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Tax Topics

from Manulife's Tax & Estate Planning Group

Health and Welfare Trusts

Introduction

Bill C-47 which received Royal Assent on December 15, 2010 provided for a new type of employee benefit trust – "Employee life and health trust" (ELHT). The ELHT rules, to a large extent, codify but have not replaced existing administrative practice regarding health and welfare trusts ("HWTs"). The CRA has confirmed that it has no immediate plan to withdraw the administrative regime authorizing HWTs as set out in IT-85R2, dated July 31, 1986. This administrative practice will continue to apply to trusts established both prior to and after 2009 where the conditions outlined in IT-85R2 are met. Trusts established after 2009 that meet both the ELHT rules and the administrative position for HWTs, may be either a HWT or an ELHT. The CRA suggests "the trust should maintain evidence to support its intention as to which regime is intended to apply." (#2001-0398371C6 CLHIA Roundtable Q4 – June 2011.

This Tax Topic captures the current administrative practice regarding HWTs. Due to a prior initial attempt to revise IT-85R2 and statements made at the CLHIA Tax Conference and other conferences since the introduction of the ELHT rules, it is anticipated that there may be some changes to this regime. However, the timeframe for revision is not yet known.

In general, health and welfare trusts may be used to administer the provision of certain types of employee benefits for groups of employees, often selected groups of employees (for example, an executive group).

Common contexts for use of HWTs include:

- There is a need/desire for third party administration;
- Self-insurance of particular benefits (i.e. insurance policies are not funding the liabilities, rather the elements of insurance as discussed under the PHSP section below exist);
- There is a desire to keep assets funding benefit liabilities separate from the employer;
- Multi-employer industry plans (often administered by unions);
- Desire to have one vehicle to administer a number of different benefit types for a group of employees where those benefits may be provided for under a collection of individual policies.

It should be noted that, the existence of a HWT does not replace the requirement that the underlying plans qualify as group sickness or accident insurance plans, private health services plans or group term life insurance. Where, for example, individual accident or sickness insurance policies are grouped together in order to form a group sickness or accident insurance plan by common plan, if this characterization fails (for example, because it is not a proper "group" or benefits provided are not provided in an employment capacity but rather in the capacity as a shareholder), the existence of a HWT will not fix this. In other words, adding a HWT to an existing characterization problem will not eliminate the problem.

This Tax Topic will discuss the nature of health and welfare trusts and how they are taxed. Particular focus will be made on whether universal life insurance and critical illness insurance policies would be suitable as investments of a HWT.

Setting up a HWT

To set up a HWT, no formal registration with the CRA is required. However, a trust document, plan documentation and other supporting documents (which may include actuarial valuations and reports) are generally the norm. Ongoing maintenance of the arrangement is required (i.e. annual tax returns for the trust must be filed, ongoing actuarial valuations may be required, etc.) Many of the public documents concerning HWTs are rulings which often outline the particular terms of the trust documents in question. From a review of these documents one may get a good idea of the common terms contained in documents that set up HWTs. In relation to any particular case, it may be prudent to seek a ruling to ensure that any particular arrangement would be treated as a HWT by the CRA.

What is a HWT?

Generally, a HWT is a structure used by an employer to fund health and other benefits for employees (and their families). HWT's are, as the name indicates, trusts. As such, HWT's are generally subject to the same tax rules governing any other inter vivos trust. There is no definition of a HWT in the Income Tax Act. The CRA has published Interpretation Bulletin IT-85R2 "Health and Welfare Trusts for Employees" dated July 31, 1986. This bulletin's stated purpose "is to describe the tax treatment accorded to an employee health and welfare benefit program that is administered by an employer through a trust arrangement that is restricted to" certain plans or policies (see (a)-(d) below). In essence, IT-85R2 attempts to extend the application of 6(1)(a)(i) exclusions where an employer sets aside funds in a trust to provide benefits which would be characterized as being "derived from contributions" to the types of plans or policies listed.

