Critical illness insurance
Health and welfare trusts
and other concepts

Jon Hitchcock  CFP, CLU, CH.F.C., TEP
Director, Affluent Insurance Market Development

Jim Wendland  CMA, MBA
Director, Individual Product Taxation

Wealth Protection Group

January 2006
### Table of Contents

What is a health and welfare trust? ................................................................. 3  
Key requirements of a health and welfare trust ........................................... 4  
Tax issues ........................................................................................................ 4  
  For the trust ................................................................................................. 4  
  For the employees ........................................................................................ 5  
Restrictions on transferring out on retirement/termination ............................. 5  
Health and welfare trusts in Quebec ............................................................. 5  
Administration of the trust .......................................................................... 6  
Alternatives to a health and welfare trust ...................................................... 6  
  Group critical illness insurance ................................................................. 6  
  Corporate-owned critical illness insurance policy ..................................... 6  
Advanced structures/strategies for critical illness insurance ............................ 7  
  Shared ownership and/or shared benefit arrangements .............................. 7  
    Preliminary issues .................................................................................... 7  
    Types of sharing ...................................................................................... 7  
    Sharing the benefits .............................................................................. 7  
    Sharing the premium payments ............................................................ 8  
    Risks, drawbacks and hurdles ............................................................... 8  
Appendix A – Review of CRA materials .......................................................... 9  
  TI - 9126876 Group sickness and accident insurance plan ............................ 9  
  TI - 2003-0026385 - Critical illness insurance .......................................... 9  
  TI - 2003-0004265 - Critical illness insurance .......................................... 9  
  TI - 2002-0160155 - Critical illness insurance whether a tax benefit .......... 9  
  TI - 9411015 - Removal of a disability policy from employer plan .......... 10  
  TI - 5-8067 - Shareholder or employee benefits .................................... 10  
  TI - 2000-0055145 - Accident and sickness insurance ............................. 10  
  TI - 2003-0034505 - Critical illness insurance .......................................... 10  
  TI - 9711505 - Critical illness insurance .................................................. 10  
  TI - 2003-0182875 - Transfer of insurance policies .................................. 11  
  TI - 2004-0090791C6 – Critical illness and long-term care insurance ......... 11  
  IT-85R2 – Health and welfare trusts for employees ..................................... 11  
Appendix B – Alternatives comparison ........................................................... 16

The information presented here is for your information only. Sun Life Assurance Company of Canada does not provide legal, accounting, taxation or other professional advice to advisors or their clients. Before you act on any of this information on behalf of a client, always have your client seek advice from a qualified professional including a thorough examination of your client’s specific legal/tax situation.

Sun Life Assurance Company of Canada is a member of the Sun Life Financial group of companies.
What is a health and welfare trust?

A health and welfare trust is an arrangement between an employer and its employees, where the employer agrees to provide one or more benefits for employees and/or their families. Permitted benefits include life insurance, accidental death and dismemberment insurance, private health services plans, wage loss replacement plans and provincial health services premiums.

There is no definition of a health and welfare trust in the Income Tax Act. These trusts have evolved over time as a vehicle to fund selected employee benefits, often in a unionized environment, or in an employee group that is too small to make a group insurance contract viable. The Canada Revenue Agency (CRA) has developed administrative processes for them based on its interpretations of various provisions of the Income Tax Act relating to group insurance coverages. If conditions set by CRA are not met then the arrangement can be taxed as a deferred income plan, which generally involves much less favourable tax treatment.

These arrangements are often attractive because employer contributions to qualified health and welfare trusts are tax-deductible, provided they are reasonable. And premiums paid for sickness and accident insurance or for personal health insurance plans will not constitute a taxable benefit in the hands of the employee, except in Quebec. For Quebec employees, the premiums paid are only a taxable benefit on their Quebec tax return, not the federal return. Employee contributions to a health and welfare trust are not tax-deductible for the employees.

CRA’s Interpretation Bulletin IT-85R2, dated July 31, 1986¹, outlines CRA’s requirements for such an arrangement to meet the definition of a health and welfare trust. The main criteria are:

The trust must
• be a formal trust, and the trustees must act independently of the employer.
• include two or more employees as members of the health and welfare trust.
• have a sole purpose – to provide health and welfare benefits to employees.
• be an insured plan.

Benefits must be restricted to
• a group sickness or accident insurance plan;
• a private health services plan;
• a group term life insurance policy; or
• any combination of the above.

The restrictions on the employer contributions include:
• No portion of the funds can revert to the employer at any time, and they cannot be used for any purpose other than providing the health and welfare benefits for which contributions are made to the plan.
• The contribution is limited to the amount actually required to provide the benefits.
• Contributions are mandatory (and enforceable by the trustees) and cannot be voluntary.

There is no requirement that the plan be registered with, or approved by, the CRA.

