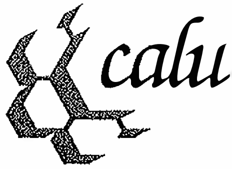

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April 29, 2010

Mr. Gerard Lalonde
Director, Tax Legislation
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Mr. Lalonde:

Re: CALU Submission on Employee Life and Health Trusts

Enclosed please find the Conference for Advanced Life Underwriting (CALU) submission relating to the above noted draft legislation, which was released for comment on February 26, 2010. A hard copy of this submission will follow in the mail.

We would be pleased to discuss this submission with the appropriate people in the Department of Finance at your convenience.

Yours truly,

Kevin Wark

cc. Alexandra McLean, Chief, Savings and Investment
Personal Income Tax Division

Submission on the Draft Legislation Governing Employee Life and Health Trust

Submitted by
The Conference for Advanced Life Underwriting to the Department* of *Finance

April 2010

CALU, the Conference for Advanced Life Underwriting, is a conference of Advocis
Suite 1200, 2235 Sheppard Ave East, Toronto, Ontario M2J 5B5

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1. Background on Advocis and CALU

The Financial Advisors Association of Canada, which operates under the trade name Advocis™, is the largest voluntary professional membership association of financial advisors in Canada. Advocis members are financial advisors licensed to distribute life and health insurance, mutual funds and other securities. Advocis members provide financial and product advice to millions of Canadians. The members also provide advice regarding estate and retirement planning; wealth management; risk management; and tax planning.

Advocis traces its origins to the founding of the Life Underwriters Association of Canada in 1906. It continues an uninterrupted history of serving Canadian financial advisors and their clients. It is committed to professionalism among financial advisors.

The Conference for Advanced Life Underwriting (CALU) was formed to meet the needs of Advocis members who specialize in advanced applications of life insurance and related financial services, including such areas as estate planning, business succession, employee benefits, wealth accumulation and retirement planning. Many of the clients of CALU's members are owners of small and medium-sized business.

The core activities of Advocis are:

- *Education*: Advocis maintains standards of proficiency through short- and long-term educational programs, and a requirement that all members qualify as a Chartered Life Underwriter (CLU), Certified Financial Planner (CFP) or certain other generally accepted professional designations.
- *Market Conduct*: Advocis maintains standards of market conduct through the enforcement of a Code of Professional Conduct and the development of practice standards. Advocis enforces its Code through a process of supervised peer review and sanctions.
- *Public Affairs*: Advocis and CALU participate in the development of policy and regulation affecting financial advisors and their clients before all levels of government across Canada.

2. Introduction

For a number of years the Canada Revenue Agency (CRA) has allowed employers to create "Health and Welfare Trusts" (HWTs) to provide employee benefits that are limited to group sickness and accident benefits, benefits under a private health services plan and group term life insurance (or any combination of the three). The CRA's administrative position on HWTs is set out in Interpretation Bulletin IT-85R2.[1]

HWTs are selectively used by both large and smaller employers to guarantee the funding and provision of specified benefits for their employees. The administrative rules contained in IT-85R2 have provided a framework for the tax treatment of contributions by employers and employees, the taxation of benefit payments to beneficiaries of the HWT, and the taxation of the HWT itself.

The CRA has identified a number of situations where HWTs have been used to provide unintended tax benefits to employers and/or shareholders and key employees. Examples include the use of offshore trusts in tax haven jurisdictions, excessive contributions by employers with the view of obtaining a tax deduction, and the use of HWTs to provide what might be considered inappropriately generous benefits(which in certain cases may be non-taxable) to owner-managers.

The CRA attempted to address some of these issues in 2005 by releasing revised administrative guidelines in draft IT-85R3. The tax community made a number of submissions and provided detailed commentary on the proposed administrative changes, and in the end the CRA never proceeded with the revised interpretation bulletin.

The Department of Finance ("Finance") has now released draft legislation amending the Income Tax Act (the "Act") to address Employee Life and Health Trusts ("ELHTs"). This legislation is for the most part welcomed by CALU as it will give legislative effect to most of the CRA's current administrative guidelines for HWTs. It also clarifies and in some respects enhances the tax treatment for trusteed benefit plans in contrast to the guidelines for HWTs in IT-85R2.

The legislation also attempts to address the perceived abuses that have been identified by the CRA. While CALU understands the policy rationale for addressing these situations, we believe that the provisions are in some cases too far reaching. In particular, we feel the rules governing the deductibility of employer contributions, as well as the limitations relating to key employees, will discourage the use of ELHTs in the small business sector. This will be to the detriment of both employers and non-key employees.