By contrast, paragraph 1 of IT-85R2 highlights "in some cases, the scope of the excepted benefits (i.e. those benefits excluded from the paragraph 6(1)(a) general inclusion of all benefits in employment income) and applicable tax treatment are well established by other provisions of the Act." The bulletin then specifically refers to those other provisions of the Act involving "registered pension funds or plans, deferred profit sharing plans, supplementary unemployment benefit plans, the standby charge for use of an employer's automobile, employee benefit plans and employee trusts."

In addition to IT-85R2, the CRA has commented on numerous occasions on the subject of HWT's in technical interpretations, advanced income tax rulings and, in the fall of 2002, at the Annual Conference of the Canadian Tax Foundation (publishing their remarks in Technical News No. 25, October 30, 2002). As discussed above, a revised interpretation bulletin is expected which deals with these latter statements. A draft IT-85R3 was provided to certain groups for comment. The Joint Committee on Taxation of the CICA-CBA and the Conference for Advanced Life Underwriting (CALU) have provided comments. As a result of these comments, the CRA stated "we believed that it was necessary to set it (revised IT-85R3) aside." It is expected that the CRA will eventually revisit the earlier draft but the timeframe for this review is unclear. Until its views are reflected and available, the draft IT will not be reflected in this Tax Topic.

The aggregate of all of these statements form the CRA's interpretation of the relevant law and administrative practice in relation to these structures. However, one should note that much of this area is interpretive at best. Therefore, staying within the scope of these stated positions may mean different things to different people.

CRA's Stated Positions

IT-85R2 provides the CRA's view of what will qualify as a HWT. Paragraph 1 provides that benefits administered by an employer through such a trust must be restricted to:

a) a group sickness or accident insurance plan;
b) a private health services plan ("PHSP");
c) a group term life insurance policy; or
d) any combination of (a)-(c)."

Each of (a) and (b) will be dealt with in turn.

Group sickness or accident insurance plan

The term "group sickness or accident insurance plan" is also not defined in the Act. Some direction from CRA is contained in IT-85R2 at paragraph 2. It states that in the absence of any statutory definition, the CRA generally accepts that an employer's contribution to a sickness or accident, disability or income maintenance (or salary continuation) plan would be a contribution to a "'group sickness or accident insurance plan'… provided that the particular plan is a 'group' plan and an insured plan." For a full discussion of what constitutes a "group sickness or accident insurance plan" see the Tax Topic entitled "Individual Insurance for Employee Group Plans". The following briefly summarizes this discussion.

To be a "group" plan, the plan must cover more than one individual. This requirement is found in numerous interpretation letters and in the health and welfare trust context in paragraph 7 of IT-85R2. It is possible to offer different benefits to different classes of employees with each class of employees constituting a "group".

It is possible to form a "group sickness or accident insurance plan" by aggregating a number of individual accident or sickness policies "pursuant to a common plan". This would include an undertaking by the employer to insure a certain class or group of employees against sickness or accident as well as the relevant contracts themselves. The plan would be properly authorized and supported by evidence (for example by way of minutes of the Board of Directors of the company.)

What is an "insured plan"? Contracting with an insurance carrier to provide the promised sickness or accident benefits would satisfy this requirement.

Private Health Services Plan (PHSP)

A PHSP is defined in section 248 of the Act as:

(a) a contract of insurance in respect of hospital expenses, medical expenses or any combination of such expenses, or
(b) a medical care insurance plan or hospital care insurance plan or any combination of such plans…

Interpretation Bulletin IT-339R2 "Meaning of 'Private Health Services Plan'" dated August 8, 1989 sets out the CRA's position regarding PHSP characterization. Paragraph 3 sets out the requirement that a PHSP be a plan in the nature of insurance and provides that the following basic elements must exist:

(a) an undertaking by one person,
(b) to indemnify another person,
(c) for an agreed consideration,
(d) from a loss or liability in respect of an event,
(e) the happening of which is uncertain.

