Tax-Efficient Delivery of Health & Disability Benefits

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Elizabeth Boyd

Designing effective employee health and disability plans is complex. Although just one of many factors employers must take into account, tax considerations should not be overlooked since they can have a significant impact on the cost of a plan design to the employer and its perceived value to employees.

Consider the following: an employee who receives and uses $2,000 worth of annual credits to cover medical and dental benefits under his or her employer-sponsored healthcare spending account (HSA), which is a private health services plan (PHSP) under the *Income Tax Act* (Canada) (ITA), is not taxable on any of that $2,000. In turn, the employer receives a tax deduction of $2,000.

Yet, another employee who receives and uses $2,000 worth of annual credits to cover medical and dental benefits under an employer-sponsored HSA, but one that is not a PHSP, is required to include the entire $2,000 in income from employment. Assuming a marginal tax rate of 40%, the $2,000 HSA benefit is actually worth $1,200 to the employee after-tax. The employer still gets a $2,000 deduction, but the after-tax value provided to the employee is considerably less than in the first scenario. Moreover, if the second employer’s intention had been to deliver $1,200 of after-tax benefits, the employer could have done so at a cost of only $1,200 (pretax, that is, without factoring in the value of the employer’s deduction).

How, then, should an employer deliver health and disability benefits in a tax-efficient manner? Here, we focus on two types of employer-sponsored arrangements — group medical/dental plans that meet the PHSP requirements of the ITA and policies of the Canada Revenue Agency (CRA), and group long-term disability (LTD) plans — providing employees with income replacement benefits. We’ll also discuss the income tax aspects of funding PHSP and LTD benefits through a health and welfare trust.

Private Health Services Plans

The key requirements for a PHSP under the ITA are that: i) it is a contract of insurance or an insurance plan; ii) it covers hospital or medical care or expenses; and iii) it excludes provincial health insurance plans under the *Canada Health Act*, such as OHIP.

CRA has expanded on the PHSP requirements set out in the ITA in IT-339R2, a 1989 interpretation bulletin that outlines its views on the requirement that a PHSP be a contract or plan of insurance (or “plan in the nature of insurance” according to IT-339R2) and imposes limits on who may be covered, and what types of expenses or care may be covered, under a PHSP. With respect to the requirement that a PHSP be a plan [in the nature] of insurance, CRA has identified five criteria that must be satisfied:

One. The plan must contain an undertaking by one person
Two. To indemnify another person
Three. For an agreed consideration
Four. From a loss or liability in respect of an event
Five. The happening of which is uncertain.

CRA specifically acknowledges that an arrangement whereby an employer reimburses its employees for medical or hospital care cost can be a PHSP.

IT-339R2 also sets out CRA’s position as to the type of health care expenses that can be covered under a

PHSP. It is CRA's view that a PHSP must be limited to providing coverage for only those services and expenses identified in the ITA as eligible for the medical expense credit. It is not clear that CRA is correct to impose this requirement in light of the fact that the PHSP definition itself simply refers to hospital and medical expenses and care, but does not otherwise define those expenses or care. However, this is a longstanding policy of CRA and seems unlikely to change in the future.

Where a PHSP is maintained by an employer for its employees, CRA also limits the individuals who can be covered under the PHSP. It is CRA's position that a PHSP can cover an employee and individuals for whom the employee could claim PHSP premiums for the medical expense credit — that is, the employee's spouse or common-law partner and any member of the employee's household with whom the employee is connected by blood relationship, marriage or adoption. In addition, with the exception of the employee's spouse or common-law partner, the other individuals connected to the employee who may be covered under the PHSP must be dependants of the employee within the meaning of the ITA.

CRA generally allows healthcare benefits for former employees, spouses, common-law partners and eligible dependants to be provided on the same basis as benefits for active employees. That is, a PHSP can be established for retirees and the tax treatment of the retirees and the employer will be the same as under a PHSP for active employees.

