Health and Welfare Trusts

Introduction

A health and welfare trust (HWT) is a formal trust that an employer creates to pay health and welfare benefits for its employees. It must conform to the trust laws of the province where the employer does business. Working with its legal advisors, the employer creates a trust and appoints a trustee. The employees are the beneficiaries of the trust.

Health and welfare trust basics

The sole purpose for an HWT is to deliver specific employee health and welfare benefits. Those benefits are listed in subparagraph 6(1)(a)(i) of the Income Tax Act (ITA) and in paragraph 1 of “Interpretation Bulletin IT-85R2 – Health and Welfare Trusts for Employees” (IT-85R2):

- Group sickness or accident plans – GSAIPs (we will discuss these in a future article).
- Private health services plans – PHSPs (we discuss these in our article, “Private Health Services Plans”).
- Group term life insurance policies (we will discuss these in a future article).

While the benefits that an HWT can provide are listed in the ITA, the ITA does not describe or govern HWTs. HWTs are an administrative concession by the Canada Revenue Agency (CRA). They are governed by IT-85R2 and other CRA guidance, and by the sections in the ITA that deal with employer deductions, trust taxation and the tax treatment of employee benefits.

In 2005 the CRA circulated a draft of successor guidance to IT-85R2, IT-85R3, but withdrew it after receiving comments from the financial services industry. Beyond specific industry groups, IT-85R3 has never been made public. When and whether IT-85R3 or a successor to IT-85R2 will be implemented is uncertain.

In Quebec, the creation of an HWT is also possible under a separate administrative tolerance:

We confirm that subject to the particular specifications of the tax system in Quebec, the position of the Ministère du Revenu is identical to that expressed by the Canadian Revenue Agency (CRA) in Interpretation Bulletin IT-85R2 as regards income tax payable under Part I of the Québec Taxation Act.
Employee life and health trusts

An employer may also use an employee life and health trust (ELHT) to provide the same employee health and welfare benefits as an HWT. We will discuss ELHTs in a subsequent article. The table at the end of this article highlights many of the differences between ELHTs and HWTs. The most important difference is that ELHTs are governed by a specific section in the ITA, section 144.1, whereas HWTs are governed by CRA administrative guidance.

ITA section 144.1 received Royal Assent on December 15, 2010, and applies only to trusts created after 2009. IT-85R2 and its successor guidance, if any, will continue to govern HWTs created before 2010 (and trusts created after that date that conform to the HWT rules but not to the ELHT rules). The CRA has said that it has no present intention of withdrawing IT-85R2. If for any reason the CRA later changes its mind, though, it has promised that it will revoke IT-85R2 only after public consultation.

Because IT-85R2 will remain in force, it’s possible to structure a trust that satisfies the rules governing HWTs in IT-85R2, but not the rules governing ELHTs in ITA section 144.1. The rules that establish a trust as an ELHT are set out in ITA subsection 144.1(2). Employers therefore have some choice in determining which rules their trust will comply with. The CRA has said that either regime could apply, depending on which rules were satisfied:

- Trusts established after 2009 that satisfy the specific conditions outlined in section 144.1 of the Act will be subject to the applicable ELHT legislation.
- For greater certainty, a trust established after 2009 to provide benefits to employees from a group sickness or accident insurance plan, a group term life insurance policy or a private health services plan, may be a HWT or an ELHT, where the requirements under the respective regimes are satisfied.

If the trust qualifies as an ELHT, it will be treated as an ELHT, even if it also qualifies as an HWT. Conversely, if the trust qualifies as an HWT, but fails to qualify as an ELHT, it will be treated as an HWT.

As a result, an employer should be able to choose the rules under which its trust will be governed.

In the same document, the CRA goes on to say, “However, the trust should maintain evidence to support its intention as to which regime is intended to apply.” The use of the term “intention” in this sentence may be confusing. ITA subsection 144.1(2) says in part, “A trust that is established for employees...is an employee life and health trust if...”, and lists the requirements for ELHT status. Intention therefore is established in the trust language by including the elements needed for the trust to satisfy the legislative requirements. Any other documentation, though it may establish an “intention” to create an ELHT or HWT, probably will have no bearing on the question.
Reasons for creating an HWT

Apart from providing employee health and welfare benefits, an employer could have several reasons for creating an HWT:

- **To relieve the employer of responsibility for providing employee health and welfare benefits.** With an HWT the employer is responsible only for making contributions to the trust; the trustee is responsible for providing the promised benefits.

- **To rely on an expert's skills to administer the plan.** A trustee may be better equipped to run the plan.

- **Lack of time and resources.** Administering the plan may consume too much of the employer's resources.

- **Self-insurance.** The employer can fund the trust and let the trustee handle the claims.

- **Tax efficiency.**
  - As discussed below, the employer’s contributions are tax deductible in the year made, even if those contributions provide no benefit to employees until a later year.
  - An employer’s contributions are not taxable income to the employees. There are three exceptions to this rule:
    - Contributions paid to provide GSAIP benefits where any GSAIP benefits are paid to employees tax-free.
    - Premiums paid for group term life insurance policies are treated as income to employees.
    - All contributions (except those paid for disability income benefits, and for the benefit of a surviving spouse of a deceased employee) an employer makes to an HWT for employees living in Quebec are treated as income on the employees' provincial (not federal) tax returns. Throughout Canada, benefits paid from an HWT are not taxable, except disability income benefits where the employer has contributed to any part of the benefit.

- **Common administration.** An employer can have all the health and welfare benefits it provides administered using one vehicle.

- **Greater security for employees.**
  - Once an employer makes a contribution to an HWT it cannot get its money back. Any money in an HWT must be spent solely to provide employee health and welfare benefits, according to the trust language. If the employer suffers a financial reversal, money in the trust generally is not subject to the claims of the employer's creditors.
  - The employee relies on the trustee's judgment as to whether a claim should be paid, not the employer's.
Requirements for a trust to qualify as an HWT

A plan of insurance

An HWT must be a plan of insurance. But there's no need for the trust to use insurance policies to deliver the benefits it promises as long as the plan is based on insurance principles. Contributions to a self-insured plan must be determined by an actuary, and can't exceed the amount required to provide the promised benefits. Whether contributions in fact exceed the amount required to provide the promised benefits is a question of fact, suggesting the need for periodic actuarial testing.