This submission will discuss in more detail CALU's concerns with these two aspects of the draft legislation, and suggests some options that might address tax abuses without negatively impacting the availability of these types of programs within the small business

[1] "Health and Welfare Trusts for Employees" dated July 31, 1986, hereinafter referred to as IT-85R2.

sector. This submission also comments on issues that may arise if the CRA withdraws IT-85R2 as a result of the enactment of the ELHT legislation.

3. Linking Deductions to Benefits Paid

By way of background, an employer who wishes to provide employee benefits without using a HWT structure has several options:

- It could find an insurance provider that offers employee benefit programs and pay an annual premium in respect of such coverage
- It could choose to "self-insure" some or all of such benefits, or some or all of the liabilities attached to each benefit (i.e. creating internal reserves and/or using insured stop-loss pools)

The method chosen for funding such benefits will depend on a number of factors including:

- The nature and type of benefits that are being offered to employees
- The cost and availability to the employer of appropriate insurance programs[2]
- The financial ability of the employer to assume the risk of self-insuring certain benefits
- The size of the employer and its ability to absorb and spread risk
- Negotiations between the employer and employees or union groups

The "self-insuring" option may make sense for certain benefits where:

- The risk is predictable from year to year for relatively low cost but high frequency claims such as short term disability and health/dental coverage
- The employer can earn higher yields on required or implicit reserves

Depending on the workforce demographics and the size/type of business, the employer may also determine that it is more cost effective to self-insure certain risks rather than to insure those risks through the payment of premiums to an insurance company.

There are of course financial risks to both the business employer and its employees where certain benefits (such as long term disability (LTD)) are self-insured. From the employer's perspective, the occurrence of a number of disability claims within a short period of time could have a serious and long term impact on the financial strength of the employer. A small business employer may be susceptible to even greater financial risk posed by the disability or death of the owner or a key employee. If the employer does experience financial difficulties for whatever reason, this could jeopardize the payment of disability benefits.

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[2] Larger employers will typically have access to a larger selection of insurance based benefit programs at a more cost effective price than those available to smaller employers.

An employer may use a trusteed arrangement such as an ELHT to reduce certain risks normally associated with self insured arrangements. The terms of the trust would clearly define the obligations of the employer to make contributions to the trust to fund the specified employee benefits. In turn, assuming that once a claim is incurred it is funded by the employer based on actuarial principles, the risk of the disabled employee losing benefits due to the financial difficulty of the employer is significantly reduced. Under a trusteed arrangement, the employee can also rely on an independent third party (the trustees) to review and approve a claim for benefits, as well as enforcing the employer's funding obligations in respect of such claims.

From the perspective of the employer, it generally will be prepared to enter into an obligation to fund these benefits for incurred claims and benefits provided its contribution is fully deductible in the year made and is consistent with the full cost of the promised benefit. Otherwise, it would prefer to structure the ELHT in such a way that it is only required to make contributions that are required to be paid to the employee in the year.[3]

The ability of an employer to deduct contributions required under the terms of the HWT, based on the actuarial value of an incurred claim, has been reviewed by the CRA. It has taken the position that the employer can only deduct contributions with respect to the actual benefits paid in the year due to the limitations contained in subparagraph 18(9)(a)(iii) of the Act.[4] But a number of tax commentators have disagreed with this view, and the CICA/CBA Joint Committee on Taxation made a lengthy submission on this point in 2005 when the CRA released draft IT-85R3 for comments.[5]

The draft legislation on ELHTs specifically prevents the deduction of any employer contributions except to the extent they have been made to fund designated employee benefits payable in the year.[6] It is submitted that this restriction will result in small business employers restricting their required contributions only to those amounts required to fund benefits payable in the year. As noted above, this puts all employees at risk in the event of the financial failure of the employer or other claims by creditors.

The restrictions on the deductibility of employer contributions could deter employers from using an ELHT. Some employers find self-insuring certain benefits more attractive as it can be less expensive than using insurance plans, which require full funding of future liabilities as well as having to meet minimum excess capital requirements. Allowing required employer contributions for incurred claims to be deductible will

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[3] For example, assume an employee goes on disability (an "incurred claim") which will cost $100,000 to fund on a net present value basis (amount determined on an actuarial basis). However, the annual benefit payable to the disabled employee is only $30,000. If the employer cannot deduct the full $100,000 contribution to fund this claim, it will prefer to structure the plan so that it is only contributing the amount payable in the year ($30,000).

[4] CRA Technical Interpretation 2004-009477117 and Income Tax Technical News No. 25 dated October 20, 2002.

