

The Joint Committee on Taxation of
The Canadian Bar Association
and The Canadian Institute of
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Dear Mr. Jolie:

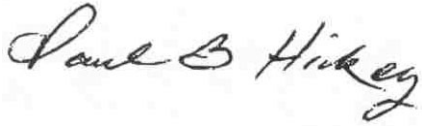
Draft IT-85R3 – Health & Welfare Trusts

We are pleased to provide you with our comments on draft Interpretation Bulletin IT-85R3 relating to health & welfare trusts. We trust that you will find our comments and recommendations helpful.

Our submission identifies a number of concerns with the draft IT. The principal concern is with the CRA's application of the prepaid expense rule in subsection 18(9) of the *Income Tax Act*. It appears to us that the application of this rule is based on a fundamental misunderstanding of the nature of insurance. The CRA's view, as we understand it, is that insurance is considered to be provided when benefits are paid. The correct view, we submit, is that insurance is considered to be provided in respect of a period if an event occurring in the period would give rise to an entitlement to benefits. The submission explains this in detail.

We would be pleased to meet with you and your colleagues to discuss any of the concerns raised in the submission. We would also be pleased to assist in revisions to the draft IT. Should you wish us to do so, please contact Bill Holmes at 604.402.4224 or holmes@thor.ca.

Yours truly,



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cc: Mr. Brian Ernewein – Department of Finance

**Submission of the
CICA-CBA Joint Committee on Taxation
Regarding
Draft Interpretation Bulletin IT-85R3**

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**Submission of the
CICA-CBA Joint Committee on Taxation
Regarding
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A. Use of Term “Health and Welfare Trust”

Draft Interpretation Bulletin IT-85R3 (the “Draft IT”) uses the term “health and welfare trust” in two different ways. Paragraph 1 states that a health and welfare trust is any trust arrangement used in administering an employer’s health and welfare benefits under the specified types of plans and policies. On the other hand, paragraph 8 sets out the conditions that must be met for a trust to qualify as a health and welfare trust for purposes of the bulletin. The Summary uses the term with both meanings. The use of the term “health and welfare trust” with two different meanings leads to some confusion.

Recommendation:

We recommend that the term “health and welfare trust” be limited to trusts to which the bulletin is intended to apply. Those places in which the term is used with a broader meaning should be revised to avoid this confusion.

B. Tax Implications to Employer

We have several concerns with the discussion in paragraphs 10 to 13 of the Draft IT.

Terminology

Plans are characterized in paragraphs 10 to 12 as “self-insured plans” and “insured plans”. While unclear, it appears that the first term is used to refer to an arrangement under which the health and welfare trust has the obligation to make the benefit payments itself, and the second term to an arrangement under which the benefits are provided by an insurance company pursuant to a group insurance contract acquired by the trustees of the health and welfare trust.

Normally, a reference to a “self-insured plan” would mean that the employer itself has a direct liability to pay the plan benefits. If that is the intended meaning, then the use of this term would be inappropriate for many uninsured health and welfare arrangements. Health and welfare trusts are often established to provide benefits to all employees in a particular industry in a specific region. Employers generally contribute to such trusts pursuant to collective bargaining agreements, and there may be a large number of employers who contribute. The employers in such a multi-employer arrangement have no direct liability to pay any of the health and welfare benefits. Thus, it would not be appropriate to refer to such arrangements as “self-insured” in the sense just described.

Furthermore, some arrangements involve hybrid approaches: one or more benefits are provided under insurance contracts, and the remaining benefits are provided directly by the trust. It would clarify the discussion to explain what is meant by “self-insured” or to use a different term, and also to recognize the use of hybrid approaches.

A further point regarding terminology concerns the reference in paragraph 11 to a pay-as-you-go plan. The term “pay-as-you-go” is used to describe benefit arrangements, primarily certain pension and long-term disability plans, under which no funds are set aside to pay benefits that have accrued. Thus, this term is not synonymous with “self-insured”, if self-insured is used to mean that a health and welfare trust is directly liable to pay benefits. Benefits provided directly by a health and welfare trust could be funded. We suggest that this reference to “pay-as-you-go” be deleted.