The CRA has indicated that critical illness insurance benefits can be provided through a health and welfare trust, provided the contract qualifies as accident and sickness insurance under the law of the province that governs the arrangement. However, the

¹ A copy of this bulletin is included on page 11.
provincial insurance acts differ in how they define accident and sickness insurance, and CRA is careful to say that the availability of favourable tax treatment for group CII, or for individual CII policies that have been “grouped” through a health and welfare trust is dependent upon the terms of the provincial Insurance Act, the specific terms of the particular CII plan, and the non-existence of any return of premium feature.

Recently the CRA was asked to confirm that a particular critical illness plan is a sickness policy according to the British Columbia Insurance Act. In a technical interpretation letter, the CRA suggested that the writer needed to contact the B.C. Superintendent of Insurance for a decision and went on to note that if it did not qualify, then any premiums paid by an employer would “likely result in a taxable benefit to the employees.”

While most provinces define sickness insurance as a payment or indemnity in the event of a sickness, the B.C. legislation defines it as insurance against loss resulting from an illness. Since a critical illness insurance payment doesn’t reimburse losses but instead pays a lump sum, this may be the source of the CRA’s discomfort with the B.C. legislation.

Consequently, an employer who wishes to be certain that the desired result will be obtained should seek an advance tax ruling from CRA on the arrangement and the terms of the CII policy being used.

The employer should also consider contacting the B.C. Superintendent of Insurance.

Key requirements of a health and welfare trust
The employer defines a benefit plan that pays benefits to an insured employee who is diagnosed and survives a covered critical illness. The health and welfare trust manages the benefit plan on behalf of the employer for the benefit of the covered employees. The health and welfare trust would purchase either a group CII policy or a series of individual CII policies to provide the benefits. In several CRA rulings and technical interpretations, CRA agreed that an individual CII policy providing CII benefits and excluding return of premium benefits would be categorized as an accident and sickness insurance policy for tax purposes. Such a policy provided as part of a group or “grouped” arrangement could be included in a health and welfare trust.

Tax issues
For the trust
A health and welfare trust is an inter-vivos trust and is taxable at the top marginal rate on its trust income (gross income less deductible expenses). The trust’s taxation year is the calendar year. The trustee is required to file form T3 (Trust Information Return and Income Tax Return) where its gross income from all sources exceeds $500.

Gross income would include investment income earned on contributions received plus any incidental income (other than contributions from employers and employees).

Where an employer contributes only the funds needed to pay the insurance premiums and the administration fees and where insurance benefits are paid in full to the beneficiaries, a health and welfare trust will not have any taxable income. The reporting of any excess income is provided for in IT-82R, paragraphs 11-14.

The trustees will also be held responsible to collect and remit any federal or provincial sales, excise or other taxes due on the employer contributions or premiums paid by the health and welfare trust. In jurisdictions where this responsibility cannot be retained by the trust, the trustees will provide information necessary to allow the insurer to meet its collection and remittance obligations.

One of the key requirements for providing CII benefits through a health and welfare trust is that the CII policies are part of a group accident and sickness insurance plan. This can be achieved through the use of a group CII plan or a series of grouped individual CII policies, which provide the benefits described in the group plan.
For the employees

Employer contributions to a group accident and sickness insurance policy are not subject to the taxable benefit rules for employees, except in Quebec. An appropriately designed group CII policy or grouped individual CII policies can meet this definition resulting in no taxable benefit for the premiums paid by the employer.

Likewise, benefits received from the health and welfare trust, including CII benefits, would not be taxable to the employee.

Restrictions on transferring out on retirement/termination

At retirement or on change of employment, the individual CII plan within the health and welfare trust is no longer needed to provide the benefits to the former employee. The policy itself could be terminated. Alternately, the policy would be transferred out to the former employee.

While a policy without return of premium (ROP) features would generally have no value from an insurance perspective, CRA reserves the right to assess a taxable benefit based on the fair market value of the policy transferred to the former employee.

To determine the fair market value, CRA would consider factors such as: the age and health of the individual, the paid-up option in the policy, the cash surrender value of the policy arising in later years, the total amount of premiums paid by the corporation on the policy to the date of transfer and whether the level of benefits or amount of premium payable for the policy is favourable relative to what the individual could purchase separately.

Health and welfare trusts in Quebec

Under the Quebec Civil Code (QCC), critical illness insurance appears to qualify as an accident and sickness plan under an “insurance of persons” contract. Unlike the Insurance Act, it allows for a beneficiary designation. In addition, the QCC makes it simpler to implement more complex CII arrangements by formally indicating that clauses of an insurance contract that accompany an accident and sickness plan are governed by the rules applicable to the principal contract.

On the tax side however, the Quebec Taxation Act (TA) does not provide for the same tax treatment as the federal legislation does. Revenue Quebec has indicated that CRA’s IT-85R2 applies to a health and welfare trust as long as it complies with the tax system particulars applicable to employees in Quebec.