Where an employer makes contributions or pays benefits under an arrangement that qualifies as a PHSP, neither those contributions nor those benefits are required to be included in an employee's income for tax purposes. The employer is entitled to a current deduction for the amount paid to the extent that the amount was laid out to earn income from business or property and was reasonable.

In general, an employer will not be entitled to deduct an amount paid under a PHSP on a current basis to the extent that the amount represents consideration for insurance in respect of a period after the end of the year of payment.

PHSP Tax Traps and Opportunities

The application of the ITA and CRA requirements to PHSPs can be complex. Plans that seem at first glance to comply may not comply or may not be operated in a manner that complies with requirements. In addition, plan terms that may not, on their face, offend the PHSP requirements may indirectly contravene those requirements.

The tax consequences where a plan fails to qualify as a PHSP can be harsh. For example, a plan under which contributions are made to a third party to fund benefits for employees may be an employee benefit plan (EBP). Under an EBP, all benefits are taxable to the covered employees upon receipt. In addition, the employer is not entitled to a deduction until benefits are paid and the amount of that deduction is limited by the amount of the benefits. In the case of an employer-paid, pay-as-you-go type plan under which the employer simply reimburses the employees for eligible expenses, the plan may not be an EBP but the amounts received by the employees may be taxable employment benefits, rather than tax-exempt benefits under a PHSP.

Alternatively, an employee healthcare plan that is not a PHSP might be a salary deferral arrangement (SDA). Under an SDA, the employer remains entitled to a deduction but the participating employees are subject to an inclusion in income for amounts to which they have a right, including a merely contingent right, under the plan.

A plan will not be an SDA unless one of the main purposes of the plan is the deferral of tax on employment income, however, plans purporting to allow employees to exchange salary, vacation pay or earned incentive compensation for health benefits are vulnerable to being characterized as SDAs.

Healthcare plans for retirees could also be treated as retirement compensation arrangements (RCAs). RCAs are inefficient arrangements from a tax perspective because all contributions and realized earnings are subject to a 50% refundable tax that must be remitted to CRA and cannot be recovered until amounts are paid out of the RCA.

As noted previously, the main requirements for a PHSP are that it provide only benefits that would be eligible for the medical expense credit under the ITA and that it be a plan or contract of insurance. As to the first requirement, the ITA and its regulations list a wide-range of health related services and products that qualify for the medical expense credit. However, certain interpretative issues arise. For example, fees paid to a “medical practitioner” are qualifying expenses, but the practitioner’s status for services rendered in Canada will generally have to be determined by applicable provincial legislation. This could result in services rendered in one province qualifying for the medical expense credit and the same services rendered in another province not qualifying. Massage therapists, for example, are regulated and thus may qualify as “medical practitioners” in some provinces, but not others.

The requirement that a PHSP only cover expenses eligible for the medical expense credit will also prevent a plan from providing employees or beneficiaries with any direct or indirect cash benefits. For example, a plan that provides a death benefit cannot be a PHSP. Also, plans that allow employees to transfer unused amounts to a registered retirement savings plan or receive a cash refund cannot qualify as PHSPs.

In Ontario, some employers are finding themselves under pressure to cover all or some portion of the recently implemented Ontario Health Premium. CRA was asked last year whether the Ontario Health Premium qualified as a medical expense for purposes of the medical expense credit. CRA concluded the Premium was a tax and not an eligible medical expense. CRA also indicated the Premium could not, in any event, be paid under a PHSP because the PHSP definition excluded provincial health insurance plans.

As to the requirement that a PHSP be a contract or plan of insurance, CRA has indicated that any one of the following features is inconsistent with an arrangement having the necessary insurance element:

- Discretionary coverage, such as covering extraordinary medical expenses in excess of the maximum normally applied under the employer’s healthcare plan
- Cash out of unused HSA credits
- Carry forward of unclaimed expenses or credits beyond the period permitted by CRA (currently 12 months following the end of a 12 month plan year)
- Carry forward of both credits and expenses
- Coverage for periods before enrolment in the plan

More troubling from a plan design perspective, however, is the following statement by CRA:

“If the plan or arrangement is such that it can be terminated at any time by the employer, with minimal notice, at the sole discretion of the employer, there may be some doubt as to the level of risk undertaken and whether this would, in fact, be a plan of insurance...the particular plan can be terminated by the employer at any time with one month’s notice. Therefore, its is our view that the arrangement is likely not a plan of insurance, and would not qualify as a PHSP.”