Statement Regarding Funding

Paragraph 10 states that “an employer will normally be required to fund a H&WT with an amount that is equal to the current year’s cost of providing health and welfare benefits” plus administrative costs. The purpose of this statement is unclear. It does not appear to be intended to impose a condition for a trust to qualify as a health and welfare trust (the conditions are imposed by paragraph 8). Rather, it seems to be an observation on what happens in practice. If so, it is probably not an accurate description for many trusts. Employers contributing to multi-employer health and welfare trusts are often required to contribute a negotiated amount expressed on a cents per hour basis (that is, the employer’s contributions are determined by multiplying the number of hours worked by employees in each time period by a rate per hour).

We suggest that this statement be deleted. The last sentence of the paragraph (funding to pay benefits in future years) also seems to be an observation on what happens in practice, and so we suggest that it be deleted as well.

Linking Deductions to Benefits Paid

Our principal concern is with the position taken in paragraph 11 regarding the timing of the deduction of employer contributions. The CRA’s view is that contributions made in an employer’s taxation year are deductible only to the extent that the contributions are made to fund benefits that may reasonably be expected to be paid out in the year, plus administrative costs. (The paragraph is confusing because the first sentence expresses a different position: it states that contributions are deductible when incurred. Given the remainder of the paragraph, we have assumed that this is not the intended position.) The basis stated by the CRA for its view is that contributions made in a year in excess of these amounts are regarded as consideration for insurance in respect of a period after the end of the year, and so the deduction of such contributions is prohibited by paragraph 18(9)(a) of the Income Tax Act (the “Act”).

We submit that the CRA's view as to the application of paragraph 18(9)(a) is based on a fundamental misunderstanding of the nature of insurance. Insurance consists of an undertaking to make payments on the occurrence of specified events. Insurance coverage for a particular period is an undertaking to pay insurance proceeds if any of the specified events occurs in the period. To say that insurance is in respect of a period (the language used in subparagraph 18(9)(a)(iii)) means that insurance proceeds will be payable if an insured event occurs in that period.

Assume that a health and welfare trust provides medical and dental insurance benefits to the employees of an employer, and that the employer's taxation year is the calendar year. As with all such insurance, employees become entitled to insurance proceeds upon incurring qualified medical or dental expenses. Qualified expenses incurred, for example, in 2005 will result in the payment of insurance proceeds because insurance is provided in respect of 2005. Hence, no portion of the contributions made to the trust by the employer in 2005 to fund the claims arising from qualified expenses incurred in 2005 constitutes a prepaid expense. The contributions are solely for insurance in respect of 2005. Contrary to the view expressed by the CRA, the fact that particular claims may not be paid until 2006 does not alter the timing of the insurance. In other words, it is completely irrelevant to the application of subparagraph 18(9)(a)(iii) when insurance proceeds are actually paid.

The CRA's position regarding the application of the prepaid expense rule in subsection 18(9) is particularly problematic for long-term disability (LTD) benefits, in view of the fact that benefit payments may be made over many years. According to the CRA, employers can deduct contributions made to a health and welfare trust in a particular year to fund an LTD plan only to the extent that the contributions are expected to be used to pay LTD benefits in the year. As we have explained above, the application of the prepaid expense rule to produce this result seems to be based on a misunderstanding of insurance. The event in respect of which the LTD insurance is provided is the incurral of a disability. This is the event that results in the obligation to make benefit payments. If a disability occurs in 2005, for example, benefits are payable because insurance coverage has been provided in respect of 2005. Thus, there is no element of prepaid insurance if an employer makes contributions to fund the full amount of benefit payments expected to be made as a result of disabilities occurring in 2005.

