

Employee Life and Health Trusts

Julia Dean, CA, is a Tax Specialist in the Peterborough office of Collins Barrow.

In February 2010, the Federal Government introduced legislation to formalize the rules for Employee Life and Health Trusts (ELHTs). ELHTs can be organized for one employer or for many, and generally are established to provide designated employee benefits to employees (and/or former employees) and their families. Designated employee benefits (DEBs) include group sickness or accident insurance plans, group term life insurance policies, and private health services plans.

To qualify as an ELHT, a trust must satisfy these conditions:

1. The only object of the trust is to provide DEBs to employees or to provide pro-rata benefits to beneficiaries on the wind up of the trust;
2. The ELHT is resident in Canada;
3. Each beneficiary is an employee, a former employee, an individual related to those individuals, or another ELHT;
4. The ELHT is not maintained primarily for "key employees";
5. Key employee rights are not more advantageous than those of a "reference class";
6. No non-designated employee benefits are provided to employers or those not operating at arm's-length with employers;
7. The ELHT is administered according to its terms and objects;

Each year, the ELHT will be required to file a trust return to report the income earned.

8. The ELHT has a legal right to enforce payment of contributions from employers; and
9. Employer representatives do not constitute a majority of trustees.

"Key employees" include specified shareholders, persons not dealing at arm's-length with the employer, and employees who in any two of the previous five years earned more than five times the maximum pensionable earnings for the year.

The reference class of employees must represent at least 25% of the beneficiaries of the trust for

a particular employer. Fewer than 25% of the members of that class may be key employees, and the rights of each member of that class must be identical.

An employer's contributions to an ELHT are deductible to the employer to the extent they are reasonably regarded as having been contributed to fund designated employee benefits payable in the year to, or for the benefit of, its employees. Contributions to the ELHT in excess of what is required for the current year will not be deductible in the year contributed, but may be deducted in future years. In addition, contributions made to fund anything other than DEBs will not be deductible.

Each year, the ELHT will be required to file a trust return to report income earned. The trust will be entitled to deduct as expenses amounts that became payable in the year as designated employee benefits. If expenses exceed income,

IN THIS ISSUE

Employee Life and Health Trusts	1
Employee Profit Sharing Plans	2
Purchase Price Adjustment Clauses	3

the ELHT may carry the loss back or forward three years.

The tax treatment in the hands of employees of the DEBs provided by the ELHT will not change because of the existence of the ELHT. The *Income Tax Act* provides that some benefits are tax-exempt (i.e. private health services plans), others are not taxable until received (i.e. disability benefits, wage loss replacement), and others are taxable during the year of coverage but not taxable upon receipt (i.e. group term life insurance).

A trust that fails to qualify as an ELHT will be treated as an employee benefit plan, and any

payments from it will be taxable as employment income unless they are for the payment of DEBs.

This new legislation codifies the rules for health and welfare trusts with some additional provisions. The new provisions should be reviewed carefully by employers who have established employee benefit plans or are considering doing so now that the rules provide a clearer picture of the tax implications to employers and employees.

Contact your Collins Barrow advisor for more information on ELHTs and this new legislation. §

Employee Profit Sharing Plans

Jason Melo, CA, CPA, CFP, is a Senior Tax Manager in the Leamington office of Collins Barrow.

Employee profit sharing plans (EPSPs) have gained popularity in the small business environment in recent years and, in appropriate circumstances, can provide significant and immediate benefits to an organization. Key advantages include the possible reduction or elimination of Canada Pension Plan (CPP) and Employment Insurance (EI) remitting requirements, and additional tax deferral opportunities.

An EPSP is defined in subsection 144(1) of the *Income Tax Act* (ITA) as an arrangement whereby payments computed in reference to an employer's profits are required to be made to a trustee for the benefit of employees. Not all employees are required to participate in the EPSP, though it is recommended that a plan have at least two employees as beneficiaries.

One of several technical requirements in establishing the validity of an EPSP involves the computation of payments to the plan in accordance with a pre-determined formula that references the employer's profits. In most circumstances, an election is filed in prescribed form such that

payments to the EPSP are deemed to be made "out of profits" of the employer. This election provides for considerable flexibility in the establishment of an acceptable formula and allows a plan to qualify notwithstanding payments are not computed specifically by reference to profits.

Payroll withholdings

The obligation to withhold amounts on certain employee remuneration is governed by the *Income Tax Act*, the *Canada Pension Plan Act* and the *Employment Insurance Act*. Despite the technical nature of the applicable provisions, the requirement to withhold and remit both CPP and EI on allocations from an EPSP is effectively eliminated, given these allocations are not deemed to be "payments" for these purposes.

The Canada Revenue Agency has provided technical interpretations¹ indicating that, in cases where an employee is paid his or her total salary through an EPSP, it is a question of fact whether the arrangement would satisfy the provisions of section 144 of the ITA. However, the decision of the Tax Court of Canada in *Greber Professional Corp. v. M.N.R.*² appears to have validated the acceptability

of this strategy despite the Canada Revenue Agency challenging the EPSP as a conduit and attempting to subject the allocations to CPP contributions.