Employers establishing a group benefit plan of any type will often want to retain control over the amendment and termination of the plan and it is common practice to include provisions in pension plans, incentive plans and other benefit plans that allow the employer to amend or terminate the plan at any time.

CRA's position raises concerns that such provisions could not be included in an PHSP and employers' ability to terminate or reduce coverage under a PHSP may be subject to common law notice periods or other potentially significant constraints. This is of particular concern in the case of PHSPs providing post-retirement benefits, as the better view is that, under the common law, unless the employer has reserved a clear right to amend or terminate such plans, they cannot be altered to reduce benefits or terminated with respect to retired employees.

Unrestricted carry forwards of credits or expenses and the carry forward of both credits and expenses can be issues in the design of an HSA. As noted above, a typical HSA involves the allocation of notional credits to participating employees, who can then claim reimbursement for eligible expenses up to the value of the credits allocated to the HSA.

It is CRA's position that HSAs need to work on a "plan year" basis, such that the number or value of credits to be allocated to a participating employee's account is established before the plan year. In addition, CRA has indicated an HSA may allow participants to carry forward either unused credits or unused expenses for up to 12 months following the end of the plan year (assuming a 12 month plan year) and still qualify as a PHSP. In CRA's view, however, an arrangement that permits employees to carry forward both credits and expenses, or permits carry forwards beyond 12 months following the end of the relevant plan year will lack the element of insurance required to be a PHSP. CRA is also of the view a plan that permits employees to cash out unused credits, directly or indirectly (for example, by way of a transfer to and RRSP) will not be a plan of insurance.

For an HSA (or any healthcare plan) to be a PHSP, it is also necessary to ensure the plan does not cover expenses incurred before an employee became covered by the plan. While this may seem a straightforward requirement, where a plan is part of a broader flexible benefits plan, under which employees may elect to participate in different types of benefit plans (as well as different coverage levels within a particular plan) on an annual basis, employees who choose in one year not to participate in the HSA component of the flexible benefit plan will not be able to receive reimbursement in the following year (assuming they participate in the HSA for that year) for medical expenses incurred in the year in which they were not HSA participants. This will be the case even if the HSA program allows participants to carry forward expenses and the expenses in question qualify for the medical expense credit pursuant to the ITA.

Structuring a PHSP

If an employer wishes to establish a healthcare plan for its employees that is a PHSP, these tax issues will need to be taken into account in designing the plan. Most employer sponsored healthcare plans take one of two forms: a "major medical" plan that covers most medically necessary expenses (especially drugs) that are not covered by public health plans, semi-private or private hospital care and dental for a broad range of employees, or an HSA under which employees have more flexibility to with respect to the covered expenses.

A major medical plan is typically insured or at least administered by an insurance company. The main tax issue with these types of plans is ensuring the benefits provided qualify for the medical expense credit under the ITA. As noted above, this is not simply a question of whether a particular expense is listed in the ITA, but may require an analysis of provincial legislation applicable to the practitioner providing the service or product for which reimbursement is sought.

HSAs are most often structured to permit employees to receive some level of reimbursement for medical expenses that still qualify for the medical expense credit but on a less restrictive basis than under a major medical plan. For example, a major medical plan may cover up to $500 worth of physiotherapy in any one year whereas, under an HSA which provides an employee with $2,000 worth of credits in a year, the employee can apply the entire $2,000 to physiotherapy services (from a qualified physiotherapist in the jurisdiction in which the services are rendered).