An HWT may dispense with insurance policies and actuarial estimates, and pay covered claims on a pay-as-you-go basis. The CRA has said that operating a trust on a pay-as-you-go basis, where no actuarial estimates are used, will not by itself preclude the trust from qualifying as an HWT.

Coverage is for at least two employees

An HWT needs at least two employees as beneficiaries. If the number of employees falls to one, the trust fails to qualify as an HWT. There is an exception for HWTs that provide only benefits qualifying as PHSP benefits. This exception is very narrowly construed – a trust with only one beneficiary that offers PHSP and non-PHSP benefits will not qualify as an HWT.

If an HWT’s beneficiaries are not employees or dependents, the trust fails to qualify as an HWT, even if the trust beneficiaries are making the contributions to the trust themselves.

The employer must make at least some contribution to the trust

Although a trustee administers the trust, the employer is the source of at least some of the money that pays for the benefits. Without employer contributions there is no HWT. In one case, a union representing the employees established, administered and funded a trust for the benefit of its members, without any involvement from the employer. The CRA ruled that the trust was not an HWT because there was no employer involvement in the trust. In another case, the CRA said, “A health and welfare trust created by a union in which contributions are only made by the union members and the union would not be a trust contemplated by IT-85R2” and would therefore not qualify as an HWT.

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In other cases, individuals have established organizations that they have tried to characterize as fraternal benefit societies, have organized benefits programs through trusts established by such societies, and have tried to characterize the trusts as HWTs. The CRA has not approved of such arrangements owing to the absence of employer contributions.

Although there is no HWT without an employer, an HWT can have multiple employers contributing to the same trust for the benefit of all their employees. This arrangement is often found in union settings, where the union has negotiated benefits with several employers on behalf of its members. However, the CRA has said that there is no need for the employers to be in the same or related businesses.

**CRA approval for HWTs**

There is no need to obtain the CRA’s approval for a proposed HWT. However, the CRA is willing to give advance tax rulings (ATRs) on proposed HWTs, and it can be wise to obtain one. An ATR should take between three to six months to get, depending on the complexity of the issues. There is also a charge for obtaining one. The benefit to obtaining an ATR is that it binds the CRA to the position it has taken in the ATR, though only for the taxpayer who has requested the ATR, and only for as long as the facts on which the ruling was based remain in effect.

If the employer does not get a ruling, and the CRA later decides on audit that the trust does not qualify as an HWT, the consequences can be severe. According to the CRA, “A trust which does not qualify as a health and welfare trust [as per IT-85R2] will likely be an employee benefit plan or an employee trust as described in Interpretation Bulletin IT-502 “Employee Benefit Plans and Employee Trusts.”

The general tax consequences would be as follows:

- **No immediate taxation to employees on amounts contributed to the plan or trust,**
- **Taxation of amounts paid from the plan or trust to employees only in the year paid (except death benefits and return of employee contributions), and**
- **No deduction for employer contributions made to the plan or trust; deductions for an employer only for those amounts that are paid to employees and included in the employees’ incomes.**
Benefits allowed and not allowed

An HWT can provide only the following benefits:

- GSAIPs,
- PHSPs,
- Group term life insurance policies, or
- Any combination of the above.

Unless a benefit fits within one of the three categories, an HWT can’t offer it. Nor can an HWT provide benefits on a discretionary basis, for example by providing hardship benefits. A provision for providing hardship benefits would not be a plan of insurance.

Critical illness insurance

Critical illness insurance (CII) can be offered as a benefit in an HWT as long as it provides CII benefits only and does not have a return of premium (ROP) rider. If offered, the CII policy will qualify for inclusion in the HWT as part of a GSAIP, not as part of a PHSP.

CII cannot be offered in an HWT as a PHSP because the CII benefit is paid regardless of whether the insured employee has incurred any medical expenses. A requirement for a benefit to be considered a PHSP is that money paid out must reimburse the insured employee for medical expenses. We discuss CII and PHSPs in our article, “Private Health Services Plans.”

On the other hand, a CII policy should qualify as “sickness or accident” insurance because it pays benefits as the result of sickness and/or accident. Since there is no definition in the ITA of the term, “sickness or accident insurance”, the CRA relies on the definition of the term (or its approximation) under the various provincial insurance acts. If a CII policy satisfies the definition of sickness or accident insurance in the province where the HWT is resident, the policy should qualify as “sickness or accident insurance” under ITA subparagraph 6(1)(a)(i), and an HWT should be able to offer it as a benefit. We will discuss sickness or accident insurance more fully in a subsequent article.

Assuming that the changes to the ITA announced in the March 29, 2012, federal budget regarding GSAIPs become law, employer contributions to an HWT for CII will be taxable to the employee in the year made.
Long term care insurance

Whether an HWT can offer long term care insurance (LTCI) as a benefit is more complicated. Generally, there are two types of LTCI policies: reimbursement and income-style. Reimbursement LTCI policies reimburse the insured for covered LTC expenses the insured has incurred or is responsible for. Income-style LTCI policies pay a set amount to an insured who meets the requirements for payment under the policy, regardless of the amount or existence of any LTC expenses.

The CRA has not considered specifically whether LTCI can be offered as a benefit in an HWT, either as a PHSP or GSAIP. However, the CRA has considered whether LTCI policies qualify as PHSPs. If an LTCI policy qualifies as a PHSP, then it should be possible for an HWT to offer it as a benefit.

The CRA has said that only reimbursement LTCI policies can qualify as PHSPs, and only where all the expenses that the policy reimburses qualify as medical expenses under ITA subsection 118.2(2). There is some controversy about whether the CRA is correct in this view, and about whether LTCI policies that reimburse for medical expenses even if they are not listed under ITA subsection 118.2(2) also qualify as PHSPs. We discuss this issue in more detail in our article, “Private Health Services Plans”. But if a reimbursement LTCI policy does qualify as a PHSP, an HWT should be able to offer it as a benefit.