Specifically, this bulletin indicates clearly that IT-85R2 does not apply to payment by the trustee of all or part of the employee premiums to a private sickness insurance plan. The amount of the premiums is a taxable benefit and must be included in the calculation of the employee’s taxable income for the year. In addition, since the premiums are included in the employee’s remuneration, they are also subject to payroll taxes. And since they are employee remuneration, the amount is deductible from the employer’s income as long as the expenses are reasonable.

A critical illness insurance benefit is a lump sum benefit payable without any specific requirement to be used for medical purposes. Therefore the premiums included in the employee’s income will not qualify for the medical tax credit. On the other hand, since there is no tax relief for the premiums paid, the benefits paid are probably not taxable to the employee. To date, there has been no firm position or formal interpretation of these matters from the Quebec tax authorities.

---

2 Article 2445 Quebec Civil Code (QCC)
3 Article 2394 QCC
4 Taxation Act, R.S.Q., c. 1-3
5 Technical Interpretation 96-010030, Fiducies de santé et bien-être au bénéfice d’employés, July 19, 1996
6 Article 37.0.1.2 and 37.0.1.3 TA
Administration of the trust

As previously noted, the trustee must be independent of the employer. The trustee will have the following roles and responsibilities:

• Apply to the insurer for a critical illness insurance policy for all participants
• arrange to transfer ownership of existing policies owned by the employer where appropriate
• Collect funds from the employer to enable the trustee to pay the premiums and taxes due as well as other expenses
• enforce payment where the employer is in default
• pay premium taxes and sales taxes where appropriate
• ensure that benefits are paid to the appropriate party, e.g., the participant in case of a critical illness or the designated payee in the event of the death of the participant
• facilitate direct dealing between the participants and the insurer with respect to the handling of forms required to administer the policy including beneficiary change forms, claim forms, etc.
• transfer the ownership of a policy from the trust to the participant if the participant ceases to be an employee, or cancel the coverage where appropriate, e.g., where the participant is covered under a group plan

Trustees must set up a separate bank account for the trust, provide a regular invoice to the employer for premiums and expenses as well as maintain records and provide safekeeping of the policies.

Alternatives to a health and welfare trust

Group critical illness insurance

Many group carriers now include critical illness insurance benefits in their plans. Premiums are tax-deductible to the employer and benefits paid to participants are not taxable. It is important that any group plan include employees who are not shareholders in order to avoid having the plan deemed to be a shareholder benefit. Premiums for shareholder benefits are not tax-deductible and the benefits themselves may be taxable.

A return of premium benefit is generally not offered under a group plan.

Corporate-owned critical illness insurance policy

Corporations and/or partnerships may want to protect themselves against the loss of a key person due to a critical illness. While the employee may well survive the critical illness, they may not be able to carry out the same duties as before or may lose some of the drive and ambition that made them so valuable.

With the consent of the insured employee, the employer can own and benefit from a critical illness insurance policy on the key person. If the insured employee suffers a critical illness that satisfies the requirements of the plan, the benefit would be paid to the corporation on a tax-free basis. Premiums are not tax-deductible to the corporation.

Proceeds from a critical illness insurance policy do not qualify for capital dividend account treatment. Any payment of the proceeds to the employee would be taxable as either a salary or bonus. If the board of directors elected to use the funds to pay a dividend to shareholders, it would be a taxable dividend.

---

7 See Appendix B for a comparison of the alternatives.
8 See TI – 2000-0055145 in Appendix A.
Advanced structures/strategies for critical illness insurance

Shared ownership and/or shared benefit arrangements

In a July 1991 discussion paper on the tax treatment of flexible benefit plans, the CRA was asked about the use of a “split-dollar” life insurance policy on key employees insured under the health and welfare trust. The answer:

There are only three types of insurance coverage that the Department accepts for inclusion in a trust; i.e., a private health services plan, a sickness or accident insurance plan, or a group term life insurance plan. A “split-dollar” life insurance policy is not any of these. Therefore the purchase of such coverage would put the trust offside. I should mention that an employer is not entitled to a deduction for premiums paid to purchase a split-dollar policy.

This suggests that a health and welfare trust cannot be a party to a shared ownership or “split-dollar” arrangement. Anyone considering the implementation of such a strategy should get independent legal and tax advice and is strongly advised to request an advanced tax ruling before proceeding.

Preliminary issues

Whereas most life insurance sharing arrangements involve a “face plus” type of policy, CII coverage tends to be “either/or” – it pays a benefit following diagnosis of a covered critical illness, or it pays a return of premium on cancellation (ROPc), expiry (ROPe) or on death (ROPd) but it does not pay both. Thus, the party who owns the right to the ROP could lose it if the individual is diagnosed with a critical illness. The alternative is to have the ROP amount reimbursed to that party out of the CII payout. The longer the policy is in force, the greater the risk that the ROP amount could be a substantial portion of the total payout, reducing the potential value for the party entitled to the CII benefit.

For life insurance, there is clear statutory authority for naming beneficiaries on death. CII has no clear statutory authority, except in the case of death by accident, and there is no provision for designating beneficiaries irrevocably.