HSAs can be structured to allow employees to choose different levels of coverage or provide different classes of employees with different benefits. HSAs can also provide a tax planning opportunity for employees who receive bonuses as part of their remuneration. According to a recent CRA advance tax ruling, an employee may elect to convert a bonus, which would normally be taxable upon receipt, into credits under an HSA, which enables the employee to receive non-taxable health benefits with a value equal to the notional value of the credits. This is an interesting ruling as CRA has, in the past, been adamant that employees cannot convert otherwise taxable salary or vacation pay into non-taxable HSA credits or benefits.

It appears the key factors in this ruling were that the employees elected to convert their bonus before they had a legal entitlement to it — that is, they would receive nothing if they terminated employment before the bonus was paid — and they elected the level of HSA credits before the start of the HSA plan year. The HSA also appeared to meet the general criteria for a PHSP. In particular, only expenses eligible for the medical expense credit were payable under the plan, participation elections were made before the start of the plan year and the carry forward of unused credits was permitted but only for one additional year.

Converting bonuses into HSA credits may be attractive for employees with anticipated healthcare costs not covered by the employer's basic major medical plan. However, employees need to understand that if they effect such a conversion and do not incur sufficient eligible medical expenses during the relevant plan year or the one year carry forward period, they will be required to forego the portion of their bonus that related to the unused HSA credits.

Further, the CRA ruling applies only to the employer that obtained it and thus there remains a concern that an arrangement under which employees can elect to convert otherwise taxable bonuses to non-taxable PHSP entitlements could result in immediate tax to the employee, either on the basis of constructive receipt or on the basis that the arrangement was an SDA. It would be advisable for any employer considering the establishment of such an arrangement to obtain their own advance tax ruling, or at least consult with CRA to obtain some comfort that the employer's arrangement would receive the same tax treatment as the plan described in the ruling.

Long-term Disability Plans

Here, LTD Plans are "group sickness or accident insurance plans," as referred to in the ITA, and "sickness or accident insurance plans" or "disability insurance plans" for the purposes of the ITA. While the ITA refers to a "group sickness or accident insurance plan" and indicates certain tax consequences attach to such plans, it should be noted the term is not defined in the ITA itself.

In fact, it appears CRA defers to provincial insurance legislation in determining whether a particular plan is a "group sickness or accident insurance plan." As a result, as with medical expenses, it is possible employees could be subject to different treatment depending on their province of residence. CRA has indicated that, for tax purposes, the main thing is that the plan be a group plan (that is, it cover more than one employee) and an insured plan.

In general, as an "insured plan," an LTD Plan will involve an undertaking to pay an amount in the event of the sickness or accident of the insured employee. The amount may be payable on an indemnity basis or a non-indemnity basis. In the case of an indemnity-based plan, the employee must demonstrate a loss as a result of the sickness or accident and the plan will provide compensation for that loss, subject to whatever limits are imposed under the plan terms.

Where an employer makes contributions under a “group sickness or accident insurance plan” in respect of an employee, those contributions are not required to be included in the employee’s income for tax purposes. The employer is entitled to a current deduction for the amount paid to the extent that the amount was laid out to earn income from business or property and was reasonable.

An employee will be taxable on benefits received under a LTD Plan to which his or her employer has contributed since such benefits represent income from employment in the year of receipt. Where the employee and employer have both contributed, the portion of the benefits included in the employee’s income will be reduced by the amount of the employee’s contributions (to the extent that they were not previously taken into account for the purposes of calculating his or her income in respect of the plan).

Employees are not taxed on any benefits received under an LTD Plan that is an “employee pay-all” plan — that is, a plan under which all contributions / premiums are paid by the employees. In general, an employer will not be entitled to deduct an amount paid under an LTD Plan on a current basis to the extent that the amount represents consideration for insurance in respect of a period after the end of the year of payment.

Tax Traps and Opportunities

The tax consequences are significantly different for an employee pay-all LTD Plan and an LTD Plan under which any employer contributions have been made. Where employers wish to provide employees with tax-free LTD benefits, as opposed to tax-free LTD Plan contributions, the plan terms and the administration of the plan must all support the conclusion that the obligation to contribute rests with the employees and that the funds actually contributed are employee monies.