This insurance requirement would be satisfied if an insurance carrier were contracted by the employer to provide the relevant benefits. In a technical interpretation (# 2010-0374891E5 dated March 14, 2011) the CRA stated that "a plan administered by an insurer on an ASO (administrative services only) basis is not generally considered a contract of insurance, as the insurance company does not typically bear any risk…" In the same interpretation, the CRA also stated, in the context of employee funded disability insurance plans, that "an employer with no obligation to make contributions to or under a particular plan will also not assume any risk with respect to the provision of benefits under a plan." But, where a plan is "self-insured" this would not necessarily preclude HWT treatment. In the PHSP context, a HWT was seen to exist where eligible benefits were self-insured (see ATR-8, dated May 12, 1986). In that case, contributions to the trust were actuarially determined.

Paragraph 4 of IT-339R2 requires that the coverage be in respect of expenses that normally would otherwise have qualified as a medical expense under subsection 118.2(2) of the Act. It is the CRA's view that if there is even one benefit covered which would not qualify as a medical expense, the plan would not be considered a PHSP. In interpretation letter # 9433745 dated May 5, 1995, the CRA provides the following advice: "While it is a question of fact as to whether any particular expense qualifies as a medical expense as defined in subsection 118.2(2) of the Act, a list of eligible expenses should be described with sufficient precision of terms to ensure that coverage is not inadvertently extended to non-qualifying expenditures." For more information regarding PHSPs, see the Tax Topic entitled "Private Health Services Plans."

Other Requirements for HWT status

In addition to limitation on the types of benefits which can be provided, the CRA sets out other requirements for HWT status primarily in IT-85R2 but also in other public commentary.

Reversion to and Control of the Employer

Paragraph 6 of IT-85R2 states that trust funds cannot revert to the employer or be used for any purpose other than providing health and welfare benefits for which the contributions are made. Interpretation letter #9433745, noted above, states that "acceptable uses of trust funds upon windup include distribution to a registered charity as defined in section 149.1 of the Act and the provision of additional qualifying benefits as described in paragraph 1 of IT-85R2 to the employees covered by the plan." The trust agreement involved in a 2002 HWT ruling did allow for the return of contributions (from HWT surpluses) to the employer paid in error as certified by an actuary (#2002-0165123).

If the employer ultimately controls the trust funds, the CRA states that a HWT does not exist. In interpretation letter # 2002-0170015, dated January 16, 2003, it made the following statement after reviewing the trust document for a particular situation:

> In any situation where the agreements relating to the setting up of a H&WT do not include a provision that specifies that the funds of the trust can never revert back to the employer, and/or a provision that provides the trustees with the power to enforce the contributions required by an employer to the trust and/or includes provisions whereby the trustee(s) appointed by the employer ultimately control any matters relating to the funding of, the administration or, the investment by, or the payment of any benefits under, a H&WT, it is our view that such a trust arrangement would not be considered to be a trust arrangement that is described in IT-85R2.

Related to this, in several rulings, there are express limitations on the investments that can be made with trust funds – prohibiting investments in the employer or corporations related to the employer. (See for example, 2002 Ruling # 2002-0120233.)

Paragraph 6 of IT-85R2 also requires that payments by the employer not be voluntary or gratuitous and must be enforceable by the trustees should the employer not make the required contributions. The trustee(s) must act independently of the employer. This is contrasted with an "arrangement initiated by the employer who has control over the use of the funds whether or not there are employee contributions." Control by the employer is further explained in paragraph 6 by the following statement: "Employer control over the use of funds of a trust (with or without an external trustee) would occur where the beneficiaries of the trust have no claim against the trustee or the fund except by or through the employer."

Funding of the Trust

Paragraph 6 of IT-85R2 provides that "contributions to the fund must not exceed the amounts required to provide these benefits." In numerous interpretation letters and more recently in Tax Technical News No. 25 dated October 30, 2002, the CRA has emphasized that it is their view that this statement in combination with the requirement that the payments not be made voluntarily or gratuitously means "the 'current' cost of paying out the benefits for a particular year."

