collective bargaining agreement.²⁷ If the class contains 24 employees, at least 18 of those employees cannot be key employees. That leaves room for only 6 key employees in the class. If ABC wants 7 or more key employees to be part of the class, then it can only do so if ABC’s contributions to the ELHT in respect of the arm’s length key employees in the class are determined by a collective bargaining agreement. At the other extreme, if the class comprises all 96 employees, at least 72 employees in that class cannot be key employees. That leaves room for 24 key employees in the class, more than enough to allow all 16 of ABC’s key employees to be beneficiaries of the trust.

If an ELHT cannot meet the requirements summarized in the first bullet point, and under ITA paragraph 144.1(2)(e)(i), it can still maintain its status as an ELHT by providing a PHSP for all employees (including key employees, and persons included in clauses 144.1(2)(d)(i) and (ii)) with benefits up to \$2,500 per covered person per year,²⁸

With only one class of beneficiaries, the ELHT must offer identical benefits to the key and non-key employees. This could be a problem if ABC wants to provide different benefits for its key employees.

²⁶ ITA subclause 144.1(2)(e)(ii)(B)(I).

²⁷ ITA subclause 144.1(2)(e)(ii)(B)(II).

²⁸ ITA paragraph 144.1(2)(e)(ii)

However, nothing prevents an employer from creating an ELHT with more than one class of beneficiaries. Since only one class has to satisfy the 25% and 75% rules, ABC could create an ELHT with two classes of beneficiaries, one comprising the non-key employees, and the other comprising the key employees. The key employees do not have to have rights identical to the non-key employees', only rights that are "not more advantageous".²⁹

The proposed amendments provide a saving provision under ITA paragraph 144.1(3)(a). An ELHT will not fail to qualify as an ELHT under ITA subparagraphs 144.1(2)(d)(i) or (ii)³⁰ if it is reasonable to conclude that the ELHT trustees neither knew nor ought to have known that benefits were paid to, or trust contributions were made in respect of, persons who could not be an ELHT beneficiary.

NOT MORE ADVANTAGEOUS

The ITA does not define what "not more advantageous" means. Certainly identical benefits would satisfy this requirement. But "not more advantageous" probably does not mean identical. ABC wouldn't need an ELHT with multiple beneficiary classes if it was providing identical benefits for all its employees.

Providing inferior benefits for key employees would also satisfy the "not more advantageous" requirement. ABC could remove some benefits from the key employees' package offered through the ELHT, and provide them with enhanced versions of those benefits outside the ELHT. It could also provide different or additional benefits for key employees outside the ELHT. ABC would have to take care, though, because the tax treatment for itself and its key employees would be different for benefits offered outside the ELHT.

"Not more advantageous" could also mean that benefits are calculated according to a formula that applies equally to key and non-key employees. For example, a formula that pays benefits as a

²⁹ ITA paragraph 144.1(2)(f).

³⁰ Generally requiring that the trust beneficiaries be employees, their spouses or common-law partners, members of their households or dependents. See above, "Who can be a beneficiary of an ELHT".

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percentage of an employee's earnings could be seen as "not more advantageous" because the same formula applies to all employees even though higher paid employees could receive more money from the plan. The plan could include caps on benefit amounts to reduce potential disparities between the highest and lowest paid employees.

"Not more advantageous" could also allow ABC to provide benefits to key employees that are different in kind from those it offers to its non-key employees, but of equal or lesser value. Of course, ABC would have to justify its assertion that the benefits were of equal value or lesser if the CRA questioned its approach.

Remember that the CRA has approved none of these approaches to the "not more advantageous" issue. Ultimately, it may need to provide guidance on how it will interpret "not more advantageous". An employer considering how to reward its key employees through a benefits package should obtain tax advice about how to do it in a way that's acceptable to the CRA.

On a final note, the CRA has confirmed that if all the employees in a business are key employees, the employer can't offer benefits to them through an ELHT.³¹

AN EMPLOYER'S RIGHTS UNDER THE TRUST

An employer has only three rights under an ELHT. They are:³²

- The right to designated employee benefits,
- The right to enforce covenants, warranties or similar provisions, and
- The right to prescribed payments

³¹ CRA Document 2011-0392641E5, October 3, 2011.

³² ITA paragraph 144.1(2)(g).

THE RIGHT TO DESIGNATED EMPLOYEE BENEFITS

In many smaller businesses the shareholders are also employees. This provision lets shareholder/employees belong to their own ELHTs, and to include their spouses and family members as beneficiaries.³³ Without this rule, a shareholder/employee would be treated as an employer, and would be excluded from their own benefits plan.

THE RIGHT TO ENFORCE COVENANTS, WARRANTIES OR SIMILAR PROVISIONS

The employer has the right to enforce covenants, warranties or similar provisions for two purposes. The first is to make sure that the trust is maintained as an ELHT.³⁴ If the trust is not maintained as an ELHT the employer can lose its deduction for the contributions it makes to the trust.

The second purpose is to make sure that the trust operates in a way that doesn't cause it to lose deductions under ITA paragraphs 144.1(3)(a) or (b). Under those paragraphs an ELHT loses the right to deduct the payment of designated employee benefits under ITA subsection 104(6) if it fails to satisfy all the requirements under ITA subsection 144.1(2),³⁵ or if it is operated or maintained primarily for the benefit of one or more key employees or their families.³⁶ While the ELHT's loss of deductions for its own failure to comply with the rules may not seem like the employer's problem, it could be if the ELHT becomes under financed as a result, and the employer has to make extra (possibly non-deductible) contributions so that employees continue to receive their benefits.

As we will consider soon, under the rules as they were originally written, an employer's representatives could not form a majority of the ELHT's trustees.³⁷ This provision has been changed to say that a majority of trustees have to deal at arm's length with each participating employer.³⁸

³³ ITA subparagraph 144.1(2)(g)(i).

³⁴ ITA clause 144.1(2)(g)(ii)(A).

³⁵ ITA paragraph 144.1(3)(a).

³⁶ ITA paragraph 144.1(3)(b).

³⁷ ITA paragraph 144.1(2)(i), before amendments.

³⁸ ITA paragraph 144.1(2)(i), as amended.

THE RIGHT TO PRESCRIBED PAYMENTS

This provision refers to payments prescribed under Regulation 9500. So far, Regulation 9500 is the only regulation prescribed under ITA section 144.1.

Under Regulation 9500, prescribed payments are those made to either General Motors Canada Limited or to Chrysler Canada, Inc. by the ELHT established for the benefit of retired auto workers who are members of the then Canadian Auto Workers Union (CAW), now Unifor. The payments must be reasonable in the circumstances, paid for administrative services provided to the trust or trust beneficiaries, or as reimbursement for payments made on behalf of or in contemplation of the trust being established.

