

S T E P



Society of Trust and Estate Practitioners

1 Richmond Street West, Suite 700
Toronto, Ontario
M5H 3W4
Tel: 416) 491-4949
Fax: (416) 491-9499
www.step.ca

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April 23, 2010

Gerard Lalonde
Director
Tax Legislation Division
Department of Finance Canada
19th floor, East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Lalonde,

On behalf of the 2,000 members of the Society of Trust and Estate Practitioners (Canada) (“STEP Canada”), we are pleased to submit our comments in response to the recently released Proposed Rules regarding Employee Life and Health Trusts (“ELHTs”). STEP Canada is the Canadian branch of the leading international organization of trust and estate professionals, which is comprised of lawyers, accountants, financial planners, insurance advisors and trust officers. Tax and trust planning is an integral part of the work that our members do. In this letter we offer comments on the policy impact of the proposed rules, as well as specific comments on the proposed legislative amendments. All legislative references herein are to the *Income Tax Act* (Canada) (“Act”).

Comments on ELHT Underlying Policy

We understand the thrust behind the Proposed Rules is a paucity of specific tax legislation governing Health and Welfare Trusts (“HWTs”) -- commonly used by private corporations to fund group health and accident benefits for their employees -- other than IT-85R2, and the provisions in the Act related to Private Health Services Plans.

The Canada Revenue Agency (“CRA”) perceives there to be "creative" use by employers of various provisions of the Act to avoid tax on income or gain arising in HWTs that could be sheltered at the employer/contributor level. It is clear to us that the Proposed Rules seem to be addressing these concerns. STEP Canada recognizes the policy basis for addressing perceived abuses.

Despite such concerns, we respectfully submit that from a policy perspective employers must have the ability to tax-efficiently set aside funds for designated employee benefits and we welcome the Department of Finance’s initiative in this regard.

Further, we believe some of the Proposed Rules overreach in attempting to address perceived abuses. In particular, we submit that the proposed rules governing employer deductions as presently stated will serve to dissuade employers, especially those in the small business sector, from using ELHTs. Canada’s economic recovery will depend, in large part, on a viable small business sector. We believe that Canadian tax policy should strive to support this sector of our economy.

Comments on the Proposed Rules

We are of the view that the Proposed Rules are too restrictive, will impede the development of tax-efficient ELHTs, and ultimately curb their use by employers. We offer the following specific comments:

“Key Employees”: The rules set out in draft paragraph 144.1(1) reflects ongoing CRA concern regarding potential unfair beneficial treatment of “key employees”, in particular, high income earners and specified shareholders, i.e., owner-managers. The stated intention of an ELHT is for it to be maintained principally for the benefit of “non-key employees” rather than key employees, such that an ELHT is not used to provide an “unfair advantage” to key employees.

We understand but do not necessarily agree with the reasoning behind the “25% / 75% rules” found in draft paragraph 144.1(2)(e) and the requirement for the trust not to be maintained primarily for the benefit of key employees under draft paragraph 144.1(2)(d).

In a very competitive environment, recruiting and retaining skilled and effective employees is a real concern for many employers. The aging population and the growing cost of medical care, especially care not covered by the public system and/or standard group insurance, such as dental prosthodontics/orthodontics, make an HWT or ELHT a cost-effective and powerful tool enabling employers to offer extra benefits and reach that goal. The Proposed Rules will prevent employers from providing enhanced benefits to employees that are high income earners, which is often desirable, by setting up an ELHT.

While it appears possible to form a separate class for key employees and a separate class of non-key employees, in a company where more than 75% of employees are key employees, the 75% rule of draft subparagraph 144.1(2)(e)(ii), the 25% rule in subparagraph 144.1(2)(e)(i) will never be met. In a corporation large enough to enable the owner-manager to be reasonably treated in the same manner as the rest of the workforce, perhaps an ELHT as proposed might be a good tool. However, the restriction against maintaining an ELHT primarily for key employees and the 25% / 75% rules work against closely held corporations, such as family owned businesses that are the source of many Canadian jobs, and

where the majority of employees could be considered key employees. As presently set out, the proposals could therefore prevent many small employers from establishing an ELHT.

In addition, many small businesses are members of employers' associations that provide ELHT-type benefits for them. The Proposed Rules could adversely impact employers participating in group plans provided by those associations if one member of the group is an employer that does not meet the 25% / 75% rules.

Future changes in salary and ownership would have to be constantly monitored to ensure that an employer's ELHT does not go offside the Proposed Rules, even when there is no change in the benefits provided by the ELHT. This will place burdensome compliance costs on the employer and add to the complexity of these plans.

The concept of "identical rights" set out under draft subparagraph 144.1(2)(e)(iii) will present difficulty for employers. How will the "rights" be determined to be "identical"? Employers need clarity regarding how the CRA will review ELHT plans to determine if key employees are receiving an unfair advantage. It is not obvious that the 25% / 75% rules will be helpful to the CRA in making such a determination.

There are other ways to overcome the policy concern regarding the unfair advantage conferred on key employees. For example, subsection 15(1) of the Act already safeguards against overly advantageous benefits being conferred on owner-managers on the basis that they are receiving the benefits in their capacity as shareholders rather than as employees.

Alternatively, it could be more reasonable to handle the unfair advantage concern by limiting an employer's deductible contributions when the majority of the ELHT's beneficiaries are key employees based on a set percentage of Year's Maximum Pensionable Earnings.

For the reasons noted above, we would therefore recommend the 25% / 75% rules be withdrawn from the draft legislation.