In interpretation letter # 9433745, dated May 5, 1995 the CRA discussed the use of actuarial calculations in determining the contribution required to provide benefits for the current year as follows:

> The sample documentation you submitted states that the employer would contribute sufficient funds to the trust to provide the benefits available under the plan. An employer's deduction for amounts contributed to the trust may be restricted depending on the manner in which the contribution level is determined. In order to be deductible in a particular year, the employer must be under a legal obligation to make the contributions in that year and the amount must be reasonable in relation to the amount that is expected to be paid out of the trust in the current year. Where the level of annual contributions is determined on an actuarial basis to be the amount required to provide benefits in the current year, the Department will consider the contribution to be reasonable and thus not restricted by subsection 18(9) of the Act.

However, the CRA has stated in Technical News No. 25 that "over-funding" of benefits through lump sum payments which would fund 100% of the estimated value of all future benefits payable with respect to insured claims under a long-term disability benefits provided under a HWT would result in a limitation of deductions by the employer pursuant to subparagraph 18(9)(a)(iii) of the Act (prepaid expenses are not deductible in the year they are paid but rather in the year in relation to which the expenditure is made). The CRA has already performed audits and issued reassessments on this basis. It is expected that amendments to IT-85R2 will be made to specifically restate this position.

While in fact, funding 100% of all future benefits may be different in nature than reasonably established "contingency reserves" for the payment of future benefits, it appears that the CRA's position may not be able to easily distinguish between the two. It appears that in making actuarial determinations, some abuses have occurred in assessing the probability of claim so as to allow lump-sum single deposits to fund all future benefits. The application of limitations on deductions along the lines described by the CRA would seriously limit the amount of funding permitted to be deductible in a given year even if the contribution were permitted to occur without jeopardizing HWT status. This would have the practical impact of potentially limiting the desire to provide benefits to employees that require anything more than a pay-as-you go or yearly renewable term approach.

It should also be noted that where these abuses go too far, the CRA could always potentially argue that the amounts contributed to a HWT are not laid out to gain or produce income and deny deductibility on general principles. This was the case in the context of an offshore HWT set up for the benefit of the part-time employed spouse of the business owner. (See Labow et. al. vs. The Queen 2010 TCC 408.)

For Employees

The individuals covered must be employees and be entitled to receive benefits in their capacity as employees (not as shareholders). Often, in owner-manager situations, an individual is both an employee and a shareholder. In this case, it is a question of fact whether a benefit is conferred on the individual in the capacity as a shareholder or in the capacity of an employee. This is critical since, different tax consequences would result (i.e. generally, the premium is included in the shareholder's income with no deduction to the corporation). For an in depth discussion of this issue please refer to the Tax Topic entitled "Individual Insurance for Employee Group Plans."

While a HWT could be set up for partners, paragraph 7 of IT-85R2 requires a separate trust must be set up for partners to ensure that the funds are at all times identifiable and that cross-subsidization between partner and employee plans will not occur. Different tax treatment will result to partners in relation to benefits than to employees. (The exception in subparagraph 6(1)(a)(i) of the Act, discussed below, does not apply to contributions to such a trust made for partners.)

Tax Implications of a HWT

To the Employer

Contributions to a HWT are deductible by the employer as a business expense to the extent they are reasonable. Expenses are deductible in the year in which the legal obligation to make the contribution arose. A deduction may be limited in a year if expenses are seen as prepaid. (See the discussion above under Funding.) According to Technical News 25, contributions of lump sum amounts to fund future benefits would not, in and by itself, disqualify a trust as a HWT but would be subject to limitations on the amount deducted by the employer.

To the Employee

In general, the value of all benefits received by a taxpayer in the year in respect of, in the course of, or by virtue of an office or employment is included in income under paragraph 6(1)(a) of the Act. Exclusions from this general inclusion are provided for "any benefit derived from the contributions of the taxpayer's employer to or under a registered pension plan, group sickness or accident insurance plan, PHSP, supplementary unemployment benefit plan, deferred profit sharing plan or group term life insurance policy…". This treatment is extended where the employer makes a contribution to a HWT.