An LTCI policy that fails to qualify as a PHSP may still be offered as a benefit in an HWT if it qualifies as a GSAIP. If an LTCI policy satisfies the definition of sickness or accident insurance in the province where the HWT is resident, the policy should qualify as “sickness or accident insurance” under ITA subparagraph 6(1)(a)(i), and an HWT should be able to offer it as a benefit.

Most LTCI policies sold in Canada, whether reimbursement or income-style, would qualify as sickness or accident insurance in all provinces and territories, and would therefore satisfy the CRA’s requirements for inclusion in an HWT. As a result, it should be possible for an HWT to offer LTCI as a benefit, either reimbursement or income-style policies. Remember, though, that even if an HWT offers a non-PHSP LTCI policy, the employer's cost of providing the benefit will be taxable to the employees (assuming that the changes announced in the March 29, 2012, federal budget become law).
Disability insurance benefits

Disability insurance qualifies as a GSAIP under IT-428:

A “group sickness or accident insurance plan” is not defined in the Act but paragraph 14 of Interpretation Bulletin IT-428, “Wage Loss Replacement Plans” indicates that this exception would apply to any of the three types of plans described in paragraph 6(1)(f) of the Act (i.e. a sickness or accident insurance plan; a disability insurance plan; or an income maintenance insurance plan and collectively referred to as “wage loss replacement plans”) as long as the particular plan is a group plan. A “group” must consist of more than one employee. Where the plan is a group sickness or accident insurance plan, such as a group long term disability plan, any premium contributions made by an employer to an insurer for its employees would not be taxable under paragraph 6(1)(a) of the Act.

If disability insurance is offered under an HWT, employer contributions to the HWT to pay for the insurance would be tax deductible to the employer, and not included in employee income. Any payment of benefits would be treated as taxable income to the employee under ITA paragraph 6(1)(f). The amount the employee includes in income “is reduced by the total amount of any contributions made by the employee to the particular plan before the end of the year and to the extent that such employee contributions have not already reduced the amount of benefits previously received by the employee.”

If the employee is legally obligated to pay the entire premium for a wage loss replacement plan, none of the benefits will be taxable to the employee. The important part is “legally obligated”. The CRA has made the following comments on that requirement:

It is not a question of who paid the premiums but rather whether the plan itself places upon the employees the legal obligation to pay 100% of the premiums. Such a determination can only be made by looking at the actual wording of a particular plan. Of prime consideration will be whether the plan, either as a term of the policy with the carrier, the employment contract, or some other document, places upon the employees the legal obligation to pay 100 per cent of the premiums (although the employer may still be responsible for remitting the premiums on their behalf). If such an obligation exists and the employer remits the premiums to the plan carrier and accounts for them in the manner of salary and wages, the plan will be considered an employee pay-all plan provided such an arrangement was in place at the time the payment was made.
Because of the way the CRA defines the term “legally obligated”, an employee who pays the premiums for a disability insurance benefit may still be taxed on receipt of that benefit if he or she was not “legally obligated” to pay those premiums. However, the CRA does not insist on the employee directly paying the premiums. An employee will still be treated as having paid the premiums if the employer pays the premiums but collects those premiums from the employee under an agreement between the two.

Further, if employees are to receive their disability income benefits tax-free under an employee-pay-all plan, all employees in the group must pay all of their own premiums. If only one employee in the group receives employer contributions to even part of their disability insurance plan, the entire plan will be tainted, and all employees will have to include their disability income benefits in income.

Because of the severe tax consequences that can result from tainting an employee-pay-all plan, it’s important that such plans be kept strictly separate from plans where employers make any contributions.

The CRA has said that if a long-term disability plan is funded entirely from employee contributions, but the contributions do not go to pay premiums under a third party insurance contract, the plan may not qualify as a plan in the nature of insurance, and may not be allowed in an HWT.

The changes to GSAIPs announced in the March 29, 2012, federal budget do not apply to GSAIPs where the benefits paid from the plan are treated as taxable income to the insured employee, such as disability income insurance plans where the employer makes any contribution to the plan. As a result, employer contributions to such plans should remain tax-free to the insured employees.

**No payment for government programs**

An employer can’t create an HWT to compensate for work-related illnesses or injuries that are covered under applicable provincial workers’ compensation laws. Such benefits would be taxable income to the employee under ITA paragraph 56(1)(v) and deductible to the employer under ITA subparagraph 110(1)(f)(ii).

Nor can HWTs offer to pay premiums for provincial health care programs, like the Ontario Health Insurance Plan (OHIP), unless payment for such premiums is segregated from the rest of the trust.
Retiree benefits

An HWT can provide benefits for retired employees without being disqualified as an HWT or being categorized as a retirement compensation arrangement (RCA), though the determination is one of fact.

Benefits for sole proprietors, partners and shareholder/employees

An HWT can provide benefits for sole proprietors and partners, as long as the accounting for those benefits is kept separate from those for employees. The reason for separate accounting stems from the different tax treatment allowed for contributions to plans that provide employee and owner benefits.

While partners and sole proprietors may make HWT contributions to pay benefits for themselves, they cannot exclude those contributions from their incomes under ITA subparagraph 6(1)(a)(i). That subparagraph excludes from a taxpayer's income contributions made by “the taxpayer's employer”. Since the partners and sole proprietors are the employers, they may not exclude HWT contributions from their incomes. Instead, they must make those contributions using after-tax income.

But while the owners’ contributions to an HWT will not be deductible, the benefits they get from the HWT will be subject to the same tax treatment as their employees' benefits. If the owners’ contributions are comimgled with the employees', the owners could get tax-free benefits paid at least partly from tax-deductible contributions they made for their employees. At best, the CRA would never know whether or to what extent the benefits that an employer received had come from deductible or non-deductible contributions. Therefore, to ensure that “cross-subsidization does not occur” the CRA requires plans for employees and employers to remain separate.