This may be easier to see by considering LTD insurance provided by an insurer. Assume that an employer acquires a group insurance policy under which the insurer provides LTD insurance to the employer's employees. If an employee becomes disabled in the first policy year, the insurer will be obligated to make payments to that employee for the duration of the disability (or to a maximum age), regardless of whether the employer renews the policy at the end of the first year. Hence, the insurer will require the employer to pay sufficient premiums in the first year so that, on an actuarial basis, the premiums are expected to be sufficient to pay all claims in respect of disabilities occurring in that year (plus the insurer's administrative costs and a profit margin). Clearly, in paying the premiums for the first year, the employer is buying insurance for that one year, i.e. insurance in respect of the year. The fact that disability payments will

be made in subsequent years does not alter this. The same is true of the premiums paid for each subsequent year.

We see no substantive difference between contributions made by an employer to a health and welfare trust in respect of LTD insurance for its employees, and premiums paid by the employer under an LTD insurance policy. Contributions made in a year to a health and welfare trust to fund the benefits payable from the trust as a result of disabilities occurring in the year are made to acquire insurance on a current basis, not to acquire insurance for future years, just as no portion of the premiums paid to an insurer in a year for LTD insurance in respect of the year represents the prepayment of insurance coverage.

▪ Another way to see why subsection 18(9) should not have application is to compare the situation where a health and welfare trust provides the LTD insurance directly (i.e. the trust has the obligation to make LTD payments) with the situation where a health and welfare trust acquires an insurance policy under which the LTD insurance is provided. In this latter situation, paragraph 12 of the Draft IT implicitly recognizes that no part of the contributions payable by employers in a year to a health and welfare trust to enable the trustees to pay premiums for the year under an LTD policy would be regarded as a prepaid expense. The only difference between the two situations is in who is liable to make the benefit payments – the trust or an insurance company. It cannot possibly make any difference to the application of the prepaid expense rules whether the insurance is provided directly by the trust or under an insurance policy acquired by the trust. From the perspective of employers, in both cases contributions are made to acquire the same insurance for their employees.

Actuarial Reserves

It is unclear what sorts of reserves are contemplated by paragraph 13. We think this paragraph is intended to describe the amounts that a health and welfare trust must have on hand at the end of a fiscal year in order to pay claims that have been incurred before the end of the year. For example, if dental benefits are provided by a health and welfare trust, the reserve in respect of such benefits would equal the sum of the claims that have been reported to the end of the year but not paid (the “unpaid claims reserve”) and the claims incurred in the year that have not been reported by the end of the year (the “incurred but not reported reserve”). These reserves would be relatively small in relation to the annual contributions to fund the dental benefits. If LTD benefits are provided through a health and welfare trust, the primary reserve at the end of a year would be the disabled life reserve, which is the present value of benefits to be paid in the future to employees who have become disabled before the end of the year and whose disabilities have been reported to the trustees. The total amount of this reserve for all disabled lives (i.e., those who have become disabled in the current year and those who have become disabled in previous years) could be substantial relative to the annual cost of the disability coverage. There would also be a much smaller reserve in respect of benefits payable to those who may have become disabled before the end of the year but have not reported their disabilities (referred to as an incurred but not reported reserve).

Assuming that our understanding of the reserves contemplated by paragraph 13 is correct, then we take issue with the assertion in the paragraph that contributions to fund the reserves are made for insurance in respect of future periods, and hence the deduction of such contributions is prohibited by the prepaid expense rule. Where benefits are payable in the future because of events that have occurred, the insurance has already been provided. What remains is for the trust to pay the benefits to which employees have become entitled and which the trust has become obligated to pay. The payment of the benefits does not constitute the provision of insurance. Thus, contributions to fund such reserves would not be regarded as amounts paid in respect of insurance for a future period. This point is closely related to the discussion of the position taken in paragraph 11 of the Draft IT regarding the deduction of contributions.

It is possible that something else is intended by the references to "reserves" in paragraph 13. If so, then this should be clarified. In this case, whether the prepaid expense rule could apply depends on the types of "reserves" the CRA has in mind.