When the benefit is ultimately paid out of a HWT it may be taxable to the employee. Generally, the tax treatment of the benefit from a HWT will be the same as if the benefit had been paid directly by the employer rather than by the HWT.

Where the HWT provides benefits which relate to a group sickness or accident insurance plan, paragraph 6(1)(f) of the Act would include "amounts received by the taxpayer in the year that were payable to him or her on a periodic basis in respect of the loss of all or any part of the taxpayer's income from an office or employment, pursuant to (i) a sickness or accident insurance plan, (ii) a disability insurance plan, or (iii) an income maintenance insurance plan…". An employer funded income loss replacement plan administered through a HWT would result in disability income to the employee included under 6(1)(f) of the ITA. Arguably, however, if the benefit received is a lump sum amount (which is not a substitution for periodic amounts), as is the case in respect of critical illness insurance, and/or if it is not in respect of loss of income from an office or employment, as is the case in respect of long term care insurance, the amount received would not be taxable to the individual.

Where the HWT provides benefits which relate to a PHSP, no income inclusion is made on receipt of benefits by the employee.

In the case of group term life insurance premiums paid by the trustee of a HWT, this will result in a taxable benefit under subsection 6(4) of the Act to the employee. The payment of the death benefit under such a policy would not be included in the employee's income, nor in the income of the beneficiary receiving the proceeds.

To the HWT

A HWT is an inter vivos trust for tax purposes. As such it is taxed on its income at the highest marginal rate for individuals on a calendar year basis. Income would be derived from investing contributions in taxable investments. Contributions from the employer would not be included in income of the trust.

Deductions from a HWT's gross income are permitted for expenses incurred in earning the income of the trust and expenses related to the normal operation of the trust. Also, paragraph 12 of IT-85R2 outlines that a deduction would be permitted for "premiums and benefits payable out of the trust income of the current year…. Benefits that are paid out of proceeds of an insurance policy do not qualify. Other benefits paid are normally regarded as having been paid first out of trust income of the year. However, premiums and benefits that would not otherwise be taxable in the hands of the employee by virtue of 6(1)(a) may be treated at the trustee's discretion as having been paid out of prior year's funds or current year's employer's contributions…".

Investments of HWTs

Other than investments in the employer or a party related either directly or indirectly to the employer, there appears to be no limitation imposed by the CRA on the types of investments which can be made by a HWT. Of course, there are general limitations on trustees regarding the nature of investments that can be made with trust funds which in most provinces require a "prudent investor" standard. In addition, the trust document itself can specify investments permitted or required with trust funds in the particular circumstances. Care would need to be taken to ensure the employer is not seen to control the trust funds in any way or HWT status could be jeopardized.

Clearly, where a group sickness or accident insurance plan is created by common plan such that each accident or sickness policy, whether that be disability insurance, critical illness insurance or long term care insurance, is viewed as forming part of the plan, there would be a perfect match between the promised benefits under the plan and the funding vehicles. The following discussion canvasses the use of life insurance or critical illness insurance as investments of a HWT to fund group sickness or accident insurance plan or PHSP obligations. It appears that in the CRA's view, the use of disability insurance that is not a group sickness or accident insurance plan can not be made in the HWT context. (See technical interpretation # 2010-0374891E5, dated March 14, 2011.) Although not directly on point, this interpretation may suggest viewing disability insurance as a funding vehicle for PHSP expenses is not possible in CRA's view.

Life Insurance Policies

A life insurance policy which is exempt from accrual taxation would have the advantage that the inter vivos trust would not be required to include the growth in the policy's cash value in income so long as there is not a disposition of the policy. Any death benefits would be received tax-free since this is not a disposition for tax purposes. It is possible for two or more parties to own an interest in a life insurance policy. This is commonly referred to as a "split-dollar arrangement" under which one party would bear the costs and reap the benefits of an interest in say, the pure death benefit portion of the policy, with the other party bearing the costs and receiving the benefits of an interest in the cash value portion of the policy. (For a more detailed discussion of split-dollar arrangements see the Tax Topic entitled "Split Dollar Life Insurance".)