Shareholders who work as employees for their corporations can receive tax-free HWT benefits, as long as they receive those benefits as employees, not as owners. For a discussion of this question, see our article, “Private Health Services Plans.”

Non-qualifying benefits

A trustee can provide benefits that do not fall within one of the three groupings in ITA subparagraph 6(1)(a)(i), as long as those benefits are accounted for separately from the qualifying benefits. In such a case, the inclusion of non-qualifying benefits would not taint the tax treatment of qualifying benefits.
Considerations for employers

Contributions must be...

Employer contributions must be limited to the amount needed to pay employee benefits plus reasonable trustee fees. Amounts needed to pay employee benefits include amounts needed to pay insurance premiums, or to establish a fund sufficient to provide the promised benefits. Trustee fees would include a one-time set up fee, plus a percentage of claims paid in order to cover the trustee’s costs of running the trust.

Employer contributions may be based on a formula requiring the employer to contribute a certain amount to the trust per each hour that each employee has worked, as long as that contribution does not exceed the amount needed to provide the benefits promised. Excess contributions won’t automatically disqualify the trust as an HWT, but may not be deductible.

Finally, employer trust contributions must be mandatory. The trustee must have the authority to compel the employer to make its trust contributions, by lawsuit if necessary.

Contributions cannot...

There are a number of restrictions on contributions. They cannot:

- Revert to the employer. An exception is allowed in cases where an over contribution is made in error, and quickly corrected.
- Be used for any purpose other than providing the benefits set out in the trust.
- Be paid to the employee in any form other than permissible employee benefits.
- Exceed the current cost of paying for the benefits for the year.
- Be invested in employer securities, or in the property or securities of a company or group of companies that does not deal at arm’s length with the employer. This restriction is discussed more fully below under the heading, “Trustee duties and requirements.”
Deductibility of contributions

Employer contributions to an HWT are deductible if they are reasonable and laid out to earn income from business or property. They are treated no differently from any other expense a business incurs. A business should have little trouble establishing that the contributions are reasonable if the trust uses insurance policies to provide its employees with the promised benefits, and if the benefits themselves are reasonable. If the trust self-insures, an actuary’s report can help establish that the contributions are reasonable.

Contributions must also be made in the year in which the legal obligation to make them arises (even if the payment of the benefit associated with the contribution does not occur until a later year). Deductibility will be denied for lump sum contributions to the extent that they provide coverage beyond the current year. Deductibility will also be denied for contributions intended to fund future benefits, though such contributions will not disqualify the trust as an HWT. If an employer makes a contribution to pay for multi-year coverage, deductibility may be amortized over the duration that the premium payment is expected to cover. This applies even if the pre-funding is designed to ensure that a specific amount of money is in the plan by a specific date, by retirement for example.

The CRA is concerned about employers trying to deduct excessive contributions to HWTs. In Labow v. R., an incorporated medical practice employed the shareholder’s wife on a part time basis for about twenty hours per week at an annual income of $20,000. The corporation created an HWT, and provided disability income coverage for her, with coverage until age 70. Although the corporation employed two other part-time secretaries, unrelated to the shareholder, they were not invited to participate in the HWT.

The HWT did not buy insurance policies to cover the shareholder’s wife, but relied on actuarial assumptions. The key assumption was that she would be completely disabled in the trust’s second year, thereby requiring the corporation to make contributions to the HWT of almost $400,000 over two years.

The CRA was concerned that the size of the HWT contributions was disproportionate in relation to the employee’s income and to the contribution she made to the practice. It denied the corporation’s deduction for the HWT contributions. The Tax Court of Canada agreed, saying that there was “no commercial reason” for the benefits package. Given that the employee was married to the shareholder, that she had disability income insurance through her other employment, and that the practice’s two other secretaries were not offered such generous benefits, the Tax Court of Canada agreed with the CRA in denying deductibility for such contributions.
Limits on amounts that an HWT may maintain

Contingency reserves

A contingency reserve is an amount of money set aside to make sure that the trust always has enough money to pay claims, even to cover unusually high claims. It’s like the emergency fund that financial planners recommend individuals and families maintain—an amount of money set aside to meet unusual expenses. If all goes well, the trust will never need to draw on the contingency reserve; nevertheless, the presence of a contingency reserve can reassure employees that the HWT is soundly managed.

In general terms though, a contingency reserve is inconsistent with the CRA’s view of HWTs as plans of insurance. It has said that establishing a contingency reserve would disqualify the trust as an HWT. Nor would amounts contributed to establish a contingency reserve be deductible for the employer, even if the reserve was actuarially recommended.

Still, the CRA has recognized that sound actuarial principles may require some provision for future premium increases, and has said that it would not deny deductibility for HWT contributions to pay for such a reserve. The CRA has also confirmed the deductibility of contributions for a contingency reserve, subject to the amount being reasonable under ITA section 67 and paragraph 18(1)(a). It has also allowed deductibility for paid up insurance (which it regards as a form of contingency reserve), but only for the part of the insurance premium used to pay for benefits in the current year.
Surpluses

Surpluses are different from contingency reserves in that they accumulate from favourable claims experience, rather than from a decision to protect the trust from potentially unfavourable experience. A trust cannot be worded in a way that permits it to accumulate surpluses. In one case, the CRA rejected language in a proposed HWT that allowed the trust to return surpluses to the employer, saying that the language could cause the trust to be treated as an employee benefit plan. Amounts paid under an employee benefit plan are generally not taxed to the employee but employer contributions are not deductible.

The usual remedy for a surplus is for the employer to reduce or discontinue HWT contributions until the surplus goes down. The CRA is generally not concerned with inconsequential or infrequently occurring surpluses that can be eliminated through such contribution holidays. But chronic surpluses indicate that contribution levels have been set too high, which could affect the employer’s right to deduct those contributions.