[5] Dated September 12, 2005. A copy of this submission is attached as Appendix A. Please refer to the discussion under Section B for a full discussion of this issue.

[6] Draft subsection 144.1(3) of the Act. Any contribution that is not deducted in one year may qualify for deduction in a subsequent year under draft subsection 144.1(4).

permit companies that "self-insure" benefits to better fund the ELHT, which will improve the security of benefits for employees.

We would also question the need for the additional limitations on the deductibility of employer contributions given the other tax provisions the CRA can rely upon to challenge inappropriate deductions. For example:

- Paragraph 18(9)(a)(iii) would prevent the deduction of "prepaid insurance premiums" which would include contributions to an ELHT for potential future claims
- Section 67 of the Act which only allows a deduction for an outlay or expense to the extent it is "reasonable in the circumstances"
- The provisions of the draft ELHT legislation which prevents:
    - employers from generally having any rights to distributions from the trust;
    - employer representatives constituting a majority of the trustees of the trust; or
    - the plan being established mainly to benefit "key employees"

Instead, we feel the legislation should include the criteria upon which the deduction of required contributions relating to incurred claims is allowed; that is, such a deduction will be allowed provided that the ELHT obtains an independent actuarial report that determines or supports the amount of the employer's contribution that is required under the terms of the ELHT for the year.

We would therefore ask Finance to reconsider the limitations imposed by the draft legislation on the deductibility of employer contributions to an ELHT where such contributions are required under the plan to fund an incurred claim.

4. Restrictions on "Key Employees"

A key employee is defined under the draft legislation as:[7]

- a "specified employee" of the employer. A specified employee is essentially an employee who owns not less than 10% of the issued shares of any class of the employer corporation or related corporation, and any persons who do not deal at arm's length with the corporation;[8] or
- any employee whose employment income from the employer in any two of the five preceding years exceeded five times the Year's Maximum Pensionable Earnings (YMPE) for the year.

[7] Definition of key employee in draft subsection 144.1(1) of the Act.
[8] A specified employee is defined in subsection 248(1) of the Act.

Key employees can only be beneficiaries of an ELHT if the following conditions are met[9]:

- it cannot be reasonably be considered, having regard to all the circumstances, that the trust is maintained primarily for the benefit of one or more key employees of the employer
- the rights under the trust of each key employee are not more advantageous than the rights of each member of a class of beneficiaries under the trust, where
  - members of the class represent at least 25% of all the beneficiaries of the trust who are employees of the participating employer
  - at least 75% of the members of the class are not key employees of the participating employer, and
  - the rights of each member of the class under the trust are identical

The purpose of these provisions is to ensure that an ELHT is not used to provide "more advantageous rights" to key employees. While again we understand the rationale for these provisions, we have several concerns.

Our first concern relates to the inclusion of "arm's length" highly paid employees in the group of employees who are subject to restrictions in terms of participation in and rights available under an ELHT. We feel this could impact the ability of employers to attract and retain employees with special management or technical skills, or lead to increased benefit costs if that employer has to design an alternative benefit program for these employees.

We expect that one of the reasons for including highly paid employees in the definition of "key employee" is to prevent an employer from having a separate class of highly paid employees with enriched benefits. This might allow the same benefits to be offered to specified employees, assuming the 25%/75% rules enumerated in the draft legislation would otherwise be met. However, for the reasons discussed below, we don't feel the rules that in effect create a "representative class of non-key employees" to ensure that key employees do not receive an unfair advantage (referred to in this submission as the "25%/75% rules"), are neither necessary nor appropriate.

This rule could prevent small employers from being eligible to create an ELHT for its employees. For example, consider a situation where the employer has ten employees, of whom eight are key employees and two are non-key employees. It would not be possible to establish a separate class representing 25% of all employees which also meets the 75% test. So this employer would not be able to establish an ELHT, even if the rights of the key employees are not more advantageous than the rights of the non-key employees under the plan.

There is also concern that with the fact pattern discussed above, the plan may not qualify as an ELHT due to the requirement that it "cannot be reasonably considered....that the trust is maintained primarily for the benefit of one or more key employees of the

[9] Draft paragraphs 144.1(2)(d) and (e) of the Act.

employer". It would be open to the CRA to conclude there where a majority of beneficiaries are key employees, the plan must be "primarily for the benefit of one or more key employees" even though the rights and benefits of all beneficiaries under the plan are identical. We would therefore recommend that this requirement be clarified to confirm that it is not contravened merely by the fact that a majority of the ELHT beneficiaries are key employees, provided that all the other requirements are satisfied.