Why was a regulation passed specifically for one ELHT?³⁹ The reason lies in the financial crisis of 2008 and 2009. At the time, GM Canada's and Chrysler Canada's American parents were restructuring as part of their bankruptcy proceedings. One issue was each company's obligation to provide health and welfare benefits for their retired workers. Until their bankruptcies, GM and Chrysler had been responsible for funding those obligations themselves. Pursuant to the restructuring, they transferred responsibility for all present and future obligations to a "voluntary employees' beneficiary association" (VEBA) in exchange for a one-time cash payment to the VEBA.

A VEBA is authorized under §501(c)(9) of the Internal Revenue Code (IRC) to provide "life, sick, accident or other benefits" to its members, and to their dependents or designated beneficiaries. According to IRC §501(c)(9), a VEBA must meet the following requirements:

- It must be a voluntary association of employees;
- The organization must provide for payment of life, sick, accident or other similar benefits to members or their dependents or designated beneficiaries and substantially all of its operations are for this purpose; and

³⁹ The following discussion relies generally on Harnum, James, "Courts Approve Retiree Settlement Providing for Participation in the First Prefunded Health Care Trust in Canada" in *Plans & Trusts*, January/February 2012, pp. 18-19.

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- Its earnings may not inure to the benefit of any private individual or shareholder other than through the payment of benefits described in the second bullet point above.⁴⁰

Membership in a VEBA is restricted to individuals who have a common economic bond, such as employees who have or had the same employer, or are members of the same union.⁴¹ VEBAs are tax exempt organizations provided they meet all the qualifications for tax-exempt status.

At the time, there was no equivalent to a VEBA under the ITA. But the CAW wanted the same benefits for its retired members as the United Auto Workers Union had secured for its. The Canadian government proposed amendments to the ITA that ultimately became section 144.1 to facilitate a prefunding of retiree health care benefits for retired Canadian auto workers, similar to the arrangement negotiated in the United States. Since the agreement and obligation to fund the trust predated the passage of ITA section 144.1 into law, Regulation 9500 lets GM Canada and Chrysler Canada treat their contributions and provision of services as if the law had already been passed.

PROHIBITION AGAINST CERTAIN FINANCIAL TIES TO THE EMPLOYER

An ELHT can't have certain prohibited financial ties with its participating employer, or with a person or partnership that does not deal at arm's length with the participating employer. Those financial ties are an interest or capital share in, or a debt of, the participating employer, as well as an interest in or a right to acquire such interest, share or debt.⁴²

Prior to the proposed amendments, avoiding these prohibited ties was a condition for continued status as an ELHT. A violation of this rule, even inadvertent and temporary, resulted in the ELHT losing its status as an ELHT for the year in which the violation occurred. Loss of ELHT status meant, among other things, loss of the employer's right to deduct its contributions to the ELHT.

⁴⁰ <http://www.irs.gov/pub/irs-tege/eotopicf84.pdf>.

⁴¹ Ibid.

⁴² ITA subsection 207.9(1), c.f. "prohibited investment".

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Under the proposed amendments, the prohibited financial ties have been converted from a condition for maintaining ELHT status to a taxable prohibited investment. If at any time during the year an ELHT acquires a prohibited investment or receives income from a prohibited investment, it will have to pay a tax equal to 50% of the value of the prohibited investment or the income it has received from the prohibited investment.⁴³ The ELHT can receive a refund of the tax paid if it disposes of the prohibited investment before the end of the year, and if it's reasonable to believe that the trust did not know (or it was not reasonable to believe that it ought to have known) that the property was a prohibited investment.⁴⁴

A prohibited investment includes employer securities or securities of related companies, or an interest in or right to acquire such securities.⁴⁵

The trust can apply for a refund of the penalty tax if it disposes of the prohibited investment before the end of the year following the year it acquired the prohibited investment, unless it was reasonable to expect that the trustee knew or ought to have known that the trust was acquiring property that was or would become a prohibited investment.⁴⁶

Any property that becomes or ceases to be a prohibited investment is deemed to have been disposed of and reacquired at fair market value (FMV).⁴⁷

According to the Department of Finance's explanatory notes to ITA section 144.1, paragraph 144.1(2)(h) was meant to "prevent trust capital from reverting, directly or indirectly, to an employer."⁴⁸ ITA paragraph 144.1(2)(h) will be repealed under the proposed legislative changes and replaced with the prohibited investment regime under ITA section 207.9, but a similar statement of legislative intent was not provided for new section 207.9.

⁴³ Proposed ITA subsections 207.9(2) and (3).

⁴⁴ Proposed ITA subsection 207.9(4).

⁴⁵ Proposed ITA subsections 207.9(1), (2) and (3).

⁴⁶ Proposed ITA subsection 207.9(4).

⁴⁷ ITA subsection 207.9(5).

⁴⁸ Explanatory Notes, page 43.

REQUIREMENT THAT A MAJORITY OF TRUSTEES DEAL AT ARM'S LENGTH WITH EACH PARTICIPATING EMPLOYER

ITA subparagraph 144.1(2)(i) requires that a majority of trustees deal at arm's length with each participating employer.

The requirement for a trustee to deal at arm's length with the employer restricts the pool of persons from which the employer could select trustees. The previous rule focused on employers' representatives. A representative could have been, but did not have to be, an employee. A representative could also be a shareholder, partner or anyone with whom the employer did not deal at arm's length. A representative could also include members of the employer's legal, accounting or consulting firms. More generally, a representative could be anyone who could have a conflict of interest were they to serve as a trustee of an employer's ELHT, or anyone whom it's reasonable to think the employer could influence were that person or entity to become a trustee.

Under the proposed amendments, it's conceptually possible for a trustee to be a representative, including an employee, as long as the representative deals at arm's length with the employer.

WINDING UP OR REORGANIZING AN ELHT

Winding up an ELHT means to end it in an orderly way. All its obligations are met, and any surplus funds are distributed. When an ELHT is reorganized, its assets may be transferred, for example to another ELHT. Under ITA paragraph 144.1(2)(b), only the following persons or entities can receive any money from the trust on a wind up or reorganization:

- Employees (current or former) or related persons, on a pro rata basis, but not key employees,⁴⁹
- Another ELHT,⁵⁰ or

⁴⁹ ITA subparagraph 144.1(2)(b)(i).

⁵⁰ ITA subparagraph 144.1(2)(b)(ii).

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- After the death of the last of a current or former employee, spouse or related individual, Her Majesty in right of Canada or a province.⁵¹

It is interesting to note the priorities established in ITA paragraph 144.1(2)(b):

- Key employees may not participate in a wind up or reorganization.
- Provincial governments and the federal government participate last, though there is no stated priority if there is a competing claim between governments.
- To the extent that they participate in a wind up or reorganization, living beneficiaries participate pro rata.