Transfer of surpluses not allowed

Surpluses can’t be transferred. The CRA has dealt with several inquiries on this issue:

- **Surpluses may not be transferred to a pension plan, group RRSP or to employees’ individual RRSPs.** The reasoning appears to be that an HWT cannot pay any benefits other than the health and welfare benefits referred to in ITA subparagraph 6(1)(a)(i). A transfer of surplus HWT funds into a registered plan would be treated as the payment of an impermissible benefit. Further, in the case of a registered pension plan (RPP), a transfer from an HWT would violate the rules governing how RPP contributions can be made.

- **Surpluses may not be transferred to employees.** An HWT may pay only health and welfare benefits, not surplus contributions.

- **Surpluses may not be transferred to the employer.** Nothing that an employer pays to an HWT may revert to the employer.
Excess contributions

Excess contributions will not cause an HWT to be disqualified if the contributions are based on actuarial calculations of the amount of money needed to properly fund the trust. But if contributions to an HWT exceed its reasonable funding requirements, the employer will not be able to deduct them, and the trust may be disqualified as an HWT.

Excess contributions may flow through to employees in the same year that the employer makes and deducts them, if the employee treats them as taxable income or as an employee benefit. In such cases, the CRA will regard the excess contributions as never having been made to the trust, but instead to the employee. But if excess contributions are paid to the employees in a different year from the year in which they were contributed, there is a risk that the HWT could be disqualified. Certainly, a trust can’t be amended to provide for excess contributions to go to employees without risking disqualification as an HWT.

Considerations for employees

Employer contributions to an HWT

Subject to three exceptions, employer contributions to an HWT are not treated as income to employees. The first exception is that employer contributions to GSAIPs are taxed to employees if the corresponding GSAIP benefits are paid tax-free. The second exception is that the value of group term life insurance coverage is treated as income to employees. The third exception applies only in Quebec. With the exception of disability income benefits, and amounts paid for certain survivor benefits for the spouse of a deceased employee (as discussed above), Quebec residents must include the value of employer-provided health and welfare benefits on their provincial tax returns (though not on their federal returns) and pay tax on the value of those benefits.
Employee contributions to an HWT

Employees may make contributions to an HWT, though employee contributions can't be used to entirely fund the trust. Employee contributions are not deductible. If an HWT accepts employee and employer contributions, the CRA will assume that the contributions have been made to pay for all the benefits the trust provides, unless the trust document specifies otherwise. In the absence of specific language allocating employee and employer contributions, no accounting will be made for the different tax consequences that could arise from HWT contributions having come from both employers and employees.

It can make sense for employees to pay all the premiums to the HWT for disability insurance (this includes short term and long term disability). Disability insurance benefits are not always paid tax-free. They are taxed as periodic payments under ITA paragraph 6(1)(f) if the employer has paid any part of the cost of providing the benefit. But if the employee is legally required to pay the entire cost of providing the disability benefit, the benefit will be tax-free to the employee.

If the employees pay for their disability insurance benefits, it’s important to keep that part of the HWT separate from the rest, to preserve the employees’ rights to receive tax-free disability benefits. Further, when using employee contributions, the parties must make sure that the plan is a plan of insurance. Using employee contributions to pay for insurance policies should satisfy the requirement. Otherwise, the plan must be run according to insurance principles.

Considerations for trustees

Trust tax issues

If the trust qualifies as an HWT, employer and employee contributions will not be treated as contributions of capital or as trust income. Benefits paid from insurance companies will not be treated as trust income, either. Certain trust tax rules are adjusted for HWTs:

- The reversionary trust rules under ITA sections 75 through 75.2 do not apply to HWTs.
- The disposition of capital rules under ITA section 107 do not apply to HWTs.
- The 21-year deemed disposition rule does not apply to an HWT.
- An HWT is allowed to deduct income that would exempt it from Alternative Minimum Tax under ITA subsection 127.52(1), although it is still subject to AMT.
Trust income

Apart from the modifications just noted, an HWT is taxed as an inter vivos trust under ITA section 104. “Inter vivos” means “during life”, and refers to trusts that are established during the grantor’s life, as opposed to testamentary trusts, which are established after death. Like all inter vivos trusts, an HWT must file a T3 tax return if its annual income rises above $500. Trust income is taxed at the highest marginal tax rate applicable to individuals. No personal tax credits are available to help reduce taxation.

IT-85R2 says that a trustee may deduct the following items from trust income:

- Expenses incurred in earning investment or other income of the trust.
- 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 ITA.
- Premiums and benefits payable out of trust income of the current year pursuant to ITA 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 ITA paragraph 6(1)(a) may be treated at the trustee’s discretion as having been paid out of the prior year’s funds or the current year’s employer contributions, to the extent that they are available, to avoid the application of ITA subsection 104(13).

CRA guidance has also suggested that a trustee may take the following deductions in calculating trust income:

- General trust administration costs. Administration costs incurred directly by the HWT are deductible from the HWT’s income. They are also deductible if incurred by a disability insurance company or management company under an administrative services only (ASO) plan on behalf of the HWT. Such expenses would include the following:
  - Reviewing and acquiring insurance policies.
  - Fees paid to administer the trust, including expenses incurred to earn trust income.
  - Administrative and operational expenses.
- ASO fees are deductible against the trust’s investment income.

Other expenses, however, are not allowed as deductions. An HWT may not deduct non-capital losses, because it cannot say that its losses have been incurred to earn income from a business or property. The CRA is willing to make an exception to this rule when an HWT’s non-capital losses result from the expenses of earning trust income exceed the income it earns. It won’t allow an HWT to treat the payment of trust benefits to employees as a loss.

An HWT may specify that employer trust contributions are subject to an additional penalty if paid late. Such late fees are treated as trust income.
Trustee duties and requirements

A trustee must maintain a separate bank account for trust funds, but the CRA has said that there is no need for it to maintain separate bank accounts for each trust beneficiary. The trustee must also account to the employer for how employer trust contributions are spent.

One of the trustee’s most important duties is to maintain independence from the employer in the administration of the trust. Whether a trustee is truly independent of an employer is a question of fact. If the trustee is not independent, the requirement that HWT contributions be mandatory may not be satisfied, and the employer’s contributions may not be deductible. The CRA has commented on a trustee’s independence in IT-85R2 as follows:

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.