Where an employer actually makes contributions under an LTD Plan and then reports those contributions as taxable benefits on the employees’ T-4s, this will likely not be sufficient, in and of itself, to make the plan an employee pay-all plan. If an employer wishes to provide some employees with taxable LTD benefits and some employees with non-taxable LTD benefits, it will be important that the recordkeeping for the plans clearly identify employee contributions and employer contributions and the non-taxable benefits can be traced exclusively to the employee contributions. This may seem self-evident; however, especially where an employer uses a single health and welfare trust to fund both taxable and non-taxable LTD benefits, clear recordkeeping may be a challenge.

Another issue that arises is referred to as “purification” of an employer-paid LTD Plan to convert it to an employee pay-all arrangement. For example, an employer may provide employees with a PHSP and an LTD Plan under which employees and the employer contribute. In this scenario, employees would receive tax-free PHSP benefits but taxable LTD benefits. The plans may be restructured such that employer will pay 100% of the PHSP costs and the employees will pay 100% of the LTD Plan costs so that both PHSP and LTD benefits will be non-taxable.

CRA has agreed that, where an employer provides a fully or partially-employer paid LTD Plan, the employer can replace that plan with a new employee pay-all arrangement and that benefits under the new plan will be non-taxable. This, however, may not be sufficient to ensure all future LTD benefits paid to employees in receipt of benefits at the date of the change in plan structure are treated as non-taxable benefits under an employee pay-all plan.

According to a CRA Interpretation Bulletin on *Wage Loss Replacement Plans* (IT-428), where an employee is in receipt of taxable LTD benefits at a time when a plan is converted to an employee pay-all plan “the benefits he continues to receive after the date of conversion, to the extent they were provided for in the old plan, will remain of an income nature because they continue to flow from the old taxable plan."

In a recent ruling, CRA appears to have clarified its position on the treatment of benefits where an LTD Plan is converted from a taxable plan to a non-taxable employee pay-all plan. This ruling involved a situation in which LTD benefits were provided from a trust, which had been funded through a mix of employee and employer contributions. Benefits payable from the trust were taxable to recipients in accordance with the ITA.

The trustees proposed replacing the existing LTD Plan with a new, employee pay-all plan and continuing to use the trust as the funding vehicle for benefits. At the time the new plan became effective, the trust was in a deficit position. CRA ruled that, in view of the deficit in the trust at the conversion date, all previous employer contributions had been used to provide taxable benefits and all future benefits (including benefits payable to individuals who had become disabled before the effective date of the new plan) could be provided on a non-taxable basis, presumably since they are being funded with contributions made pursuant to the new employee pay-all arrangement.

The settlement of LTD claims, where an employee is denied coverage, either initially or after benefits have commenced, can also raise tax issues. Traditionally, CRA took the position that if a settlement was in respect of LTD benefits that would have been taxable, the settlement amount was also taxable. The recent *Tsiaprailis* case has required CRA to change its position. In this case the Supreme Court of Canada held that lump-sum payments in respect of unpaid LTD benefits under an employer-paid LTD Plan that relate to periods before the settlement are taxable under paragraph 6(1)(f). However, a lump-sum paid to discharge a future obligation to provide such benefits is capital in nature and not taxable as employment income.

CRA initially interpreted the decision in *Tsiaprailis* as meaning a lump-sum paid in settlement of rights to future benefits under an employer paid (in whole or in part) LTD Plan constitutes proceeds of disposition of a capital property (that is, the right to receive future benefits) that must be taken into account in calculating the recipient's capital gain from the disposition of his or her right to future benefits. However, CRA appears to have backed away from this interpretation and will allow such lump-sum payments to be received tax-free.