There is no order of priorities established between the living beneficiaries, as a group, and another ELHT. Presumably, the living beneficiaries' interests under the ELHT that is being wound up or reorganized would be protected in the new ELHT to which funds are going, but that may not always be the case. There is no mention of money being able to flow to a participating employer, nor is there any mention of money being paid to the estates of any beneficiaries. Another explanation is that the legislation contemplates ELHT property going to an ELHT only on a reorganization, and to the other category of beneficiaries only on a wind up.

TAX CONSEQUENCES ON A WIND UP

FOR EMPLOYEES AND EMPLOYERS

Any payment to an employee, spouse or related person on a wind up or reorganization will not be treated as a designated employee benefit.⁵² Instead, the distribution will be treated as income to the employee, and will not be deductible to the trust. This should produce a fair tax result where the employer has received a deduction for all its contributions to the trust, because those contributions will not be distributed as tax-free designated employee benefits.

⁵¹ ITA subparagraph 144.1(2)(b)(iii).

⁵² ITA paragraph 56(1)(z.2).

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It may not seem fair where the employer has not been able to claim a deduction or where the employee has had to include the employer's contribution in income. For example, where the employer has made contributions for benefits that extend beyond the current tax year, no deduction is allowed until the tax year for which the contributions should have been made. If the trust is wound up or reorganized before then, the trust will be distributing money that will be taxable in the employees' hands, but for which the employer never received a deduction. Nothing in ITA section 144.1 deals with this potential for double taxation.

Nor does this provision contemplate the double taxation that results from the employee having to treat distributions as income when an employer contribution was treated as taxable income to the employee under ITA paragraph 6(1)(e.1). Again, there is no provision in the ITA that deals with this issue.

Where employees have contributed their own money to an ELHT to pay for benefits like disability income insurance (the insurance benefit is tax-free if funded entirely by employee contributions), ITA section 107.1 deals with the potential for double taxation.

Subsection 107.1(a) says that when an ELHT distributes property to an employee who has an interest in that property, the ELHT is deemed to have disposed of the property for proceeds equal to the property's fair market value, and the employee is deemed to have acquired that property at fair market value.⁵³ ITA subsection 107.1(c) then deems the employee to have received proceeds equal to the property's adjusted cost base.

ITA subsections 107.1(a) and (c) force an employee to recognize any unrealized capital gains or losses in the property in the year the property is transferred. If there are no capital gains or losses, the employee receives the distribution with the property's adjusted cost base equal to its fair market value, leaving the employee with no tax consequences to report.

ITA paragraph 144.1(11)(b) says that ELHT distributions paid to any person are taxable, except distributions paid to an ELHT that is a beneficiary of the ELHT paying the distribution. But ITA

⁵³ ITA paragraphs 107.1(a)(i) and (ii).

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subparagraph 144.1(2)(b)(ii) does not require the recipient ELHT to be a beneficiary in order for it to receive a distribution from another ELHT on a wind up or reorganization. While an ELHT may receive money from another ELHT, the payment will be taxable unless the recipient ELHT is a beneficiary of the ELHT that is being wound up or reorganized.

RESIDENCY REQUIREMENTS

Subject to an exception discussed below, an ELHT must be resident in Canada, as determined by the ordinary rules of residency, not by the deemed residency rules contained in ITA section 94.⁵⁴ The ordinary rules of residency determine whether a trust is resident in Canada and therefore subject to Canada's income tax system. The deemed residency rules in ITA section 94 deem a trust to be resident in Canada for certain purposes, even if it would not be under the ordinary rules. The most recent judicial guidance from the Supreme Court of Canada on the ordinary rules of residency is *Garron Family Trust (Trustee of) v. R.*⁵⁵

In *Garron*, the Supreme Court of Canada adopted the central management and control theory to determine whether a trust is resident in Canada. Two trusts were settled in St. Vincent (a Caribbean island). The trustee was a corporation resident in Barbados, and the beneficiaries were residents of Canada. The trustee disposed of trust-owned capital property located in Canada, and had to remit withholding tax. It sought a refund, asserting that it was not a Canadian resident (because the trustee was not resident in Canada), and therefore was not liable to pay Canadian tax. Significantly, Barbados does not levy taxes on capital gains.⁵⁶ If the trustee's arguments had succeeded, the trust's Canadian property, beneficially owned for Canadian residents, could have been sold for a capital gain without any tax owing.

The Supreme Court of Canada disagreed with the trustee's position. It said that

⁵⁴ ITA paragraph 144.1(2)(c).

⁵⁵ 2012 SCC 14, April 12, 2012.

⁵⁶ Barbados Revenue Authority, <http://barbados.gov.bb/bra/pages/itg.aspx>.

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[R]esidence of a trust should be determined by the principle that a trust resides for the purposes of the Act where "its real business is carried on" (De Beers, at p. 458), which is where the central management and control of the trust actually takes place.

The trial judge had found that the main beneficiaries in Canada carried out the central management and control of the trust from Canada. The trustee merely carried out those beneficiaries' instructions. Since Canada was the country from which the trust was controlled, the trust was resident in Canada, even though its trustee was resident in Barbados.

If an ELHT becomes a non-resident of Canada, it will continue to be a trust, but will cease to qualify as an ELHT, unless it can use an exception under the rules amended in 2019. If it can't, its property will be deemed to have been disposed of for fair market value, with a cost base of nil.⁵⁷ The result will be a taxable gain for the trust.

Under the proposed amendments, a trust can be resident in a different country than Canada if:

- Employee benefits are provided to resident and non-resident employees,
- One or more participating employers are non-resident, and
- The trust is required to be resident in a country (not Canada) in which a participating employer resides.⁵⁸

ENFORCING TRUST PROVISIONS

The original draft legislation implementing ELHTs contained a provision similar to that governing HWTs: "[T]he trust has a legal right to enforce payment of contributions to the trust."⁵⁹

This provision was removed from the version of the legislation that became law. Still, nothing prevents an ELHT from having such a provision; it's just not a requirement for the trust to gain and maintain ELHT status.

⁵⁷ ITA paragraph 128.1(4)(b.1).

⁵⁸ Proposed ITA paragraph 144.1(2)(c).

⁵⁹ Early draft of ITA paragraph 144.1(2)(h).

EMPLOYER'S BANKRUPTCY OR INSOLVENCY

Although an ELHT depends on the employer for funding, an employer's bankruptcy will not result in the trust losing its status as an ELHT, provided it meets all the requirements in subsection 144.1(2).⁶⁰ Still, unless the trust has been funded in advance with enough money to allow it to maintain its obligations into the future, the trust probably won't be able to provide benefits for long after the employer becomes bankrupt or insolvent.