The CRA has provided guidance on two occasions about employees acting as trustees. In one case it said that the mere fact that the employee was a trustee would not by itself mean that the trustee lacked independence. In another case, the CRA said that while it was possible for an employee to be a trustee, an employee probably could not serve in that role because the employer’s control over the employee could compromise the employee’s ability to act independently. In both cases, though, the CRA said that whether the employee was able to act independently was a question of fact.

One way to help ensure that an HWT’s trustees are independent is to recognize that they are bound to administer the trust according to the language in the trust document, CRA guidance and trust law. If the employer obtains an advance tax ruling from the CRA regarding the HWT, the employer will know that the HWT’s governing document conforms to the CRA’s requirements, including the requirement that the trustees maintain independence. The trustees will then need to make sure that they administer the trust according to trust law, CRA guidance, and the trust’s language. If they do that, it could be difficult to say that their independence was compromised, even if they were employees.

An employer can’t be involved in the administration of the HWT, and can’t have the right to approve the trustee’s major decisions. Further, if employee claims for benefits have to be made through the employer, rather than through the HWT, the trustee is not independent of the employer.

The requirement for a trustee to be independent extends to investments the trustee may make. The trustee may not invest in employer securities of any kind (debt or equity), or in investments offered by anyone who does not deal with the employer at arm’s length (or a member of such a group of persons not dealing with the employer at arm’s length). Nor may the trustee allow the employer or those related to the employer to borrow or use trust funds.
Plan changes

An employer can amend the terms of an HWT to provide additional or different benefits, even if the HWT has a surplus (so long as those benefits are allowed under ITA subparagraph 6(1)(a)(i) and IT-85R2). Indeed, providing additional benefits is one way that an employer can deal with chronic surpluses accumulating in an HWT. An employer may not amend an HWT retroactively to reverse actions that have already been taken and which may have already generated tax and legal consequences.

Trust assets may also be rolled over tax free from an old HWT to a new one if the differences between the trusts amount to administrative changes, and where there is no change in beneficial ownership.

An HWT may transfer individual insurance policies that it owns on an employee to that employee, for example, when an employee leaves or retires and wants to retain his or her coverage. The policy will be deemed to have been transferred at fair market value (FMV). While the CRA has not provided guidance on factors that affect the FMV of a health insurance policy, it has done so for life insurance policies. Many of the factors that help determine the FMV of a life insurance policy could also apply to determine the value of a health insurance policy. The parties will need to retain an actuary to provide a valuation of the policy. If the employee pays less than FMV for their policy, the difference will be treated as income to the employee.

If an employee wants to transfer their own policy to an HWT, on the other hand, it may be more complicated. To qualify as an HWT using insurance policies, the trust must have a single contract covering all employees, or a written plan that covers all employees, funded by individual insurance contracts offering the same coverage. Unless all employees covered under the plan had the same coverage, and agreed to transfer their policies to the HWT, the HWT could not accept an individual employee’s policy.

Employees may also move from one HWT to another. An employer may exit a multi-employer plan. If it does, though, any funds that it contributed to the HWT remain in the HWT. They cannot revert to the employer or be paid to the employees (except as plan benefits).

When an HWT is terminated (or wound up), there is no reversion of its funds to the employer, or payment of those funds to the employees. The CRA has said that it would be agreeable to a provision in an HWT allowing for surplus funds to be paid to a registered charity when the trust is wound up.
Trust residency

It’s possible to establish an HWT in a jurisdiction other than Canada. In general terms, there can be some advantages to establishing a trust in a foreign country:

- **Lower income tax rates,**
- **Banking secrecy laws, and**
- **Tighter creditor protection laws.**

However, these advantages may not be of much value to an HWT.

Lower tax rates should make very little difference. If a trust provides benefits by using insurance policies, the employer’s contributions should be only enough to pay insurance premiums and trustee fees. Very little should accumulate in the trust to generate taxable income.

Even if the trust self-insures, contributions and accumulations should be enough to meet claims with no surplus accumulating. If significant surpluses build in the trust, any growth they produce would be taxable, but the trust would also need to reduce contributions to reduce the surplus.

Banking secrecy laws and creditor protection should also make little difference to an HWT. An HWT is not created to protect assets from the claims of creditors, and therefore does not need to rely on banking secrecy laws or on laws which tend to frustrate the claims of creditors.

Apart from the lack of advantages to establishing a trust offshore, a disadvantage is that the CRA regards offshore HWTs as potential tax avoidance vehicles.
Conclusion

HWTs are an attractive way for employers to provide health and welfare benefits for their employees. For employers, one of their more appealing features is the right to deduct contributions to the trust in the year they are made, instead of having to wait until the trust pays a benefit to the employee. HWTs are also attractive for employees because they provide a benefits structure with greater security and formality than a written employer plan. However, these advantages and others come with a requirement to respect a more complex set of rules. But for the right businesses, the added benefits can be worth the extra complexity.

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### Health and Welfare Trusts and Employee Life and Health Benefit Plans

#### HEALTH & WELFARE TRUST (HWT) IT-85R2

- **Formal Trust Arrangement** (in Quebec: a private trust constituted by onerous title, generally speaking a trust established for commercial, not personal, purposes).
- No requirement to submit the trust agreement to the CRA for approval but must meet guidelines in IT-85R2.
- Advanced Tax Ruling (ATR) suggested where doubt as to acceptability as a HWT.

#### Benefits provided:
- **Group Sickness or Accident Insurance Plan (GSAIP).**
- **Group Term Life Insurance.**
- **Private Health Services Plans (PHSP).**
- Any combination of the above.

#### Funding:
- Employer contributions must not exceed the amounts required to provide the benefits, although some pre-funding is permitted.
- Employee contributions are possible.

#### Trustee(s):
- One or more acting independently of the employer in their administration of the trust.
- Governed by trust language, trust law, CRA guidance.