Types of sharing

There are two types of sharing:

a) Two co-owners and two parties entitled to differentiated benefits
b) One owner and benefits are divided by designating the other party as “beneficiary” or payee of one of the benefits

Sharing the benefits

There appear to be three different ways to share the benefits of a critical illness insurance policy:

a) the insured person (an employee or an employee/shareholder) receives the critical illness insurance benefit, and the corporation receives the ROP benefit to recover their premiums paid; or

b) the insured person (an employee or an employee/shareholder) receives the ROP benefit and the critical illness insurance benefit is payable to the corporation for key person, loan repayment, or buy-sell purposes; or

c) in rare cases, there may be different payees for ROPD and ROPC/E – e.g., the corporation for the critical illness insurance payout and the ROPD as key person coverage, while the insured receives the ROPC/E.
In any of these arrangements, the parties will need to determine what happens to the ROP entitlement in the event of a critical illness diagnosis. If it occurs during the period when there is no ROP, then presumably the payee for ROP is out of luck. If it occurs after this period, then the parties could negotiate a sharing of the CII benefit to provide some payment to the party that paid the premium for the ROP. As noted earlier, this becomes a bigger and bigger problem the longer the policy is in force.

Sharing the premium payments
Unlike life insurance, there is no “morbidity cost” or equivalent to the Net Cost of Pure Insurance (NCPI) prescribed in the Income Tax Act. While some insurance carriers have a separate premium for the ROP, others have bundled it into the basic premium, making it difficult to determine the appropriate amount for each party to pay.

Risks, drawbacks and hurdles
There continues to be uncertainty with respect to the taxation of critical illness insurance policies owned by corporations. Anyone contemplating a sharing arrangement between a corporation and an employee or employee shareholder will need to consider the following potential problems:

• There is no Capital Dividend Account credit for CII proceeds paid to a corporation, meaning there is no mechanism for paying the benefit out to a shareholder or employee on a tax-free basis.
• There is no possibility of deduction of any portion of the premium by the corporation or the insured person, meaning the premiums are paid with after-tax dollars.
• There are provisions in insurance acts for collateral assignment to lender, meaning the policy may not be able to be leveraged.
• There are no provisions in insurance acts for designation of a beneficiary on a sickness and accident policy. The designation in a Sun Life Financial policy is in the nature of a “payee” and may or may not hold up to a legal challenge. This makes the signed, legal contract to share benefits, costs and possibly ownership of a policy of paramount importance. There is also the question as to whether or not the ROPD will bypass probate.
• There is no “beneficiary” designation provision in sickness and accident insurance outside of Quebec, meaning
  • no creditor protection – the funds (ROP and CII benefit) are potentially vulnerable to both corporate and personal creditors’ claims
  • ROPD might not bypass probate where probate applies
• There is no certainty that the entire return of premium benefit will be tax-free and not subject to accrual taxation in a shared ownership or “split-dollar” arrangement.
• As CRA Technical Interpretations do not have force of law, there is a risk involved in relying on them over-much for the long term. Provisions for unwinding the arrangement should be built into the agreements to avoid potential employee/shareholder benefits should the law (or interpretation) change unfavourably.
  • With traditional “split-dollar” life insurance, there was no “grandfathering” available for pre-existing arrangements when the tax treatment changed in the early 1990s, although this change was made by applying existing legislation rather than by introducing new provisions.
Appendix A – Review of CRA materials

TI - 9126876 Group sickness and accident insurance plan
Date: December 11, 1991

This technical interpretation provides some insight into a series of individual plans constituting a group accident and sickness insurance plan.

A ‘group sickness and accident insurance plan’ means a plan under which a number of employees are insured either under a single contract between the insurer and the employer contracting with the insurer or under individual contracts but pursuant to a common plan.

It goes on to say that the phrase ‘pursuant to a common plan’ simply means that the individual contracts are bought in respect of employees covered by one plan. Each individual contract forms part of the plan of the employer. The insurance plan includes 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. It was also our stated position at the time that describing such a plan or undertaking in the corporate minutes would be adequate; that no formal agreement was necessary.

TI - 2003-0026385 - Critical illness insurance
Date: December 10, 2003

This technical interpretation confirms that a CII policy that provides only critical illness insurance benefits would qualify as an accident and sickness policy. In addition, the funding pattern for the policy should not, in itself, impact the status of the policy.

TI - 2003-0004265 - Critical illness insurance
Date: June 18, 2003

This technical interpretation is a follow up to the question posed at the CALU Annual General Meeting. It discusses the characterization of critical illness insurance policies.

Where a policy provides benefits only in the event of critical illness, we agree with your view that the policy should be viewed as a “sickness” policy, rather than a life insurance policy for purposes of the Act, notwithstanding that such policies are primarily issued by life insurers. In our view, the proceeds of disposition of such a policy would generally not be included in the policyholder’s income under section 3 of the Act.