Administrative Costs

In referring to contributions made to a health and welfare trust, paragraphs 10, 11 and 12 mention the administrative costs of the employer. It is unclear why such costs are mentioned. An employer would normally pay its administrative costs directly, and would not be reimbursed by the trust. We recommend that it be clarified why such costs are mentioned or, alternatively, that the references be deleted.

Recommendations:

We urge the CRA to reconsider its position on the application of subsection 18(9). The position reflected in the Draft IT is, we submit, based on a confusion between the provision of insurance and the payment of insurance proceeds.

In addition, we recommend that the changes suggested above be made to paragraphs 11 to 13 of the Draft IT.

C. Surplus

With respect to subparagraph 8(c), it is not apparent why the conditions for a trust to qualify as a health and welfare trust include a condition regarding surplus. As discussed in section D of this submission, status of a trust as a health and welfare trust is irrelevant in determining whether contributions to the trust are deductible. Furthermore, investment income earned by a health and welfare trust is subject to tax, either in the trust or, if the income is used on a current basis to pay benefits, in the hands of the beneficiaries. Thus, we request that the CRA reconsider whether there is any reason for imposing a condition with respect to surplus.

If the CRA concludes that it is necessary to retain a condition regarding surplus, then we have several concerns with the condition contained in the Draft IT. A general concern is that the condition is so vague that it will frequently be impossible to determine whether it is satisfied. Thus, it does not provide adequate guidance regarding the CRA's administrative position.

One specific concern is with the discussion of "temporary" and "permanent" surplus. It is unclear to us which, if any, surpluses are to be regarded as permanent surpluses. Moreover, it is unclear what difference it makes whether a surplus is regarded as permanent or temporary. The CRA's position appears to be that steps must be taken to eliminate both types of surpluses within a reasonable period of time.

Another specific concern is that the concept of surplus is undefined. Thus, it is unclear what the CRA regards as a surplus. While paragraph 13 of the Draft IT provides some assistance, in that it states that a reserve to meet future obligations would not be considered a surplus¹, the problem is that there is not a positive statement as to what the term "surplus" is intended to mean. Since health and welfare trusts provide insurance, we suggest that surplus be defined in an appropriate manner for insurance. Also, since surplus is a balance sheet concept, it should be defined at the end of a fiscal year. We propose that the surplus of a health and welfare trust at the end of a year be defined as the amount, if any, by which the trust's assets at the end of the year (excluding any amounts received by the trust as contributions for insurance for the first part of the following year) exceed the actuarial liabilities of the trust, determined at the end of the year, in respect of claims that have arisen before the end of the year. For this purpose, actuarial liabilities may be determined with a reasonable margin for adverse experience (i.e., to allow for the fact that amounts actually paid may exceed the estimated amounts to be paid). We suspect that this definition is close to what the CRA has in mind in using the term "surplus".

A further concern is that subparagraph 8(c) does not take into account the fact that claims can fluctuate from year to year. This is particularly so for long-term disability coverage, since the incidence of the occurrence of disability is low while the magnitude of individual claims (the present value of benefits to be paid) can be quite large. Where an insurer provides insurance on an experience-rated basis (i.e., the employer or other policyholder bears some or all of the financial risk of the insurance), the insurer will often maintain "claims fluctuation reserves" to protect against year-to-year variations in claims. Health and welfare trusts should be permitted to establish similar reserves, which would be treated like actuarial liabilities in determining if there is a surplus. In making this proposal, we are assuming that the types of reserves referred to in paragraph 13 of the Draft IT would not include claims fluctuation reserves. If this assumption is wrong, then it needs to be clarified in the bulletin that such reserves are acceptable in determining surplus.

¹ Paragraph 13 of the Draft IT actually states that a *contribution* in respect of such reserves is not considered to be a surplus. However, surplus is a balance sheet concept, whereas contributions are an income statement concept (although contributions are not income for tax purposes). We have assumed that it is intended to refer to the reserves themselves.