KEY EMPLOYEES

ELHTs distinguish between key and non-key employees. Commenting on an earlier draft of the legislation than the one which became law, the Department of Finance said:⁶¹

Paragraph [144.1(2)](d) requires, in general terms, that the trust be maintained primarily for the benefit of beneficiaries who are not key employees.

Paragraph [144.1(2)](e) requires, in general terms, that key employees who are beneficiaries of an ELHT be treated the same way as a significant proportion of the non-key employee beneficiaries under the ELHT....

The wording in the sections referred to above was changed in the legislation that became law, but the legislative intent towards key employees appears to be the same.

Under ITA subsection 144.1(1), the definition section, there are two tests for determining whether an employee is a key employee:

- a. Income, or
- b. Status as a "specified employee".

⁶⁰ CRA Document 2011-0419811E5, February 13, 2012. This decision contemplated both single and multi-employer trusts.

⁶¹ Employee Life and Health Trust – Explanatory Notes, page 7. This is a different document than the Department of Finance's Explanatory Notes, referred to above.

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Satisfying either definition will lead to the employee being defined as a key employee for the tax year. The parties must revisit the question each year to determine whether any non-key employees have become key employees, and whether any key employees no longer qualify as key employees.

INCOME TEST FOR KEY EMPLOYEE STATUS

A key employee is someone whose employment income was, in any two of the five taxation years preceding the year, more than 5 times the Year's Maximum Pensionable Earnings (YMPE) for the calendar year in which the employment income was earned. So, in the 2022 tax year, you consider years 2017 – 2021 inclusive. If in any two of the years 2017 through 2021 the employee's employment income exceeded 5 times the YMPE for those years, that person is a key employee.

The term, "employment income" is not defined in the ITA. For most people, "employment income" means salary or wages. But key employees often have additional components to their incomes like bonuses, dividends, stock options, car allowances, and the like. Will the CRA use "total income", "net income" or "taxable income", or will it calculate employment income the same way the Canada Pension Plan calculates earnings for purposes of determining an individual's YMPE? To date the CRA has not provided guidance on this question.

The following chart sets out the employment income thresholds:

Year	YMPE	5 times YMPE
2022	\$64,900	\$324,500
2021	\$61,600	\$308,000
2020	\$58,700	\$293,500
2019	\$57,400	\$287,000
2018	\$55,900	\$279,500
2017	\$55,300	\$276,500

For example, if an employee's employment income was \$280,000 in each of 2017 and 2018, that employee would be treated as a key employee for the 2022 tax year, even if their employment income never went above \$280,000 from 2017 through 2021 inclusive, and even though \$280,000 is less than 5 times the YMPE for the years 2019 through 2021 inclusive.⁶²

"SPECIFIED EMPLOYEE" TEST FOR KEY EMPLOYEE STATUS

The second test is more complicated. Regardless of income, if an employee is a "specified employee", they are a key employee.

ITA subsection 248(1) defines the term, "specified employee" as either an employee who does not deal at arm's length with the employer, or as an employee who is a "specified shareholder" (also a defined term). We'll deal with specified shareholders first.

SPECIFIED SHAREHOLDERS

A "specified shareholder" is someone who owns, directly or indirectly, at any time in the year, 10% or more of the issued shares of any class of the capital stock of a corporation or any corporation related to the corporation.⁶³ Control of the corporation does not matter. The words, "directly or indirectly" mean that a person does not need to own their shares outright to be a "specified shareholder". The ITA describes four ways in which a person could indirectly own shares in a corporation and still be a "specified shareholder", provided their ownership interest amounted to 10% or more.

⁶² ITA paragraph 144.1(1)(b), c.f. "key employee".

⁶³ ITA subsection 248(1), c.f. "specified shareholder".

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Corporate ownership. If a person or corporation with whom the individual does not deal at arm's length owns shares in the corporation, like a relative or a different corporation that the individual controls, the individual will be treated as a specified shareholder.⁶⁴

Trust ownership. If the individual is a beneficiary of a trust that owns shares in the corporation, that individual will be treated as owning those shares personally in proportion to their interest in the trust.⁶⁵ This rule applies even if the individual's rights to a share of trust income or capital depend on the trustee's exercise of or failure to exercise any discretionary power.⁶⁶

Partnership ownership. If the individual is a partner in a partnership that owns shares in the corporation, that individual will be treated as owning those shares personally in proportion to that person's interest in the partnership.⁶⁷

Personal services business (PSB) ownership. A PSB exists where a person has their own corporation provide their services to a business where it would be natural for the person to be employed directly by the business.⁶⁸ If the person may be entitled directly or indirectly to 10% or more of their own corporation's shares, that person is a specified shareholder.⁶⁹

NON ARM'S LENGTH PERSONS

Persons who do not deal at arm's length with their employer can also be key employees. Persons do not deal at arm's length when they are related by blood, marriage, common law partnership or

⁶⁴ ITA paragraph 248(1)(a), c.f. "specified shareholder".

⁶⁵ ITA paragraph 248(1)(b), c.f. "specified shareholder".

⁶⁶ ITA paragraph 248(1)(e), c.f. "specified shareholder".

⁶⁷ ITA paragraph 248(1)(c), c.f. "specified shareholder".

⁶⁸ ITA subsection 125(7). Individuals create PSBs in the expectation that the combined corporate and personal taxes they pay will be less than the tax they would pay if they were employed directly. The ITA and the CRA discourage the use of PSBs by removing many valuable tax advantages from the corporation, thereby forcing it to be taxed at higher rates.

⁶⁹ ITA paragraph 248(1)(d), c.f. "specified shareholder".

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adoption.⁷⁰ A blood relationship exists where one person is the child or descendant of the other, or where they are brothers or sisters of each other.⁷¹

Persons do not deal at arm's length with corporations they control, or if they are related to an individual who controls the corporation.⁷² The CRA has published guidance on what constitutes control of a corporation.⁷³ Since any employee owning 10% or more of a corporation's shares would be a key employee under the "specified shareholder" rule, the question of control in a non-arm's length situation will not often arise.

Still, it's worth noting that someone can control a corporation with fewer than 50% of the company's shares. For example, a minority shareholder may have superior expertise and experience in the business. Other shareholders may defer to that shareholder to such an extent that he or she could routinely count on their support, and effectively control the corporation.

In other cases a minority shareholder could own the largest block of shares, with the rest of the shares widely distributed among a large number of small shareholders. If such a shareholder could routinely influence enough shareholders to vote with them, and get over 50% of the vote, that shareholder would again be treated as controlling the company. It would not matter that each time the shareholder could be persuading different groups to vote with them, as long as the shareholder could routinely expect to get their way.