The appropriate treatment of policies providing benefits in addition to critical illness insurance benefits is less clear. Some “ROP” benefits may well be life insurance. However, we have yet to satisfy ourselves that the primary coverage under such policies should dictate its treatment for purposes of section 148 of the Act in common law jurisdictions. We can confirm that this appears to be the case under civil law.

TI - 2002-0160155 - Critical illness insurance whether a tax benefit
Date: April 3, 2003

This technical interpretation discusses the classification of a CII policy and whether employer paid premiums are a taxable benefit to the employee.

The group critical illness insurance policy in question is a stand-alone policy without any provision for life insurance coverage.

With regard to group sickness and accident insurance plans, the term “sickness and accident insurance” is not defined in the Act. We therefore need to consider the definitions in the insurance legislation of the applicable jurisdictions to determine whether a particular policy can be characterized as a sickness or accident insurance policy. Based on our review of the relevant definitions in the Insurance Act of Alberta (the employer’s location) and the terms and conditions of the particular group critical
Critical illness insurance policy, it is our view that the employer-paid premiums to this plan would not be a taxable benefit to its employees by reason of the exclusion in subparagraph 6(1)(a)(i) of the Act.

TI - 9411015 - Removal of a disability policy from employer plan
Date: July 12, 1994
This technical interpretation discusses the implications of transferring a policy from the group plan to the individual on termination of employment.
Regarding the change in ownership it states:

However, the former employee would be required to include in income any benefit arising as a result of the transfer of the ownership of the policy. Such a benefit would arise where the level of benefits or amount of premium payable for the policy is favourable in relation to that which the individual could purchase separately.

TI - 5-8067 - Shareholder or employee benefits
Date: June 28, 1989
This technical interpretation reiterates the CRA’s position that a change in ownership is subject to a fair market valuation at the time of transfer. Factors such as the age and health of the individual, the paid-up option in the policy, the cash surrender value of the policy arising in later years and the total amount of premiums paid by the corporation on the policy to the date of transfer should all be considered.

TI - 2000-0055145 - Accident and sickness insurance
Date: January 9, 2001
This technical interpretation considers when a benefit will be received as a shareholder benefit versus an employee benefit and reiterates that group coverage requires two or more employees to be covered.

In the case where an individual is both an employee and a shareholder, it is a question of fact whether a benefit has been conferred on the individual in the capacity of a shareholder or in the capacity of an employee. However, where a benefit is granted to such an individual, the benefit will be presumed to have been conferred upon him or her by reason of being a shareholder, unless the benefit is comparable in nature and quantum to benefits generally offered to employees who perform similar services and have similar responsibilities for other employers of a comparable size.

We agree with you that a group sickness and accident insurance plan must cover at least two employees. Otherwise a group is not involved.

TI - 2003-0034505 - Critical illness insurance
Date: December 9, 2003
This technical interpretation discusses the deductibility of premiums, the taxation of premiums and benefits where individual CII plans form a group under a health and welfare trust.

First, it was considered that the individual CII policies could form group accident and sickness insurance coverage provided there were no return of premium features offered. Based on this determination the tax results flow from the rules regarding health and welfare trusts. Contributions made by the employer to the health and welfare trust are deductible. The employer paid premiums are not a taxable benefit to the employee. The lump sum payment of CII benefits is also not taxable to the employee.

TI - 9711505 – Critical illness insurance
Date: June 2, 1997
This technical interpretation also deals with the deductibility and taxation issues covered above. It also reviews whether CII could qualify as a Private Health Service Plan (PHSP).
CII cannot qualify as a PHSP since the payment of a lump-sum benefit upon the first occurrence of a medical event does not appear to [CRA] to depend on, require, or otherwise relate to the incurrence of any hospital or medical expense, or any combination of such expense by the individual. As a result, the conditions outlined in the definition of a “private health services plan” in subsection 248(1) do not appear to be met.

**TI – 2003-0182875 – Transfer of insurance policies**  
Date: June 30, 2003  
This technical interpretation discusses the tax implications of transferring an in-force CII policy from the corporation to a shareholder for no consideration.

It concludes that where the shareholder acquires an in-force policy, it must include as a taxable shareholder benefit under subparagraph 15(1) the excess of the fair market value of the policy over the consideration paid.

However, CRA is of the opinion that the age and the health of the policy-holder, the amount of the refundable premiums as well as the amount of the premiums paid at the date of the transfer will be some of the elements to be considered in determining the policy’s fair market value.

**TI – 2004-0090791C6 – Critical illness and long-term care insurance**  
Date: October 8, 2004  
This technical interpretation reiterates the same principles around deductibility of premiums by the employer, taxable benefits to employees and the taxation of benefits for CII and long-term care insurance plans.

Provided the plans qualify as group accident and sickness insurance, the tax consequences flow from this classification. Again, the exclusion of refund of premium benefits was paramount to this finding.