It seems to be expected in subparagraph 8(c) that action will be taken fairly promptly to eliminate a surplus. However, this is not realistic for many multi-employer health and welfare trusts. Often, the contributions to these trusts are negotiated as part of collective bargaining, and cannot be easily changed between rounds of bargaining. Nor is it appropriate to adjust benefits from year to year. Once new or enhanced benefits are introduced, from a practical perspective they cannot be withdrawn. Even with non-bargained trusts, it will often not be easy to take steps in the short term to eliminate a surplus. If the CRA accepts our proposal to allow claims fluctuation reserves, this would alleviate our concern to some extent. However, it would not eliminate it entirely. One solution would be to exempt multi-employer health and welfare trusts (or a suitable class of such trusts) from any surplus condition. In general, there is a constraint on contributions to such trusts, since employers do not want to contribute any more than is required, and so the CRA should not have any concern with surplus in such trusts.

A final concern we have with the condition regarding surpluses imposed by subparagraph 8(c) is that the subparagraph mixes observations of what happens in practice with statements regarding what must happen in order for a trust to be regarded by the CRA as a health and welfare trust. For example, the comment regarding contributions possibly having to increase if a deficit exists appears to have nothing to do with qualification as a health and welfare trust. The statement that “temporary surpluses” are usually eliminated within one year also seems to be an observation on what happens in practice (and, as such, is probably incorrect). It would be much clearer what conditions are being imposed by the CRA if subparagraph 8(c) were limited to those conditions, and did not also include observations on how the CRA thinks that health and welfare trusts actually operate.

Recommendation:

We recommend that the condition regarding surplus be eliminated, preferably for all health and welfare trusts but at the very least for multi-employer trusts or a suitable class of such trusts. If the condition is retained for any health and welfare trusts, it should be revised to address the concerns identified above with respect to the determination of whether there is a surplus. We are not making any recommendation at this time as to the exact form the condition should take, since we would first need to find out from the CRA why there is a need for the condition.

D. Loss of Status as Health and Welfare Trust

Subparagraph 8(c) of the Draft IT states that where a health and welfare trust loses its status as such, all contributions to the former health and welfare trust will be treated as non-deductible capital contributions to the trust. We submit that this would generally not be the result under the law. Contributions which an employer is required to make to a trust to fund benefits in respect of services rendered by its employees are current business expenses, not capital outlays. They are analogous to premiums paid to an insurer to provide health and welfare benefits to its employees under a group insurance policy. Thus, such contributions would be deductible as business expenses whether or not the trust is regarded by the CRA as a health and welfare trust.

Recommendation:

We recommend that the statement regarding the deductibility of contributions if a trust ceases to be a “health and welfare trust” be deleted. Alternatively, the statement could be revised to accurately reflect the law, in which case we suggest that it be moved to a more logical position in the bulletin. It does not seem appropriate to discuss, in the context of a condition on surplus, the tax treatment of contributions made to a trust that is not regarded as a health and welfare trust.

E. Miscellaneous Comments

The following are further comments arising from our review of the Draft IT:

1. The last bullet of the Summary states that the bulletin discusses “[t]he procedures to be followed in setting up a health and welfare trust”. This is not something discussed in the bulletin, nor in our view would it be an appropriate topic for the bulletin. Thus, we suggest that this bullet be deleted.
2. Paragraph 2 of the Draft IT states that a reference to a “group sickness or accident insurance plan” includes the three types of insurance plans described in paragraph 6(1)(f) of the Income Tax Act. It then goes on to state that “a ‘group sickness or accident insurance plan’ may also be referred to as a group disability insurance plan or a group income maintenance insurance plan that is not a ‘supplementary unemployment benefit plan’”. It is unclear what is meant by this latter statement. We suggest that it be deleted or clarified. Also, the term “group sickness or accident insurance plan” has a broader meaning than just those plans listed in paragraph 6(1)(f) of the Act. We suggest that a statement to this effect be made in paragraph 2. Paragraph 15 of the Draft IT may also need to be revised, since it assumes that the only type of group sickness or accident insurance plan is one that provides wage loss replacement benefits.