Someone could also control a corporation while owning none of the corporation's shares, if they controlled corporations that in turn owned shares in the subject corporation.

Further, if a group of people controls a corporation, and if everyone in the group is related to each other, then no one in the group deals with the corporation at arm's length.⁷⁴ A group is a related

⁷⁰ ITA paragraphs 251(1)(a) and (2)(a).

⁷¹ ITA subsection 251(6).

⁷² ITA subparagraphs 251(2)(b)(i) and (iii).

⁷³ IT-64R4 – Corporations: Association and Control [Consolidated], dated October 13, 2004.

⁷⁴ ITA subparagraphs 251(2)(b)(ii) and (iii).

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group where each member of the group is related to the others by blood, marriage, common law partnership or adoption.⁷⁵

Appendix A includes charts that summarize the key employee definitions. The CRA also publishes guidance that discusses the meaning of non-arm's length relationships.⁷⁶

TAX TREATMENT

TAX TREATMENT FOR THE ELHT

An ELHT is an inter vivos trust. The tax rules governing it are:

- The trust's tax year ends on December 31 of each year.
- The trust is taxed on net income at the highest personal tax rate. The trust may not claim any personal tax credits.
- The trust may claim deductions for:
 - Expenses related to the normal operation of the trust, including administrative functions,
 - The cost of providing benefits, including the payment of insurance premiums, and
 - Expenses incurred to earn trust income (such as investment management and advisory fees).

An ELHT is also subject to other tax rules specified in ITA section 144.1:

- Amounts paid as designated employee benefits are deductible.⁷⁷
- An ELHT has a non-capital loss where its expenses exceed its income. The ELHT may carry such a loss back or forward for three years.⁷⁸ The three-year loss carry-back rule is the same as the general rule, but the ELHT carry-forward rule differs from the usual 20-year loss carry-forward rule.

⁷⁵ ITA subsection 251(2).

⁷⁶ S1-F5-C1: "Related persons and dealing at arm's length", last updated November 24, 2015.

⁷⁷ ITA paragraph 104(6)(a.4).

⁷⁸ ITA subsections 144.1(13) and 111(7.3 to 7.5).

- The definition of an ELHT exempts it from the tax treatment afforded to employee benefit plans,⁷⁹ retirement compensation arrangements,⁸⁰ and salary deferral arrangements.⁸¹

The following rules do not apply to an ELHT:

- The 21-year deemed disposition rule.⁸²
- The alternate minimum tax rules.⁸³
- The reversionary trust rules in ITA subsection 75(2).⁸⁴

Under the rules as they existed before the proposed amendments, an ELHT could lose its right to deduct expenses for the tax year if it failed to qualify as an ELHT at any time during the year, for example by failing to satisfy a provision in ITA subsection 144.1(2),⁸⁵ or if it operated or was maintained primarily for the benefit of one or more key employees or their family members.⁸⁶ ITA paragraph 144.1(3)(b) adopted the definition of an employee's family members (ITA clauses 144.1(2)(d)(ii)(A) and (B)) to define a key employee's family members.

The denial of deductibility was permanent for the tax year. The trust could also lose its right to carry forward or back any losses incurred during the year.⁸⁷ Even if the ELHT was offside for a short time during the year, it lost its right to ELHT tax treatment for the entire year.

⁷⁹ ITA paragraph 248(1), c.f. "employee benefit plan", (a). Also, see generally the discussion on EBPs in our article, "Group Sickness and Accident Insurance Plans."

⁸⁰ ITA paragraph 248(1), c.f. "retirement compensation arrangement", (f.1).

⁸¹ ITA paragraph 248(1), c.f. "salary deferral arrangement", (f.1).

⁸² ITA paragraph 108(1) "trust" (a).

⁸³ ITA paragraph 127.55(f)(iv).

⁸⁴ ITA sections 75-75.2, subsection 75(3), and paragraph 108(1)(a.1).

⁸⁵ ITA paragraph 144.1(3)(a).

⁸⁶ ITA paragraph 144.1(3)(b).

⁸⁷ ITA subsection 111(7.5).

These consequences have mostly been addressed with the proposed amendments. For example, if the trust violates the provisions of ITA subsection 144.1(2) it will lose deductibility “unless it is reasonable to conclude that its trustees neither knew nor ought to have known that designated employee benefits have been provided to, or contributions have been made in respect of, beneficiaries other than those described in subparagraph (2)(d)(i) or (ii).”⁸⁸

TAX TREATMENT FOR EMPLOYERS

Employers may deduct the contributions they make to an ELHT pursuant to ITA subsections 144.1(4) – (7). Those subsections deal with the deductibility of employer contributions, actuarial determinations, collective bargaining agreements, participation agreements in respect of a collective bargaining agreement, and the maximum amounts deductible – essentially the cost of providing benefits where the employer retains the insurance risk.⁸⁹ The ITA also imposes a general reasonableness standard on deductions.⁹⁰

Employers may also deduct ELHT contributions that pay for insurance coverage in the year or prior year to provide designated employee benefits.⁹¹ Contributions used to provide insurance coverage for a later year or years are not deductible until the year in which the benefit is provided.⁹² An exception is allowed for insurance premiums paid for group term life insurance.

⁸⁸ Proposed ITA paragraph 144.1(3)(a).

⁸⁹ The ITA does not provide a straight line to a deduction. ITA section 18 denies a deduction for any employer expenses, subject to a list of exceptions. More specifically, ITA paragraph 18(1)(o.3) denies a deduction for an employer contribution to an ELHT, except those deductions allowed under ITA paragraph 20(1)(s). That paragraph lets an employer deduct amounts paid to an ELHT trustee under ITA subsections 144.1(4-7).

⁹⁰ ITA section 67.

⁹¹ ITA subparagraph 144.1(4)(a)(i). Premiums must be paid to an insurance company licensed in Canada or a province.

⁹² ITA paragraph 144.1(4)(b).

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An employer may prepay those premiums and deduct the entire prepaid amount in the year the contribution is made.⁹³

While the right to prepay premiums and deduct them in the same year may seem like a benefit for the employer, it's important to remember that employees must include the cost of group term life insurance in their income for the year the premium is paid.⁹⁴ The more an employer prepays, the more the employee must include in income.

Further, employers may deduct ELHT contributions that provide designated employee benefits to employees, their spouses or dependents.⁹⁵ Instead of paying insurance premiums or establishing a fund large enough to pay anticipated claims, the employer could pay benefits as claims arose, using the ELHT as a conduit.