**IT-85R2 – Health and welfare trusts for employees**  
Date: July 31, 1986  
Reference: Paragraph 6(1)(a) and section 104 (also subsections 6(4), 12.2(3), (4), and (7), paragraphs 6(1)(f), 56(1)(d), and (d.1), 60(a), 110(8)(a) and subparagraphs 148(9)(c)(vii) and (ix); also section 19 of the Income Tax Application Rules, 1971.

**Income tax – Special rules – employee benefit plans**  
This bulletin replaces and cancels IT-85R, dated January 20, 1975. Proposals contained in the Notice of Ways and Means Motion of June 11, 1986 are not considered in this release.

1. The general thrust of paragraph 6(1)(a) is to include in employment income the value of all benefits received or enjoyed in respect of an employee’s employment. However, there are a number of specific exceptions many of which can be described as benefits relating to the health and welfare of the employee. In some cases, the scope of the excepted benefits and applicable tax treatment are well established by other provisions of the Act (e.g., registered pension funds or plans, deferred profit sharing plans, supplementary unemployment benefit plans, the standby charge for the use of an employer’s automobile, employee benefit plans and employee trusts). The treatment to be accorded to the other exceptions can be less clear, particularly when the benefits form part of an omnibus health and welfare program administered by an employer. The purpose of this bulletin 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 and that is restricted to

   a) a group sickness or accident insurance plan (see 2 below),
   
   b) a private health services plan,
   
   c) a group term life insurance policy, or
   
   d) any combination of (a) to (c).
2. Paragraph 6(1)(f) sets out the treatment of periodic receipts related to loss of income from employment under three types of insurance plans to which the employer had made a contribution. These types of plans are sickness or accident, disability and income maintenance (also known as salary continuation). In the absence of any statutory definition, the Department generally accepts that an employer’s contribution to any of the three types of plans will be a contribution to a “group sickness or accident insurance plan” as described in subparagraph 6(1)(a)(i), provided that the particular plan is a “group” plan and an insured plan. This is based on the assumption that a “disability” resulting in loss of employment income would almost invariably arise from sickness or an accident and that an “income maintenance” payment would likely arise from loss of employment income due to sickness or an accident if not layoff (the latter reason justifying an exception under subparagraph 6(1)(a)(i) as a supplementary unemployment benefit plan). There may be situations where these assumptions will prove invalid but, subject to this caveat, 1(a) above may also be read as a “group disability insurance plan” or “a group income maintenance insurance plan that is not a supplementary unemployment benefit plan.”

**Employee Benefit Plans and Employee Trusts**

3. Employee benefit plans are broadly defined in subsection 248(1) and can encompass health and welfare arrangements. However, funds or plans described in 1(a) to (d) above are specifically excluded in the definition and are thus accorded the tax treatment outlined in this bulletin. Health and welfare arrangements not described in 1(a) to (d) above (e.g., those not based on insurance) may be employee benefit plans or, less likely, employee trusts subject to the tax consequences outlined in IT-502.

4. Where part of a single plan could be regarded as a plan described in 1(a) to (d) above and another part as an employee benefit plan or an employee trust, the combined plan will be given employee benefit plan or employee trust treatment in respect of the timing and amounts of both the employer's expense deductions and the employees' receipt of benefits under the plan. However, if contributions, income and disbursements of the part of the plan that is described in 1(a) to (d) above are separately identified and accounted for, the tax treatment outlined in this bulletin will apply to that part of the plan.

**Meaning of health and welfare trust**

5. Health and welfare benefits for employees are sometimes provided through a trust arrangement under which the trustees (usually with equal representation from the employer or employers’ group and the employees or their union) receive the contributions from the employer(s), and in some cases from employees, to provide such health and welfare benefits as have been agreed to between the employer and the employees. If the benefit programs adopted are limited to those described in 1(a) to (d) above and the arrangement meets the conditions set out in 6 and 7 below, the trust arrangement is referred to in this bulletin as a health and welfare trust.

6. To qualify for treatment as a health and welfare trust the funds of the trust cannot revert to the employer or be used for any purpose other than providing health and welfare benefits for which the contributions are made. In addition, the employer’s contributions to the fund must not exceed the amounts required to provide these benefits. Furthermore, the payments by the employer cannot be made on a voluntary or gratuitous basis. They must be enforceable by the trustees should the employer decide not to make the payments required. The type of trust arrangement envisaged is one where the trustee or trustees act independently of the employer as opposed to the type of arrangement initiated unilaterally by an employer who has control over the use of the funds whether or not there are employee contributions. 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 trustees or the fund except by or through the employer.

7. With the exception of a private health services plan, two or more employees must be covered by the plan. Where a partnership seeks to provide health and welfare benefits for both the employees and the partners by means of a trust, two distinctly separate health
and welfare trusts (one for the partners and one for the employees) must be set up to ensure that the funds of each are at all times identifiable and that cross-subsidization between the plans will not occur. The exception in subparagraph 6(1)(a)(i) will of course not apply to such a trust established for the partners.