Tsiaprailis provides a basis for settling claims with respect to future LTD benefits in a more tax effective manner than if the entire amount were required to be treated as income from employment. In some cases, it may be possible to reduce LTD costs by offering employees a smaller lump sum (i.e., a payment that is adjusted to reflect the more advantageous tax treatment) rather than providing fully taxable periodic payments.

Health and Welfare Trusts

A health and welfare trust (HWT) is not a type of benefit plan, but a funding vehicle for certain group benefits which can include PHSPs and group sickness and accident insurance plans. As a funding vehicle, an HWT is an alternative to two common funding arrangements for group benefits, being: i) an insurance policy (under which the insurance company assumes the risk associated with providing the benefits promised under the group plan) or ii) an "administrative services only" (ASO) contract (under which a third party (typically an insurance company) administers benefits for a fee, but which is funded by the employer on a more or less current basis).

The term "health and welfare" trust is not defined in the ITA. CRA's position on these arrangements is set out in what is now a somewhat dated 1986 Interpretation Bulletin, IT-85R2, entitled *Health and Welfare Trusts for Employees*. CRA has recently prepared a revised version of IT-85R2 and released it on a limited basis for comment, but it is not available to the public and it is uncertain when it will be made available, either as a draft for further comment, or in final form.

An HWT is a true trust under the common law and an *inter vivos* trust for ITA purposes. It may be a multi-employer arrangement or may be established by a single employer.

Under IT-85R2, the main requirements are the type of benefit plans that can be funded through an HWT, which are limited to: a) group sickness or accident insurance plans; b) PHSPs; c) group term life insurance plans; or d) any combination of a) through c). As well,

- Trustee(s) must act independently of the employer;
- Employers cannot retain control of funds once they are contributed to an HWT;
- Assets of an HWT cannot be invested in securities or debt of the employer or a person that does not deal at arm's length with the employer;
- Assets of an HWT cannot revert to a participating employer (this applies even on termination of the trust); and
- Employer contributions to an HWT cannot exceed the amount required to provide the benefits under the plans funded through the trust.

Where qualifying benefits are provided through an HWT, the employees are taxed in the same way as if the benefits had been provided under an insurance policy or were paid directly by the employer. Specifically, as to PHSP and LTD benefits, the tax consequences to employees who receive benefits by way of an HWT will be the same — they will not be taxable on PHSP benefits, will be taxable on LTD benefits if the employer contributed to the LTD Plan and will not be taxable on LTD benefits if the LTD plan is an employee pay-all arrangement. The employer will be entitled to a current deduction for amounts contributed to an HWT to the extent that they are reasonable.

As noted, the HWT is an inter vivos trust for ITA purposes. In calculating its taxable income, such a trust is entitled to deduct expenses incurred in earning income, expenses of administering the trust (e.g., expenses relating to collecting and accounting for contributions, reviewing insurance policies, management fees) and amounts paid out of the trust income for benefits (or premiums) that are allocated to and included in the income of the trust beneficiaries pursuant to the ITA.

Tax Issues Since an HWT is a taxable trust, tax efficiency will be best achieved if the annual income of the trust can be used to meet deductible expenses and pay benefits in the year in which it is earned, so as to avoid taxation of income in the trust in that year and then again in a later year when it is paid out in the form of benefits.

However, a tax efficient arrangement will also ensure employees who receive benefits from an HWT are not taxed on those benefits in a different manner than would apply if the benefits were provided through a different structure (such as an insurance policy or ASO arrangement).

If benefits are paid to an employee out of an HWT's current income and deducted by the trust from its income for tax purposes as permitted by paragraph 104(6)(b) of the ITA, the value of those benefits will be required to be included in the recipients' income pursuant to paragraph 104(13)(a) of the ITA. This may result in otherwise non-taxable PHSP or employee pay-all LTD benefits becoming subject to tax.

To avoid converting otherwise tax-free benefits into taxable receipts from an HWT, it will be important that PHSP and employee pay-all LTD benefits are not deducted by the trust in calculating its own income for tax purposes. Practically, this will usually mean that it is not tax efficient to set up an HWT that provides only PHSP or employee pay-all LTD benefits, as this will mean that the trust will be required to pay tax on its income (to the extent that it cannot be reduced by deductible expenses) to ensure that the employees are not taxed on such benefits.