"Limitation on the deductions": The limitations on the deductibility of employer contributions under draft paragraph 144.1(3) create a strong disincentive to pre-fund an ELHT. However, an employer ought to be able to ensure that its ELHT is not under-funded in a given year where there are numerous claims that could not be satisfied by the mere annual contributions of the employer. It is submitted that this restriction will result in small businesses unduly restricting their required contributions to only those amounts required to fund benefits payable in the year.

Employers should be encouraged to make predictable and consistent contributions, and should be receiving a corresponding deduction when these contributions are made. In other words, the employers should not be prevented from deducting reasonable contributions to fund a small reserve for claims that may arise one to three years after the contributions have been made. Employers should also not be denied deductions for contributions that match the premiums payable by the ELHT to an insurer.

Consideration should be given to better enabling employers to establish these plans given the costs involved, by providing simpler rules for the deductibility of employer contributions. For example, the ELHT legislation could permit deductible contributions for matching payments of designated employee

benefits within a reasonable time, such as three to five years. Periodic actuarial determinations could provide a degree of assurance that contributions are reasonable in relation to the amount required to provide the designated employee benefits payable in the year the contributions are made.

“Other comments”:

1. Draft paragraph 104(6)(a.4) enables the trust to deduct amounts that "...became payable by the trust in the year as a designated employee benefit....". The Proposed Rules should clarify whether an employer's contribution will be treated as a contribution to trust capital or trust income. The CRA needs to confirm that the receipt of the contributions by the trusts is not intended to be considered trust income in computing the income of an ELHT, and that therefore the deduction contemplated in draft subparagraph 104(6)(a.4) will only be relevant regarding amounts payable by the trust in a year as a designated employee benefit, either out of its income generated in that year from its otherwise invested reserve funds or out of its capital.

Examples set out in the Technical Notes could help explain the way the Proposed Rules will work regarding the amended definition of non-capital loss in subsection 111(8) in relation to draft paragraph 104(6)(a.4). Our understanding is that an employer will make a deductible contribution to the ELHT under paragraph 20(1)(s). The trust will not be taxed on such contributions added to its capital, as they are not income to the ELHT. If all the contributions received are paid as designated employee benefits during the year, the trust will have a deduction under draft paragraph 104(6)(a.4). This will create a loss in the hands of the ELHT that will be added to the non-capital loss pool. If in the subsequent three years, the trust has income generated by its funds, it will be able to use the non-capital losses to reduce its taxable income. It is likely that most ELHTs will not pay income tax if they follow the Proposed Rules.

2. A specific concern with regard to employees is that the definition of "employee" in draft paragraph 144.1(1) uses the phrase "*...and includes an individual in respect of whom the employer has assumed responsibility for the provision of designated employee benefits as a result of the acquisition by the employer of a business in which the individual was employed.*" Is the use of "acquisition" broad enough to capture, for example, mergers or other types of divestitures and reorganizations? We recommend greater specificity.

3. Draft subparagraph 144.1(2)(a)(i) refers to "objects." Trusts – under trust law – do not have objects in the same sense that an incorporated entity has "objects" and "by-laws." Rather than objects this should be changed to read "the principal purpose."

4. Under proposed draft subparagraph 144.1(2)(a)(ii) "pro rata" needs to be clarified. Does this mean 'equally,' 'taking into account prior contributions,' or 'cost of benefit' basis? What is the policy behind excluding key employees from any benefits upon the wind-up of the ELHT? Key employees should not be prevented from participating "pro rata" in the residual value of the ELHT or receiving benefits (other than designated employee benefits) like the other employees simply because they do not deal at arm's length with the employer as contemplated by draft subparagraph 144.1(2)(f). Many of these key employees, as owner-managers, will have assumed the business risks of establishing the ELHT.

5. The definition of ELHT in draft paragraph 144.1(2)(b) requires the trust to be resident in Canada determined without reference to section 94. We submit that this restriction may not be necessary, and any concern over tax losses could in fact be overcome in the legislation. For example,

one of the best benefit providers of ELHTs may be outside of Canada. There should be no adverse impact on Canada's tax revenues if the trust was factually non-resident but deemed resident for purposes of section 94 of the Act.

6. Draft paragraph 144.1(2)(g) states that the ELHT must be "administered in accordance with its terms and objects." This provision needs to provide clearer guidance for employers, trustees and beneficiaries. An employer needs more specificity to ensure that it is acting within the bounds of compliance and that the interpretation of the trust documents is not subject to the CRA's discretion.

7. Under draft subparagraph 144.1(2)(i) employers participating in an ELHT are not permitted to constitute the majority of the trustees. However, as previously stated, many small business owners are members of employers' associations that provide ELHT-type benefits for them. While it may be desirable to ensure that plans are not subject to undue influence by the employer or owner/manager, the policy intent of this restriction is not clear. We question what the practical, cost-effective alternative might be.

8. With many Canadian employers utilizing HWTs that have been in place for some time, transitional rules are required. The Department of Finance needs to clarify whether they can continue to exist and be compliant based on advance tax rulings requested in accordance with IT-85R2. Will they be grandfathered under the new legislation? Employers need time to plan for any potential adverse impact on existing HWTs.

We would like to thank the Department of Finance for considering our submission and look forward to working with you on the ELHT proposals.

Yours very truly,

Kim G.C. Moody

Kim G.C. Moody, CA, TEP
Chair, STEP Canada

Stewart Lewis

Stewart Lewis, LL.B.
CEO, STEP Canada

Martin Lord

Martin Lord, LL.B, TEP
Chair of the STEP Canada Technical Committee (Tax)

Craig Jones

Craig Jones, LL.B., TEP
Chair of the STEP Canada Technical
Committee (Non-Tax)

Hélène Marquis

Hélène Marquis, LL.B, TEP
Director, Montréal Branch