**Tax Implications to Employer**

8. To the extent that they are reasonable and laid out to earn income from business or property, contributions to a health and welfare trust by an employer using the accrual method of computing income are deductible in the taxation year in which the legal obligation to make the contributions arose.

**Tax Implications to Employee**

9. An employee does not receive or enjoy a benefit at the time the employer makes a contribution to a health and welfare trust. However, subject to 10 below, the tax consequences to an employee arising from benefits provided under such a trust are as follows:

**Group Sickness or Accident Insurance Plans**

(a) Where a group sickness or accident insurance plan provides that benefits are to be paid by the insurer directly to the employee, the premium paid by the trustees to the insurer for the employee’s coverage will not result in a benefit to be included in the employee’s income.

(b) Where this type of group sickness or accident insurance plan existed before June 19, 1971 and the requirements of section 19 of the ITAR are met (see IT-54, “Wage Loss Replacement Plans”), the benefits paid to an employee by the trustees or the insurers under such a plan in consequence of an event happening before 1974 will not result in a taxable benefit to the employee. Where these requirements are not met and in all cases of payments for events happening after 1973, the wage loss replacement benefits will be taxable under paragraph 6(1)(f) (see IT-428, Wage Loss Replacement Plans).

**Private Health Services Plans (defined in paragraph 110(8)(a))**

(c) Payment by the trustees of all or part of the employee’s premium to a private health services plan does not give rise to a taxable benefit to the employee. Benefits provided to an employee under a private health services plan are also not subject to tax.

**Group Term Life Insurance**

(d) Payment by the trustees of a premium under a group term life insurance policy will not result in a taxable benefit to the employee unless the aggregate amount of the employee’s coverage under one or more group term life insurance policies exceeds $25,000. (See IT-227R, Group Term Life Insurance Premiums). The provisions of section 12.2 which tax accrued amounts under a life insurance policy do not apply since a group term life insurance policy will be an exempt policy for that purpose.

(e) Where a group term life insurance policy provides for a lump sum payment to the employee’s estate or a named beneficiary, the receipt of the payment directly from the insurer is not included in the recipient’s income.

(f) Certain group term life insurance policies provide beneficiaries thereunder with an option to take periodic payments in lieu of the lump sum payment and others provide only for periodic payments to beneficiaries. Prior to the introduction of the accrual rules in section 12.2 for 1983 and subsequent taxation years, benefits thus paid by the insurer to a beneficiary, whether as a result of exercising the option or by the terms of the policy, were annuity payments that were income of the recipient (paragraph 56(1)(d)) who deducted the capital element of the annuity payment (paragraph 60(a) of the Act and Part III of the Regulations).

(g) For the 1983 and subsequent taxation years, paragraphs 56(1)(d) and 60(a) continue to apply to a beneficiary who is a holder and annuitant under an annuity contract if subsection 12.2(3) does not apply because of the exceptions in paragraphs 12.2(3)(c) to
(e) or the application of subsection 12.2(7). Generally speaking, this will occur where the annuity contract

(i) is a prescribed annuity contract as defined in Regulation 304,

(ii) was acquired before December 2, 1982 under which annuity payments commenced before December 2, 1982,

(iii) is an annuity contract that was received as proceeds of a group term life insurance policy which was itself neither an annuity contract nor acquired after December 1, 1982, or

(iv) was acquired before December 2, 1982, can never be surrendered and in respect of which the terms and conditions have not been changed and is not the subject of an election under subsection 12.2(4).

(h) For annuity contracts other than ones described in (g) above, the annuitant is required by subsection 12.2(3) for the 1983 and subsequent taxation years to include in income accrued amounts on every “third anniversary” of the contract. In addition, in any year that does not include a “third anniversary,” paragraph 56(1)(d.1) requires the inclusion of amounts in respect of annuity payments received during the year under the contract. As an alternative to the application of subsection 12.2(3) and paragraph 56(1)(d.1), the annuitant may elect under subsection 12.2(4) (before annuity payments commence) to include accrued amounts on an annual basis. In each instance, the issuer will provide the annuitant with a T-5 information slip indicating the amount of income to be reported in respect of the annuity contract.

Shared Contributions
10. In 9 above the trustees are assumed to be receiving contributions only from the employer to pay for the cost of benefits under the trust plan. However, the trustees may also receive employee contributions to pay a part of the cost of the benefits being provided under the plan. If the plan does not clearly establish that the trustee must use the employee contributions to pay all or some part of the cost of a specific benefit, then it will be assumed that each benefit under the plan is being paid out of both the employer and employee contributions. If the benefit in question is otherwise taxable to the employee, then in these circumstances a part of it is non-taxable. The non-taxable part is that proportion of the benefit received by the employee for the year that the total of employee contributions received by the trustees in the year is of the aggregate of the employer and employee contributions received by the trustees in the year. The above treatment will not apply if the benefit must be reported as income according to paragraph 6(1)(f) (see 9(b) above). However, the employee’s contributions to plans referred to in 9(b) may be deductible for tax purposes from benefits received from the plan. See IT-428 for details.