In the typical owner-manager scenario, assuming both spouses are compensated from the family business, the result is immediate cash savings of approximately \$8,500 per year should income levels attract the maximum CPP contribution. If additional family members are involved in the business, the savings and attractiveness of the structure begin to multiply. In most cases, these savings more than offset any costs associated with establishing the structure, as well as compliance costs in the first year of operation.

Despite these potential savings, and as in any remuneration plan, the individual circumstances of the shareholder should be considered and, in most cases, individuals would be well advised to maintain some amount of salary.

The Tax Deferral

Traditional planning for the small business owner often involves some form of accrued bonus payable to individual shareholders with the remaining income taxed at the corporate level to achieve some degree of tax deferral (the amount of which varies based on the personal circumstances of the shareholder). Assuming the deferral is maximized, payroll withholdings will fall due six months following the corporation's year-end.

Should a corporation choose instead to implement an EPSP and allocate a portion of profits to the

shareholder, an additional one-time deferral of up to thirteen months is made available.

The following example illustrates the effect of the tax deferral:

Corporation ABC Inc. maintains a September 30 year-end and desires to pay its sole shareholder an additional \$100,000 for work performed throughout fiscal year 2010.

The bonus alternative (to be paid by March 31, 2011 to preserve the deduction at the corporate level) will result in withholding taxes due by April 2011, and include CPP of \$4,300 (employee and employer portion).

Under the EPSP alternative, and as noted above, the requirement to withhold CPP and income taxes is eliminated. The EPSP payment (to be made to the plan within 120 days of year-end – January 31, 2011 in this example) will attract a tax liability due April 30, 2012, resulting in an additional thirteen-month deferral and immediate savings of \$4,300.

Note that in subsequent years the EPSP participant must pay quarterly personal tax installments through EPSP allocations, and accrued bonuses may be used in alternating years to rectify this cash flow concern.

Contact your local Collins Barrow Tax Advisor to determine whether your organization might benefit from an EPSP strategy. §

¹ 2000-0017, 2000-0055055

² 2007 TCC 78

Purchase Price Adjustment Clauses

Dave Clarke, CA, CBV, is a Partner in the Ottawa office of Collins Barrow.

Many tax planning initiatives involve transactions in which assets are exchanged. Many of these exchange transactions are intended to occur on a rollover basis, such that they do not trigger immediate income tax

consequences. Generally, the *Income Tax Act* requires transactions to occur at fair market value (FMV). Accordingly, when transactions occur between related parties, the FMV must be estimated.

Since professional judgment is always involved in estimating the FMV of an asset, it is possible that a Canada Revenue Agency (CRA) valuator might draw a different conclusion of value than the parties to the transaction. In addition, since the CRA may review the transaction several years after the transaction date, it would have the benefit of seeing how events have unfolded since the date of the transaction, which might affect the CRA's perception of the FMV of the asset.

To mitigate the risk of negative income tax consequences resulting from the CRA reassessing the FMV of an asset, purchase price adjustment clauses (PPAs) are usually included in the asset transfer or exchange agreements. Essentially, should the CRA reassess the FMV of the assets transferred, the PPA will revise the transaction retroactively to ensure that an immediate income tax liability does not result from the reassessment of FMV.

The inclusion of a PPA in the asset transfer or exchange agreement is not a guarantee that income tax consequences will not arise should the CRA reassess the FMV. CRA Interpretation Bulletin 169 (IT-169) states that the CRA will only honour a PPA if the share agreement reflects a *bona fide* intention of the parties to transfer the asset at FMV arrived at by a fair and reasonable method. IT-169 goes on to state that whether the method used to determine FMV is fair and reasonable will depend on the circumstances of each case. In other words, should the CRA decide that the method of determining fair market value is not fair and reasonable, it likely will conclude that the parties did not intend to transact at FMV. The result will be significant income tax consequences.

In the case of *Guilder News Co. (1963) Ltd. et al v. MNR*, the shareholder taxpayers included PPA clauses in their corporate reorganization agreements to mitigate the risk of a valuation adjustment by the CRA (then called Revenue Canada). The CRA reassessed the shareholders

on the transactions on the basis that the FMV of the assets sold was greater than the price stipulated in the agreement. The shareholders were assessed a benefit for the excess FMV over the price stipulated in the agreement, an assessment that would have resulted in double taxation of the excess FMV. The Court concluded that the PPA was a sham, agreeing with the CRA's position that the shareholders never intended reasonably and in good faith to transact at FMV. Thus the CRA was justified in not recognizing the PPA.

Even where the parties to a transaction determine FMV by some methodology, IT-169 states that the CRA will determine whether that methodology is fair and reasonable. If the CRA disagrees with the methodology, the parties' actual intentions are irrelevant.

Valuation is an art. There is, necessarily, a degree of subjectivity. However, a valuation by a qualified Chartered Business Valuator should be sufficient to demonstrate a taxpayer's intention to transact at fair market value, and should help to support the validity of a PPA.

Contact your Collins Barrow advisor for more information. §

Collins Barrow publishes a quarterly Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

www.collinsbarrow.com
info@collinsbarrow.com

Clarity Defined.™