Even after considering the rules governing what an employer may or may not deduct, there is still a limit on the total amount than an employer may deduct: total ELHT contributions in the current and preceding year minus all amounts deducted in the preceding tax year relating to ELHT contributions.⁹⁶ According to the Department of Finance:

This rule is intended to prevent an employer from attempting to claim a deduction in the later years of a pre-funded ELHT in respect of amounts related to inflation, income earned by the trust or to higher than anticipated benefit payments which are facilitated by strong investment performance within the trust.⁹⁷

The Department gives an example of an ELHT that expects to be in existence for 50 years, and expects to pay \$50 million in benefits during the first 13 years of its existence. The employer funds it in year 1 with \$50 million. During the ELHT's first 13 years, as the \$50 million is paid out in benefits,

⁹³ The types of premiums for which a deduction may be claimed are described in ITA clause 18(9)(a)(iii)(B), while the right to the deduction is set out in ITA clause 144.1(4)(a)(ii)(A).

⁹⁴ ITA subsection 6(4).

⁹⁵ ITA clause 144.1(4)(a)(ii)(B).

⁹⁶ ITA subsection 144.1(7).

⁹⁷ Explanatory notes, page 45.

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the employer will be able to deduct what the ELHT pays out in each tax year. The trust expects that the money needed to pay the remaining 37 years of benefits will come from growth on the initial \$50 million contribution. The employer will not be able to deduct the payment of any designated employee benefit that comes from this investment growth.

While this provision will prevent an employer from benefitting early from its contributions, other types of benefits, like premium holidays that an insurance company may offer to compensate for differences in actual versus projected claims experience, are not captured by this rule.

We discussed earlier in this article the tax treatment when an ELHT lends money to an employer or invests in employer securities (or in the securities of related companies). But an employer may still issue a promissory note to the ELHT as evidence of the employer's outstanding obligation to make contributions.⁹⁸ But a promissory note will not be treated as a trust contribution,⁹⁹ so the employer will not be able to deduct anything just for having lent money to the trust.

For the ELHT, the employer's interest payments on the promissory note cannot be treated as trust income under the accrual rules in ITA section 12. Liability under ITA section 12 would depend on how principal and interest payments were structured.

The employer will have to treat repayments of interest and principal on the promissory note as contributions to the trust, governed by the rules covering contributions, not as a repayment of principal and interest.¹⁰⁰ As a result, the employer will not be able to deduct interest on the note under ITA paragraph 20(1)(c) because it won't be able to characterize any part of those payments as interest.

On a final note, if the trust was an ELHT when a promissory note was issued, it's deemed to still be an ELHT whenever the employer pays anything on the promissory note.¹⁰¹

⁹⁸ ITA subsection 144.1(8).

⁹⁹ ITA paragraph 144.1(8)(a).

¹⁰⁰ ITA paragraph 144.1(8)(b).

¹⁰¹ ITA subsection 144.1(9).

TAX TREATMENT FOR EMPLOYEES

As discussed above, employer contributions to an ELHT are not taxable to employees if they are used to pay for benefits under a PHSP.¹⁰² Employer contributions used to pay for group term life insurance premiums are taxable to employees.¹⁰³ Employer contributions used to pay for GSAIP benefits are taxable to employees if the benefits paid from those contributions are tax-free. This means that employer contributions used to provide benefits like critical illness insurance (CII), income-style long-term care insurance (LTCI) and accidental death or dismemberment (ADD) insurance will be taxable to employees, as long as the benefits from such plans are tax-free.

Employer contributions used to pay for disability income insurance (DII) will remain tax-free because the benefits paid from such plans are taxable if the employer has paid any part of the premium, and if the benefits are paid on a periodic basis.¹⁰⁴ An employee can ask their employer to contribute their retiring allowance to their ELHT, but the employer will be required to withhold tax on the contribution. The retiring allowance is treated as income received by the employee under ITA subparagraph 56(1)(a)(ii), and then contributed to the ELHT.¹⁰⁵

Taxation of contributions made to provide CII, ADD and income-style LTCI benefits may not make much of a practical difference in some plans. While many employers continue to offer core benefits (with or without some form of cost sharing with their employees), some are moving to offer “non-core” benefits like CII, LTCI and ADD on a voluntary basis. Employees may choose which non-core benefits they want from a menu of available benefits, and pay for those benefits themselves. Apart

¹⁰² In Quebec employees must report the cost of their benefits as income, but only on their provincial tax return.

¹⁰³ ITA subsection 6(4).

¹⁰⁴ ITA paragraph 6(1)(f).

¹⁰⁵ CRA Document 2012-0467221E5, March 21, 2013.

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from the cost savings to employers from having employees pay for their own benefits, there is a tax advantage for employees who pay for at least one benefit, disability income insurance, themselves: they receive disability income insurance benefits tax-free.¹⁰⁶

An employee could also make contributions to an ELHT that would pay for benefits under a PHSP. This feature allows employees to treat their contributions as medical expenses, for which they may be able to claim a medical expense tax credit. We compare the tax outcomes from having the employer or employee pay PHSP premiums in our article, "Private Health Services Plans".

If employees are the only ones contributing to an ELHT (for example, disability income insurance plans where plan benefits are to be paid tax-free) the ELHT must be worded to make sure that the trust qualifies as an insurance plan. As an alternative, the ELHT could purchase group or individual insurance policies for the employees, with contributions being used to pay insurance premiums. If the CRA concludes that the plan is just a contingency fund lacking the required elements of insurance, the trust will fail to qualify as an ELHT.¹⁰⁷

The general rule for payments from an ELHT is that all payments are treated as income unless an exception applies.¹⁰⁸ There are several exceptions. The most important is that designated employee benefits are paid tax-free¹⁰⁹ unless included in income for another reason (such as disability income insurance payments under ITA paragraph 6(1)(f)).

Employees would also pay tax on payments of residual surplus from the trust on a wind up or reorganization under ITA subparagraph 144.1(2)(b)(i).

If the beneficiary were a non-resident, an ELHT payment will not be subject to non-resident withholding tax under ITA Part XIII to the extent that it is a payment of a designated employee benefit.¹¹⁰ Any other payments could be taxable, and would be subject to 25% withholding tax. These

¹⁰⁶ Ibid.

¹⁰⁷ CRA Document 2010-0374891E5, March 14, 2011.

¹⁰⁸ ITA subsection 144.1(11).

¹⁰⁹ ITA paragraph 144.1(11)(a).

¹¹⁰ ITA paragraph 212(1)(w).

would include payments to employees on a wind-up or reorganization. It's uncertain how the payment to a non-resident of taxable designated employee benefits, like disability income payments, which may be taxable under ITA paragraph 6(1)(f), would be treated.

MULTI-EMPLOYER PLANS

Former ITA subsection 144.1(6) allowed deductibility with respect to employer contributions made to ELHTs where a collective agreement was in place. The proposed amendments have removed the requirement for a multi-employer plan. The requirements in respect of a collective agreement and the requirement for contributions to be determined by hours worked or by another measure specific to an employee, remain.