In deciding whether to establish an HWT, an employer will want to consider the expected income of the trust relative to the expenses and taxable and non-taxable benefits to be provided. The employer's cost of funds may also be relevant to the decision to establish an HWT. In determining that cost, the employer will want to consider the extent to which it can deduct amounts contributed to the HWT (and borrowing costs, if any, associated with those contributions). CRA's position on "pre-funding" benefits under an HWT is relatively restrictive. An employer, however, may still find the after-tax cost of making contributions to an HWT and having the trust pay benefits is less than if the employer retained the contributions and paid the benefits directly.

While not primarily a tax issue, the employer's risk tolerance will also be relevant to the decision to establish an HWT. In this regard, under a single employer HWT, the employer will generally be responsible for any difference between the amount the trust can pay and the amount of the benefits to which the covered employees and their eligible beneficiaries are entitled. This is essentially the same as under an ASO arrangement except that the HWT facilitates the investment of contributions and may result in more favourable accounting treatment for benefit liabilities that are secured by trust assets.

In contrast, under a multi-employer arrangement that requires employers to contribute fixed amounts as negotiated under a collective agreement, the participating employers will generally not be the ultimate guarantors of the benefits being provided through the trust.

The key requirements for an HWT can also raise some concerns. In particular, the requirement for independent trustees may be difficult to apply, especially in the case of an HWT that is not collectively bargained. In addition, CRA's position on the funding of HWT benefits is also problematic in some respects.

Regarding the independence of the trustees, CRA indicates in IT-85R2 that "[t]he 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 there are employee contributions." In the case of a single employer trust, it would not be unusual for the employer to wish to appoint the trustees. CRA has acknowledged that the fact that all the trustees of an HWT are appointed by the employer or are employees is not in and of itself determinative of the issue of whether the trustees are independent of the employer. Nevertheless, the trustees' independence will be a question of fact and it may be more difficult to demonstrate the appropriate level of independence where the employer determines who may act as an HWT trustee.

With respect to funding and, in particular, the deductibility of HWT contributions, CRA's position has been that contributions to an HWT cannot exceed the amount required to provide the health and welfare benefits and such contributions may be calculated on an actuarial basis. In October 30, 2002, CRA noted this requirement refers to the "current" cost of paying out benefits for a given year.

In CRA's view, contributions to an HWT in respect of benefits payable over future years represent consideration for insurance in respect of a period after the year in which the contributions are made, which is not deductible in the year in which the contributions are made. CRA's "compromise" with respect to such contributions is that they will not result in the arrangement ceasing to be an HWT, provided they are based on actuarial determinations of the amounts needed to fund the future benefits.

A good argument can be made that CRA's position on the deduction of contributions to an HWT is flawed. A Joint Committee on Taxation of the Canadian Bar Association and Canadian Institute of Chartered Accountants made this argument to CRA in connection with draft IT-85R3 in September 2005. It will be interesting to see how CRA responds.

However, the HWT is really a creature of CRA policy and provides an exception to the general rule that, in the absence of a specific provision in the ITA authorizing a deduction for contributions to a trust, such contributions will be in the nature of capital and not deductible at all. As the ability to take any deduction for contributions to an HWT is in the nature of an administrative dispensation on the part of CRA, it is not clear they would be prepared to expand that dispensation to encompass what could be significant lump-sum contributions (particularly in connection with LTD benefits).

Conclusion

As can be seen, it is important that employers and employees appreciate the ITA and CRA requirements for PHSPs and LTD Plans, as well as the consequences of failing to meet those requirements, to ensure the delivery of the desired benefits at the expected cost. It is also important that employers considering using an HWT to fund their PHSP and LTD Plan obligations fully understand the tax advantages and limitations of such trusts before making a decision to establish one.

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