3. Paragraph 6 of the Draft IT contemplates the situation where part of a particular plan is a plan referred to in paragraph 1 of the Draft IT, and another part is an employee benefit plan or employee trust. It states that, as long as there is separate accounting for the two parts, the part that is a plan referred to in paragraph 1 will not be treated as an employee benefit plan or trust. In practice, it is more likely that the issue will arise where two or more distinct plans are funded through the same trust, rather than one plan with multiple parts. We suggest that it be clarified that the position taken in paragraph 6 also applies in the case of multiple plans.
4. Paragraph 7 of the Draft IT makes statements that do not appear to be requirements that must be met for a trust to qualify as a health and welfare trust, but rather are observations on the characteristics of some health and welfare trusts (composition of trustees; benefits agreed to by the employer and the employees). We have a similar concern with this paragraph as expressed above with respect to subparagraph 8(c). We find it confusing to include such observations in the bulletin. We recommend that these observations be deleted from paragraph 7.
5. Subparagraph 8(e) of the Draft IT refers to “situations where the beneficiaries of the trust have no claims against the trustees or the fund, except by or through the employer”. We do not think that the courts would give effect to any provision that sought to prevent the beneficiaries of a trust from enforcing their rights against the trustee. Thus, the situation contemplated by this reference should never arise. For this reason, we are wondering whether the CRA actually has something else in mind.
6. In paragraph 15 of the Draft IT under the heading “Group Term Life Insurance Policies”, the first sentence of subparagraph (b) makes a statement that appears to be irrelevant to the determination of the tax consequences to an employee. It notes that the disposition of an interest in a life insurance policy can result in an income inclusion to the policyholder. Since employees are not policyholders of policies held by health and welfare trusts, it is not apparent why this statement is made. It does not seem to have any relevance to the statement that follows, that a lump sum payment made to an employee’s estate or named beneficiary is not included in income. The same comment applies to subparagraph 15(c), which comments on the life insurance accrual rules in subsection 12.2(1) of the Act. These rules apply to policyholders, and so also seem irrelevant in determining the tax consequences to employees.
7. Subparagraph (e) under the heading “Group Term Life Insurance Policies” in paragraph 15 provides only half the picture regarding the tax treatment of settlement option annuities. It refers to the inclusion of payments in income pursuant to paragraph 56(1)(d) of the Act, but not to the deduction of the capital amount under paragraph 60(a). A further problem is that the interrelationship between subsection 12.2(1) and paragraph 56(1)(d) is misdescribed. The way double taxation is avoided is by excluding from the application of paragraph 56(1)(d) any annuity contract to which subsection 12.2(1)(d) applies. As an

alternative to revising this subparagraph, we suggest that the CRA consider deleting any discussion of settlement annuities, since they are not something that is unique to health and welfare trusts. They can also arise in connection with employer-owned group term life insurance policies.

8. Paragraph 16 of the Draft IT (Shared Contributions) makes a general statement that if a taxable benefit is being paid, in part, out of employee contributions, a pro-rated portion of the benefit will be non-taxable. This statement is confusing. As is made clear in the next paragraph, it does not apply to paragraph 6(1)(f) benefits. Thus, the only taxable benefit to which it could apply is group term life insurance. It would be much clearer if the statement referred specifically to this benefit. We submit that it would also help clarify paragraph 16 if it referred to the benefit as consisting of the provision of the life insurance coverage. Lastly, the position in this paragraph conflicts with the rules in Part XXVII of the Income Tax Regulations for determining taxable benefits in respect of group term life insurance. We recommend that paragraph 16 state that any employee contributions towards group term life insurance will be taken into account in determining the amount of the taxable benefit as provided by the rules in Part XXVII of the Regulations.
9. Another issue with paragraph 16 of the Draft IT is that it incorrectly describes the application of paragraph 6(1)(f) of the Act in a shared-cost situation. Paragraph 16 states that “the entire amount received by an employee must be included in income in the year received”, whereas paragraph 6(1)(f) reduces the benefit by the amount of employee contributions.