While it may be possible for the trust to own life insurance or an interest therein, the use of such a vehicle to fund promised benefits would have to be examined in light of the cash flows expected to be paid out of the trust to see if investing in an exempt life insurance policy or an interest therein makes sense in the circumstances. One would have to examine the need for death benefits (and the costs associated with providing this coverage), the age of the individual insureds (as age increases, so do the costs), the years to the expected cash flow requirements (i.e. the investment window available to accumulate cash values for this purpose). Also, one should consider the impact of the CRA commentary regarding the limitation of deductions by the employer for prepaid expenses in the particular circumstances to determine if investment in an exempt life insurance policy or an interest therein would be an appropriate funding vehicle for the promised benefits in the circumstances.

Critical Illness Insurance Policies

One can take a similar approach to that discussed above in relation to life insurance policies in assessing whether a critical illness insurance policy would be an appropriate investment of a HWT. The tax treatment of a critical illness insurance policy is not as clearly delineated as an exempt life insurance policy. The general position is that a critical illness insurance policy should not be considered to be a "life insurance policy" under the Act due to the fact that its primary character is that of accident or sickness insurance. As such, there is no provision of the Act which would expressly include benefits received under a critical illness insurance policy into income. Please refer to the Tax Topic entitled "Taxation of 'Stand-alone' Critical Illness Insurance that is Individually Owned" for a full discussion of the nature of critical illness insurance and its taxation in the individually owned context.

Viewed entirely as an investment vehicle, one would have to consider again if the policy's benefits would adequately track the required cash flows anticipated out of the HWT. Since critical illness insurance covers only specific conditions, funding for promised benefits would only be available on the occurrence of conditions covered under the particular policy. This could result in a shortfall, unless the promised benefits were matched to expenses or benefits arising from the conditions covered in the critical illness insurance policies invested in. The latter limitation, generally, would not be viewed as desirable by employees. The result is that if benefits are not linked to expenses or benefits arising from a critical illness there could be a mismatch between benefits promised and the investment used to fund the promised benefits.

Also, most critical illness insurance policies have the ability to add return of premium features as riders – return of premium on death and return of premium during life at the expiry of the term of the critical illness coverage or after a certain specified period of coverage without claim. Where a HWT purchases critical illness insurance policies containing both return of premium features to fund promised benefits and a critical illness is never diagnosed, the HWT would receive a return of premiums at some point. The main issue is whether the employer making the contribution to the HWT should be permitted to deduct amounts contributed to pay the premium for ROP riders. It is arguable that such amounts would not be taxable to the HWT since they are benefits received from an accident or sickness insurance policy and not in the nature of income, but this position is not entirely without doubt. (See the discussion in the above noted Tax Topic concerning Stand-alone Critical Illness insurance for more detailed discussion of this issue.) Again, unless the promised benefits were matched to the benefits received by the trust from such critical illness insurance policies, receipt of return of premium benefits would potentially create a surplus at the HWT level. If the ROP benefit were paid anywhere other than to the HWT, this could call into question the HWT (see discussion above entitled "Reversion to and Control of the Employer").

Conclusion

A HWT can be an effective method for an employer to provide benefits for selected groups of employees that supplement or replace standard group benefits. Where a HWT exists, contributions to the trusts are deductible to the employer provided they are reasonable in the circumstances. Employees would not receive a taxable benefit for benefits derived from contributions to the HWT (except to the extent that they represent group term life insurance premiums) but they may receive an inclusion in income for benefits ultimately received, depending on the nature of those benefits.

Life insurance and critical illness insurance may be considered as possible investments of a HWT. In considering this, CRA comments regarding the permitted amount of deductible funding of a HWT should be read in detail.

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Last updated: July 2011

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