Taxation of Trust
11. A trust which invests some of the contributions received and earns investment income, or has incidental income (other than contributions from employers and employees which are not included in computing income of the trust), is subject to tax under section 104 on the amount of such “trust income” remaining after the deductions discussed in 12 below. Where gross income (i.e., the aggregate of its income from all sources) exceeds $500 in the taxation year (and in certain other circumstances indicated on the form), the trustee is required to file form T3 (Trust Information Return and Income Tax Return).

12. In computing trust income subject to tax, the trust is allowed to deduct, to the extent of the gross trust income, the following expenses, premiums and benefits it paid, and in the following order:

(a) expenses incurred in earning the investment or other income of the trust,
(b) expenses related to the normal operation of the trust including those incurred in the collection of and accounting for contributions to the trust, in reviewing and acquiring insurance plans and other benefits and for fees paid to a management company to administer the trust, except to the extent that such expenses are expressly not allowed under the Act,

(c) premiums and benefits payable out of trust income of the current year pursuant to paragraph 104(6)(b). 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 paragraph 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, to the extent that they are available, to avoid the application of subsection 104(13).

The remainder of the income of the trust is subject to income tax under section 122 of the Act. As an inter vivos trust, the taxation year of the trust coincides with the calendar year.

13. For administrative simplicity, payments of taxable benefits by the trustee to or on behalf of employees are to be reported on Form T4A by the trustee and not on the T3 Supplementary. Information on the completion of Form T4A is contained in the “Employer’s and Trustee’s Guide.” Although the trustee is required to withhold income tax from taxable benefits paid to employees, these amounts will not be subject to either Canada Pension Plan contributions or unemployment insurance premiums when paid by the trustee.

14. Although actuarial studies of the trust may recommend the establishment of “contingency reserves” to meet its future obligations, transfers to such reserves are not deductible for tax purposes by the trust.

**Setting up a Plan**

15. There is no formal registration procedure for a health and welfare trust and no requirement that the trust agreement be submitted to the Department for approval prior to the implementation of the plan. However, the advice of the District Taxation Office may be requested where there is any doubt as to the acceptability of the trust agreement as a health and welfare trust. Full particulars of the arrangement including a copy of all pertinent documents should accompany the request.

*This review of CRA materials is provided for illustration purposes only. Each technical interpretation is specific to a particular situation, and may not apply to all situations. In addition, while the comments in a particular paragraph may relate to provisions of the law in force at the time they were made, these comments are not a substitute for the law. Before you act on any of this information on behalf of a client, always have your client seek advice from a qualified professional including a thorough examination of your client’s specific legal/tax situation.*
### Appendix B – Alternatives comparison

<table>
<thead>
<tr>
<th></th>
<th>Health and welfare trust</th>
<th>Small Group CII</th>
<th>Corporate-owned Individual CII</th>
<th>Individually-owned CII</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong># of members</strong></td>
<td>Two or more</td>
<td>Generally 3-5 or more</td>
<td>One</td>
<td>One</td>
</tr>
<tr>
<td><strong>Plan type</strong></td>
<td>No ROP</td>
<td>No ROP</td>
<td>All CII features can be included</td>
<td>All CII features can be included</td>
</tr>
<tr>
<td><strong>Administration costs</strong></td>
<td>Costs to establish the plan, annual trustee fees and annual tax filing – paid by the employer</td>
<td>Built into the plan and generally paid by the employer</td>
<td>Built into the plan premium</td>
<td>Built into the plan premium</td>
</tr>
</tbody>
</table>
| **Income tax treatment**         | Employer – required contributions are tax deductible  
Employee – employer contributions not taxable and benefits received not taxable | Employer – required contributions are tax deductible  
Employee – employer contributions not taxable and benefits received not taxable | Employer – Premiums not tax deductible. Benefits not taxable to the corporation.  
Employee – Benefits passed to the employee taxed as employment income.  
Employee – Amounts paid to the employee to fund the policy taxable as employment income.  
Employee – Benefits passed to the employee taxed as employment income. | Employer – Amounts paid to the employee to fund the plan are tax deductible as salary.  
Employee – Benefits passed to the employee taxed as employment income.  
Employee – Amounts paid by employer to fund the policy taxable as employment income.  
Benefits received are not taxable. |
| **Challenges**                   | Health and welfare trust with only two members may have to be wound up if one dies or otherwise leaves the plan | Employer may decide to discontinue the plan or this benefit at any time, leaving the employee without coverage. | Employer controls the plan and may decide to terminate it at any time. The company controls benefits received.  
Coverage likely terminates on termination of employment. | No challenges. |
| **Benefits**                     | Health and welfare trust ensures benefits are funded and payable according to the trust agreement. | Most group plans include the ability to convert coverage to an individual plan on termination. | Protects the corporation against loss of key employee.  
Provides greatest flexibility to the employee who can continue coverage even if corporate funding is ended. | |