#### Participating employer(s): Single or multi-employer trust arrangement

#### EMPLOYEE LIFE & HEALTH TRUST (ELHT) ITA section 144.1

- **Formal Trust Arrangement.**
- Employer/employee labour contract.
- No requirement to submit trust agreement to the CRA for approval but must meet requirements of ITA section 144.1 throughout the taxation year.

#### Benefits provided:
- Trust must provide “designated employee benefits” defined as benefits under a:
  - **Group Sickness or Accident Insurance Plan (GSAIP).**
  - **Group Term Life Insurance.**
  - **Private Health Services Plans (PHSP).**
  - Any combination of the above.

#### Funding:
- Employer contributions must not exceed the amounts required to provide the benefits although some pre-funding is permitted.

#### Trustee(s):
- One or more – employer representatives must not constitute a majority or otherwise control the trust.
- Governed by trust language, trust law, CRA guidance.

#### Participating employer(s):
- Single.
- Multi-employer trust arrangement subject to special rules under ITA subsection 144.1(6)

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**continued**
### HEALTH & WELFARE TRUST
**(HWT)** IT-85R2

#### Tax Implications

<table>
<thead>
<tr>
<th>Trust residency:</th>
<th>Trust residencys requirement but the CRA has recently challenged some non-resident HWTs.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employer contributions:</strong></td>
<td>Deduction of reasonable contributions to earn income from business or property paid in the year the legal obligation to make the contribution arose. No trust funds can revert to employer. Note – The CRA has indicated that it will not allow employers to deduct contributions that relate to benefits payable in a subsequent taxation year.</td>
</tr>
</tbody>
</table>

#### Employees (beneficiaries):

- No restrictions on the participation of key employees. Shareholders wanting to include themselves as beneficiaries may also want to include non-owner employees in the HWT to help avoid having the CRA treat the benefits offered by the HWT as taxable shareholder benefits.

- No taxable benefit when employer's contributions are for:
  - a **GSAIP** where the plan pays benefits that are taxable to the employee (assuming changes announced in the March 29, 2012, federal budget become law)
  - a **PHSP**
  - a combination of the two above under ITA subparagraph 6(1)(a)(i)

- Premiums paid under a group term life insurance policy are a taxable benefit to the employee under ITA subsection 6(4), as are contributions paid for a GSAIP where the GSAIP pays benefits that are not taxable to the employee (assuming changes announced in the March 29, 2012, federal budget become law).

- Employee contributions to the trust usually not deductible except when expressly provided.

- Amount paid as an employee benefit has to be included in the income of the recipient except if otherwise excluded by other provisions of the ITA.

### EMPLOYEE LIFE & HEALTH TRUST
**(ELHT)** ITA section 144.1

#### Tax Implications

<table>
<thead>
<tr>
<th>Trust residency:</th>
<th>Trust must be a Canadian resident.</th>
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<tbody>
<tr>
<td><strong>Employer contributions deductible when:</strong></td>
<td>Used to pay premiums to licensed insurance company to provide benefits in the year and prior year. Reasonable expense to earn income from business or property deductible in the year or prior year the legal obligation to pay the benefits arose. Contributions based on an independent actuarial report provide a rebuttable presumption that the contribution was made to enable the trust to make the benefit payments required during the year. The employer has no right to trust distributions. No trust funds may revert to the employer. No loans to the employer or to a related person. Contributions made in one year that are not deductible may be deducted in future years to which benefit payments relate.</td>
</tr>
</tbody>
</table>

#### Employees (beneficiaries):

- Trust must contain restrictions on the extent to which key employees may be trust beneficiaries.

- The trust must contain at least one class of beneficiaries representing at least 25% of beneficiaries who are employees of the employer.

- At least 75% of the members of the class cannot be key employees. Key employee defined as an employee who owns 10% or more of the employer's shares, or of a corporation related to the employer, or an employee who, in any two of the preceding five years, has earned more than five times the year's maximum pensionable earnings (YMPE) - $241,500 in 2011 and $250,500 in 2012.

- No taxable benefit when employer's contributions are for:
  - a **GSAIP** where the plan pays benefits that are taxable to the employee (assuming changes announced in the March 29, 2012, federal budget become law)
  - a **PHSP**
  - a combination of the two above under ITA subparagraph 6(1)(a)(i)

- Premiums paid under a group term life insurance policy are a taxable benefit to the employee under ITA subsection 6(4), as are contributions paid for a GSAIP where the GSAIP pays benefits that are not taxable to the employee (assuming changes announced in the March 29, 2012, federal budget become law).

- Employee contributions to the trust usually not deductible except when expressly provided.

- Amount paid as a designated employee benefit has to be included in the income of the recipient except if otherwise excluded by other provisions of the ITA.

- No taxable disposition of the employee's participation rights in the ELHT when a participating employee ceases to be a Canadian resident.

**continued**
**HEALTH & WELFARE TRUST (HWT) IT-85R2**

<table>
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<td><strong>Taxation of trust:</strong></td>
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<tr>
<td><strong>Inter Vivos Trust:</strong></td>
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<tr>
<td>Taxation year at December 31.</td>
</tr>
<tr>
<td>Taxed at the higher individual tax rate on its investment income and incidental income other than employer/employee contributions minus deductible expenses incurred in earning investment income, normal operation of trust, premiums and benefits payable out of the trust income.</td>
</tr>
</tbody>
</table>

**Trust distribution:**
- No limitation to the usual “flow-through” rules applicable to the Trust, i.e.:
  - transfer at cost for the trust
  - transferee acquires at cost
- Trust assets cannot revert to an employer.
- Distribution to a charity is permitted on wind-up or reorganization.

**Subject to:**
- 21-year deemed disposition.
- Alternative Minimum Tax.

**Trust no longer a Canadian Resident:**
- Trust property subject to deemed disposition rules in section ITA 128.1 at fair market value.