In some industries, like construction, an employee can belong to one union but have many employers. Rather than belong to many different ELHTs, employees can belong to one ELHT that their employers collectively contribute to. Employer contributions to such ELHTs are deductible where the following two conditions apply:

- An employer contributes to the trust under a collective bargaining agreement (or a participation agreement in respect of the collective bargaining agreement) and according to a negotiated contribution formula that does not provide for any variation in contributions by reference to the trust's financial experience,¹¹¹ and
- An employer's contributions are determined in whole or in part by reference to the number of hours worked by each individual employee, or by another measure that is specific to each employee for whom contributions are to be made.¹¹²

An ELHT that administers benefits for employees of more than one employer, and receives contributions for employees of more than one employer, can elect to be treated as more than one separate trust.¹¹³ The trustee must designate in an election that property from an employer that is to

¹¹¹ ITA paragraph 144.1(6)(b).

¹¹² ITA paragraph 144.1(6)(c).

¹¹³ ITA subsection 144.1(12).

be held separately is to be held in a separate trust for the benefit of specific beneficiaries. The trustee must make its election on or before the filing due date of the first tax year of the separate trust.¹¹⁴

Upon making the election, and under the terms of the trust, contributions from the employer and the income derived from those contributions will accrue solely for the benefit of those beneficiaries.¹¹⁵

HWT TO ELHT TRANSITION RULES

The 2018 Federal Budget, delivered on February 27, 2018, announced an end to HWTs. Further, proposed legislative changes were announced on May 27, 2019 and November 20, 2020, introducing two measures designed to help facilitate transitions of HWTs to ELHTs.

The CRA will continue to apply its administrative guidance to HWTs that were in existence on or before February 27, 2018, but only until the end of 2022. After that, HWTs then in existence will no longer receive favourable tax treatment under the CRA's administrative guidance. Nor will the CRA administer its HWT guidance to any trust created after February 27, 2018. Effectively, no new HWTs can be created after February 27, 2018, and HWTs existing as of that date will be allowed to continue only until the end of 2022.

Before the end of 2022, trustees, employers and employees of HWTs that were in effect before February 28, 2018 will need to decide what to do with their trusts. The proposed legislation provides two transition options:

- Amend the terms of the existing HWT so that the HWT becomes an ELHT, or
- Create an ELHT, and transfer assets from the existing HWT to the new ELHT.

Let's consider the Amend option first. This option applies to trusts that were in existence on or before February 27, 2018, where contributions to the trust were determined according to a collective bargaining agreement, and where all or substantially all (generally 90%) of the employee benefits provided by the trust satisfy the definition of designated employee benefits under section 144.1. If

¹¹⁴ ITA paragraph 144.1(12)(a).

¹¹⁵ ITA paragraph 144.1(12)(b).

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these requirements are met, and if the trust elects in prescribed form (regulations not released as of this writing) to be treated as an ELHT as of May 27, 2019 (the date the proposed legislative amendments were first announced), the trust will be deemed to be an ELHT, and the ELHT rules will apply to it until the earliest of the following dates:

- The end of 2022 (i.e. December 31, 2022),
- The effective date of the business' next collective bargaining agreement after May 27, 2019,
- The date the trust satisfies the requirements of subsection 144.1(2), or
- The date the trust fails to satisfy the requirement that all or substantially all of the benefits provided by the trust be designated employee benefits under section 144.1.

Effectively, if an HWT so elects, it will have to ensure that all or substantially all of the benefits it provides are designated employee benefits until the employer and bargaining unit renegotiate the collective agreement. It will also have to ensure that the collective agreement will be renegotiated before the end of 2022, and that the new collective agreement provides that all the benefits it delivers are designated employee benefits, failing which it will lose its status as an ELHT.

Since the CRA guidance governing HWTs will have been withdrawn by the end of 2022, the trust will be subject to the ordinary trust rules if it falls out of compliance after 2022. It's important to note that one of the requirements for deemed ELHT status is that all or substantially all of the trust benefits be designated employee benefits. After 2022, or going forward from the renegotiation of the collective bargaining agreement, the requirement will become the legislative one – all of the trust benefits will have to be designated employee benefits, and the trust will have to satisfy all of the requirements under subsection 144.1(2), including the requirements applicable to key employees.

Not all HWTs will be able to choose the amendment route, particularly those where the employer's contributions are not determined according to a collective bargaining agreement. But if the benefits the HWT provides are substantially all designated employee benefits, and if notice has been provided in prescribed form (regulations not released as of this writing) the proposed legislation lets the HWT transfer its assets to a new ELHT without generating tax consequences. This option must be exercised before the end of 2022. The new ELHT will need to comply with the ELHT rules as they currently exist; there are no deemed ELHT provisions attached to this option.

For some HWTs, these options will either be unavailable or undesirable. For example, and as discussed earlier in this article, if all the business' employees meet the definition of key employee, the business will not be able to have an ELHT.¹¹⁶ The same would likely hold true if too many of the business' employees were key employees, not just all of them. In those cases, and in cases where the business owners don't want an ELHT, the only remaining option is to end the HWT.

When an HWT is wound up, funds in the HWT may not revert to the employer or be paid to the employees. Instead, the HWT will need a provision in its terms whereby surplus funds can be paid to a registered charity, following which the trust is wound up.¹¹⁷ If the HWT owns insurance policies, the CRA has said that an HWT may transfer individual insurance policies that it owns on an employee to that employee,¹¹⁸ for example, when an employee leaves or retires and wants to retain their coverage. The policy will be deemed to have been transferred at fair market value (FMV). While the CRA has not provided guidance on factors that affect the FMV of a health insurance policy, it has done so for life insurance policies.¹¹⁹ Many of the factors that help determine the FMV of a life insurance policy could also apply to determine the value of a health insurance policy. The parties will need to retain an actuary to provide a valuation of the policy. If the employee pays less than FMV for their policy, the difference will be treated as income to the employee.

After the transfer, the money received in exchange for the policies, plus any other funds in the trust, can be donated, and the trust terminated.

HEALTH INSURANCE POLICIES ALLOWED IN AN ELHT

As stated above, ELHTs can only offer "designated employee benefits."¹²⁰ Among those benefits are

¹¹⁶ CRA Document 2011-0392641E5, October 3, 2011.

¹¹⁷ CRA Document 9328517, December 23, 1993.

¹¹⁸ CRA Document 2003-0182875, June 30, 2003.

¹¹⁹ Information Circular 89-3, dated August 25, 1989.

¹²⁰ ITA paragraph 144.1(2)(a).

