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Health and Welfare Trusts — Are you at risk of losing your status?

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In July of this year, the Canada Revenue Agency (CRA) released new *Income Tax Folio S2-F1-C1: Health and Welfare Trusts*. This folio outlines their administrative policy on Health and Welfare trusts (HWTs). This folio replaces and cancels *Interpretation Bulletin IT-85R2, Health and Welfare Trusts for Employees* which has been in effect since 1986.

What's New?

In general, the new folio provides clarification of the CRA's policies that were outlined in the cancelled Interpretation Bulletin, updated for changes in legislation since 1986. In addition, the new folio provides further commentary on the following generally accepted items:

- A HWT can provide self-insured health and welfare benefits but cannot self-insure group term life insurance;
- Benefit plans administered by a HWT cannot provide coverage for non-employees (other than former employees), regardless of whether such individuals pay for coverage themselves;
- On a wind-up of the trust, any remaining funds can be used to provide additional benefits or can be distributed to the employees or to a registered charity; and
- A HWT is not subject to the 21-year deemed realization rule which is generally applicable to trusts.

This new folio also provides further commentary regarding surplus funds in a HWT, and these comments have created uncertainty and concern for trustees of HWTs.

Surplus – The Concern

Of the new comments in the folio, the potentially most problematic for trustees relate to a fund surplus and the possibility of a continued surplus causing a HWT to lose its status for Canadian income tax purposes (see commentary below regarding the impact of loss of status as a HWT).

The CRA distinguishes between a temporary and a permanent surplus and appears only to be concerned when a HWT has a permanent surplus. The folio provides two examples of what could contribute to a temporary surplus; in one situation the cost of providing benefits was lower than anticipated and in the other situation, the investment income was higher than anticipated. However, if these temporary surpluses continue, they could be considered permanent, as discussed later in this article.

Some HWTs rely on actuarial studies or a benefits consultant's report to establish that an existing surplus will be eliminated in the future, either through committed benefits or through additional benefits that the trust

could provide. The folio is silent on whether contingency reserves established for the purpose of providing health and welfare benefits to eligible members would be excluded from the definition of a "permanent surplus" and therefore would be considered to be "temporary surpluses" or not be considered "surpluses" at all. With an ageing population and workforce, these surpluses may look large now and may not be eliminated for years but still may not be sufficient to pay for the projected current and retired employee benefits. While it is unknown whether the CRA would accept these types of surpluses as temporary surpluses, an analysis prepared by a third party showing a future use of the surplus could bolster the assertion it is a temporary surplus.

When explaining a permanent surplus, the folio describes the permanent surplus as arising where "the level of annual contributions…continues to be in excess" of operating and benefit costs. While this statement alone is lacking in detail, the folio then goes on to say that employer contributions "may not be deductible if steps are not taken within a reasonable time to eliminate the [permanent] surplus".

The CRA has proposed the following options as methods of eliminating a permanent surplus:

- Premium (contribution) holiday;
- Provide additional benefits; or
- A combination of both

In practice these two options will prove problematic for multi-employer trusts. Multi-employer HWTs usually consist of employees belonging to the same union where the contributions are determined as a result of collective bargaining.

With respect to the first option, in a multi-employer trust, once a union has negotiated a set contribution level from the employer, it is highly unlikely that the trust will reduce the contribution levels in future years regardless of the trust's level of benefit payments/investment returns. This is particularly relevant for trusts for employees who are employed in cyclical industries (unions will be quick to point out that there once was a time when defined benefit pension plans showed large surpluses and look at what happened to many of those).

And with respect to the second, while it is a more reasonable option, once a trust agrees to provide certain additional benefits, it will be very difficult to withdraw those benefits in the future should the trust's surplus be eliminated.

It would be much more prudent for a multi-employer trust to substantiate their surplus as temporary based on the utilization of contingency reserves which may be supported by third party studies where feasible. Generally, multi-employer trusts plan to use accumulated surpluses to provide benefits to eligible members in the future, such as in retirement, or to utilize the funds to continue to provide benefits to eligible members in an economic downturn.

We are still left with the following unanswered and problematic questions regarding permanent surplus:

1. At what point does the CRA consider the surplus to "continue to be in excess"?; and
2. What is a reasonable amount of time to eliminate the permanent surplus?

As there is little CRA guidance on permanent surpluses for HWTs, we look to Not-For-Profit entities for direction. Similar to HWTs, IT-496R outlines that a Non-Profit Organization (NPO) accumulating surplus funds in excess of its current needs may affect the association's status as a tax-exempt NPO.

In the L.I.U.N.A. Local 527 Members' Training Trust Fund Case (92 DTC 2365), the Fund had surpluses from 1985 to 1987. These surpluses arose for a number of reasons including; 1) higher contributions from union members due to increased employment rates; 2) reduced training applications in these high employment periods; 3) increased interest rates on investments.

The Tax Court of Canada concluded that the fund did not have control over these items. The fund was governed by a collective agreement whereby employers contributed to the fund at a fixed rate per hour worked by each employee. Due to this agreement, the fund could not reduce the contributions received from the employers. In addition, it would have been irresponsible for the fund not to invest the surplus funds in interest-bearing investments. Furthermore, there was no indication that the fund was operating to earn profit as opposed to operating according to the fund objectives. Due to the restrictions set out for the use of cash in this case, the court could not see another motive for the trustees earning investment income other than to provide future training to members.

This case is helpful in that it is similar to a multi-employer HWT. In much the same way, the union and employers collectively bargain the contribution per employee hour to the trust, and as a result the trust cannot reduce the contributions received from the employers. We would hope the CRA would apply a similar rationale to a surplus in a multi-employer HWT.

In summary, while there is no definitive commentary on what would constitute a permanent surplus, third party studies supporting a future elimination of surplus may help to establish it as temporary. Where trustees are unable to support a surplus as temporary, it may be time to look at increasing benefits to eliminate the surplus, or instituting a contribution holiday, if feasible. Readers are cautioned however that until the CRA draws a line in the sand and a case makes its way through the courts, the waters will continue to be murky on this issue.

What not to do with your Surplus

The folio also provides a list of unacceptable alternatives, as these are not appropriate uses of the trust funds and may disqualify the trust. The trust cannot distribute the surplus funds to employees, which includes transferring the funds to any of the following:

- Pension plan
- Group registered retirement savings plan
- Individual employee's registered retirement savings plan

Providing Ineligible Benefits

As discussed in the folio, a HWT may only administer the following plans:

- a private health services plan;
- an accident insurance or group sickness plan;
- a group term life insurance policy;
- Any combination of the above mentioned plans.

Accordingly, the assets of the trust should only be used for these purposes. A trust that provides benefits other than the above would not qualify as a HWT unless the funds to provide non-qualifying benefits are maintained separately, and the related contributions, income and disbursements are separately identified and accounted for.

What happens if you lose your status?

If a HWT were to lose its status, there could be immediate tax consequences to both the employer and the employee. Without status as a HWT, the trust could be considered to be an employee trust or possibly an employee benefit plan. For the employee, the loss of status can result in any benefits received, or in some cases the employer contributions, becoming taxable. For employers, the timing of the deduction of the contribution is affected.

In conclusion, there may be aspects of this folio that may be of concern to HWTs in the multi-employer sector. In such cases, it is advisable to work with your professional service providers to assess and proactively address these concerns.

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