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**EMPLOYEE LIFE & HEALTH TRUST (ELHT) ITA section 144.1**

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<td><strong>Inter Vivos Trust:</strong></td>
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<tr>
<td>Taxation year at December 31.</td>
</tr>
<tr>
<td>Employed/employee contributions are trust capital.</td>
</tr>
<tr>
<td>Taxed at the higher individual tax rate on its investment income and incidental income other than employer/employee contributions minus deductible expenses incurred in earning investment income, normal operation of trust, premiums and benefits payable out of the trust income.</td>
</tr>
<tr>
<td>Non-capital losses limited to a three year carry-forward and carry-back, as long as the trust qualifies as an ELHT for the year the deduction is claimed and was operated in accordance with its terms.</td>
</tr>
</tbody>
</table>

**Trust distribution:**
- Employer has no right to trust distributions.
- On wind-up or reorganization, the property of the trust may only be distributed to employees and certain family members (other than key employees and related persons), another ELHT, or in certain circumstances to Her Majesty in right of Canada or a province.
- Distribution to a charity is not permitted (but is under consideration by the Department of Finance).
- Distribution from the ELHT occurs at FMV unless recipient is another ELHT.

**Subject to:**
- Not subject to:
  - 21-year deemed disposition.
  - Alternative Minimum Tax.

**Trust no longer a Canadian resident:**
- Trust property deemed to be inventory with a “nil cost base” and disposed of at its fair market value (FMV).
- Trust no longer qualifies as an ELHT whether or not benefits are still paid to Canadian beneficiaries.
Endnotes

1 In Quebec, the trust is a private trust constituted by onerous title. “Onerous title” generally means that the trust has been established for commercial, not personal, purposes.
3 The CRA has said that the comments it received from the industry suggested that “the issues were more complex than they initially appeared” (CRA document 2010-036302C6 – STEP Conference 2010 – Proposed Section 1441, dated June 8, 2010).
4 Revenu Québec interpretation letter 96-010030, dated July 9, 1996.
5 The CRA’s guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA’s interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the Income Tax Act and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.
9 Ibid.
10 The March 29, 2012 federal budget contained provisions that will make employer contributions to a GSAIP taxable to employees if the corresponding benefits from the GSAIP are paid tax-free. Conversely, if GSAIP benefits will be treated as taxable income when paid to employees, employer contributions to the GSAIP will not be taxable to the employees.
11 ITA subsection 6(4).
18 CRA document 9411005, dated August 3, 1994. The trust beneficiaries in this case were independent contractors.
24 IT-85R2, paragraph 6.
28 CRA document 2006-02069101E5, dated February 15, 2007. “The term “group sickness or accident insurance plan” is not defined in the Act and therefore, its meaning would generally be interpreted in the context of legislation that regulates the insurance industry in the relevant jurisdiction.”
29 ITA subsection 118.2(2) governs eligible expenses for the medical expense tax credit.
36 CRA document 9506565, dated September 13, 1995. “Taxing workers’ compensation benefits under this paragraph affects eligibility for government benefits that are driven by net income.”
41 IT-85R2, paragraph 7.
43 Contributions based on hours of work are often found in unionized employment settings.
45 IT-85R2, paragraph 6.
46 CRA document 2002-0163123.
47 Technical News 25.
48 ITA section 118. In Quebec, employer contributions are deductible if the provisions of section 128 of the Taxation Act (Quebec) are satisfied.
50 CRA document 9922165, dated October 14, 1999.
56 CRA document July 1991–336. But see CRA document 2004-00947716, dated November 22, 2004, where a deduction for contributions to a contingency reserve was denied, but the trust retained its status as an HWT.
Endnotes

62 ITA paragraph 67[(a)(i)].
64 CRA documents October 1991-103.
67 CRA documents November 1990-240 (proposed transfer to group RRSP), 2009-0343541ES, dated February 24, 2010 (proposed transfer to employee’s individual RRSP), and July 1991-336 (proposed transfer to registered pension plan).
68 July 1991-336 and Regulation 8502(b)(iv), specifying that pension plan contributions must come from the member of the plan, not from an HWT.
69 IT-85R2, paragraph 6.
70 Ibid.
74 CRA document November 1990-240.
76 Ibid.
77 IT-85R2, paragraph 9(c).
78 This assumes that the changes proposed in the March 29, 2012, federal budget become law.
79 ITA subsection 6(4).
80 Articles 32 and 37 of the Taxation Act, R.S.Q., c. 1-3.
81 IT-85R2, paragraph 10.
88 ITA paragraph 75[(a)](b) exempts trusts that are defined in ITA paragraph 108[(a)(i)]. That paragraph defines trusts that provide benefits to individuals because of their office or employment.
89 An HWT is exempt from the disposition of capital rules because the definition of a trust in ITA paragraph 108[(a)(i)] excludes trusts that provide benefits to individuals because of their office or employment.
90 An HWT is exempt from the 21-year deemed disposition rule because the definition of a trust in ITA paragraph 108[(a)(i)] excludes trusts that provide benefits to individuals because of their office or employment.
93 IT-85R2, paragraph 11, and CRA document 9536845, dated August 2, 1995.
95 IT-85R2, paragraph 12.
104 IT-85R2, paragraph 6.
107 CRA document ACS9453, dated March 28, 1990. The employer, not the trust, paid the claims, even though a third party insurance company adjudicated those claims.
113 See the definition of "disposition" in ITA paragraph 248[(1)(e)], formerly ITA paragraph 54[(c)(v)]. See also CRA document 9412885, dated August 15, 1994.
116 CRA document 2001-0109963. The employer had created a partnership between itself and a new subsidiary corporation it had created. The partnership created a new HWT, the beneficiaries of which were former employees of the employer.
119 An ELHT could hold a promissory note issued by an employer as evidence of the employer’s indebtedness for unpaid employer contributions. As well, an ELHT could accept shares of the employer’s knowledge in its participating plan.
120 In Québec, at the provincial level only, the value of the premiums or a portion of the premiums paid to provide coverage under a personal insurance plan are taxable benefits to the employee in accordance with articles 37.013 and 37.012 TA. (Taxation Act, R.S.Q., c.1-3)