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those paid from a GSAIP or PHSP.¹²¹ Therefore, to the extent that a health insurance policy offers GSAIP or PHSP benefits, it should satisfy the definition of a designated employee benefit, and an ELHT should be able to own it. The following discussion considers this question in more detail, and refers to guidance that the CRA developed on HWTs. When considering this guidance, the differences between ELHTs and HWTs should be kept in mind.

CRITICAL ILLNESS INSURANCE

The CRA allowed HWTs to deliver critical illness insurance (CI) benefits by owning CI policies on the trust beneficiaries and their dependents. However, the CRA said that it would not allow HWTs to own CI policies with a return of premium (ROP) rider.¹²² The CRA's rationale was that the ROP benefit was not a CI benefit. It's reasonable to conclude that ELHT trustees would face a similar prohibition based on the definition of a "designated employee benefit" in ITA subsection 144.1(1). Since the CRA does not consider an ROP benefit to be a CI benefit, the ROP benefit would not be a benefit paid "from a group sickness or accident insurance plan," and therefore would not fall within the definition of a "designated employee benefit."

LONG-TERM CARE INSURANCE

The CRA never considered whether HWTs could own LTCI policies, either as PHSPs or GSAIPs. However, it's reasonable to expect that an ELHT could own an LTCI policy that provided designated employee benefits, either as a PHSP or GSAIP. The same limitation on ELHT owned CI policies offering ROP benefits should also apply to ELHT owned LTCI policies.

¹²¹ See paragraphs (a) and (b) of the definition of "designated employee benefit" under ITA subsection 144.1(1).

¹²² CRA Document 2003-0034505, December 9, 2003.

DISABILITY INSURANCE

The CRA has said that disability insurance qualifies as a GSAIP under IT-428.¹²³ For a further discussion of this issue, see our article, "Group Sickness or Accident Insurance Plans." Again, if the CRA agrees that an insurance policy is a GSAIP, and if the policy otherwise conforms to the definition of a "designated employee benefit," an ELHT should be able to own such a policy. The CRA's guidance prohibiting a CII policy in an HWT from offering an ROP benefit should also apply to ELHT owned DII policies.

CONCLUSION

When ELHTs were first introduced, they were an alternative to HWTs. Now, they are the only way in which life and health benefits may be delivered to employees through a trust. Some businesses may find that they cannot use an ELHT, if they have too many key employees, for example. Other businesses may find that they do not want to, perhaps because of the "not more advantageous" rule. For both types of business, alternatives exist to allow the business to continue providing employee benefits to owners and staff.

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¹²³ CRA document 2008-0278501E5, dated October 17, 2008.

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including a thorough examination of their specific legal, accounting and tax situation. Any examples or illustrations used in this article have been included only to help clarify the information presented in this article, and should not be relied on by you or the client in any transaction.

APPENDIX A

AN ELHT BENEFICIARY CAN BE:

- 1. A CURRENT, DECEASED OR FORMER EMPLOYEE, OR AN EMPLOYEE WHO IS EMPLOYED BY A BUSINESS THAT THE EMPLOYER HAS ACQUIRED,**

OR

- 2. AN EMPLOYER'S SPOUSE OR COMMON LAW PARTNER (SAME OR OPPOSITE SEX)**

OR

- 3. SOMEONE WHO IS RELATED TO THE EMPLOYEE BY BLOOD, MARRIAGE, COMMON LAW PARTNERSHIP OR ADOPTION, AND IS EITHER**

A. A MEMBER OF THE EMPLOYEE'S HOUSEHOLD, OR

B. SOMEONE WHO DEPENDS ON THE EMPLOYEE FOR SUPPORT

NOTE: "RELATED BY BLOOD" MEANS THAT ONE PERSON IS THE CHILD OR DESCENDANT OF THE OTHER OR THAT THE PERSONS ARE BROTHERS OR SISTERS OF EACH OTHER

A KEY EMPLOYEE IS:

- 1. AN EMPLOYEE WHO EARNED MORE THAN 5 TIMES THE YEAR'S MAXIMUM PENSIONABLE EARNINGS IN ANY 2 OF THE 5 YEARS PRECEDING THE CURRENT TAX YEAR**

OR

- 2. A SPECIFIED EMPLOYEE**

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Year	YMPE	5 times YMPE
2022	\$64,900	\$324,500
2021	\$61,600	\$308,000
2020	\$58,700	\$293,500
2019	\$57,400	\$287,000
2018	\$55,900	\$279,500
2017	\$55,300	\$276,500

A SPECIFIED EMPLOYEE INCLUDES A SPECIFIED SHAREHOLDER

A SPECIFIED SHAREHOLDER IS SOMEONE WHO OWNS, DIRECTLY OR INDIRECTLY, 10% OR MORE OF ANY CLASS OF THE EMPLOYER'S ISSUED SHARES OR OF A CORPORATION RELATED TO THE EMPLOYER.

DIRECTLY OR INDIRECTLY MEANS

- **THROUGH A PARTNERSHIP,**
- **THROUGH ANOTHER CORPORATION,**
- **THROUGH A TRUST,**
- **THROUGH A PERSONAL SERVICES BUSINESS, OR**
- **THROUGH A PERSON OR ENTITY THAT OWNS THE SHARES AND DOESN'T DEAL WITH THE SHAREHOLDER AT ARMS'S LENGTH.**

A SPECIFIED EMPLOYEE ALSO INCLUDES AN EMPLOYEE WHO DOES NOT DEAL AT ARM'S LENGTH WITH THE EMPLOYER

PERSONS DO NOT DEAL AT ARM'S LENGTH WITH PEOPLE TO WHOM THEY ARE RELATED BY:

- **BLOOD,**
- **MARRIAGE,**
- **COMMON LAW PARTNERSHIP, OR**
- **ADOPTION.**

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CORPORATION DO NOT DEAL AT ARM'S LENGTH WITH PEOPLE OR GROUPS WHO:

- 1. CONTROL THE CORPORATION, OR,**
- 2. ARE RELATED TO PEOPLE OR GROUPS WHO CONTROL THE CORPORATION.**

NOTE: "RELATED BY BLOOD" MEANS THAT ONE PERSON IS THE CHILD OR DESCENDANT OF THE OTHER OR THAT THE PERSONS ARE BROTHERS OR SISTERS OF EACH OTHER.

NOTE: IT ISN'T NECESSARY TO OWN 50% OF A CORPORATION'S SHARES PLUS 1 TO CONTROL A CORPORATION. SEE IT-64R4 CORPORATIONS: ASSOCIATION AND CONTROL FOR THE VARIOUS WAYS THE CRA ASSERTS THAT SOMEONE CAN CONTROL A CORPORATION WITHOUT OWNING A MAJORITY OF SHARES.