As well, these rules could result in an ELHT ceasing to be an ELHT as a result of future changes in employee salaries or share ownership, despite there being no change in the benefits provided to those employee under the ELHT. The following example illustrates this point. Employer A has ten employees, of which four meet the definition of "key employee". Employer A establishes an ELHT with two separate classes. The first class consists of the four key employees, and the second class consists of the six non-key employees. The benefits provided to each class are "identical". The ELHT would therefore appear to meet all the requirements set out in the draft legislation. Several years later two of the non-key employees become key employees due to salary increases. The "representative class" no longer meets the 75% test and the classes must be revised for the plan to continue to qualify as an ELHT. This result could also arise from normal employee attrition and/or the downsizing of staff.

The 25%/75% test will therefore require all employers, and small employers in particular, to monitor the composition of its classes under the ELHT on a regular basis since the test must be met throughout the year. This will add significantly to the administrative cost and complexity of these plans. In all likelihood small employers will consider non-trusteed employee benefit arrangements (or decide to not provide these benefits), to the possible detriment of all employees.

We are also of the view that the concerns with an "unfair advantage" being conferred on key employees can be managed through the other provisions of the Act in combination with other rules in the draft legislation, as follows:

- Subsection 15(1) of the Act permits the CRA to reassess unduly generous employee benefits to an owner-manager on the basis that the benefits are being provided to that person as a shareholder rather than as an employee[10]
- The draft legislation states that the trust cannot be maintained primarily for the benefit of one or more key employees of the employer[11]
- The rights of each member of the class must be identical
- The fact that the employer representatives may not constitute a majority of the trustees of the trust

[10] For example, in Spicy Sports v. R, (2004) TCC 463, [2004] 5 C.T.C. 2090, the Tax Court of Canada held that a payment to a shareholder-employee under a private health services plan was received in his role as shareholder and taxable under subsection 15(1) of the Act.

[11] Draft paragraph 144.1(2)(d). We would note that the term "primarily" is a subjective test that appears to give significant interpretative discretion to the Canada Revenue Agency.

It is also not readily apparent how the 25%/75% tests will be helpful to the CRA in determining if an "unfair advantage" is available to key employees under an ELHT. The CRA will still need to review the ELHT plan to determine if the rights of the key employees are more advantageous that those offered to the non key employees in the representative group. In fact, it would appear to make the audit process more onerous as the CRA will not only have to review the benefits being provided to key employees under the plan, but also ensure that there is an appropriate class to measure the value of those benefits against.

One final point relates to the interpretation of the term "not more advantageous" that is used in the draft legislation.[12] This is not a defined term and can be subject to wide interpretation. In our view, benefits that typically increase with, or are dependent on, the employee's current salary (such as group term insurance and disability benefits) should not be considered to be "more advantageous rights". We would therefore recommend that language be incorporated into the legislation to make this clear.

5. Future Status of IT-85R2

We are concerned that the CRA will withdraw IT-85R2 once the ELHT legislation has been enacted. If this occurs then the status of existing HWTs must be addressed. For example, will such plans be "grandfathered" and be able to continue to rely on the guidelines established in IT-85R2, or will employers be required to modify the terms of the HWT to comply with the new legislation?

To the extent the CRA modifies its administrative practices regarding HWTs, this will have potentially negative implications for employees and unexpected costs to employers. We therefore feel it is important for Finance and CRA to be coordinated in their approach relating to the future status of HWTs, and if necessary, Finance should introduce grandfathering and transitional rules relating to these plans.

6. Summary and Recommendations

The following is a summary of CALU's position on the draft ELHT legislation:

1. We are supportive of the draft legislation to the extent it codifies current CRA administrative guidelines as established in IT-85R2.
2. The proposed restrictions on deductibility of contributions should be modified to allow the deduction of required contributions for incurred claims provided such contributions are determined or supported by an independent actuarial report sponsored by the ELHT.
3. The rules governing key employees should be modified to only include "specified employees". As well, the 25%/75% rules should be withdrawn as they are not necessary, and unduly complicate the design and administration of such plans for small employers. As well, we feel the draft legislation needs to

[12] Paragraph 144.1(2)(e) of the Act.

provide further guidance for the terms "primarily for" and "not more advantageous" to provide direction to employers and the CRA in the interpretation of the provisions that rely on those terms.

4. The status of IT-85R2 and the treatment of existing HWTs need to be clarified. While appreciating that this is a CRA administrative position, we believe that Finance should introduce appropriate grandfathering and transitional rules if this IT is withdrawn or the administrative guidelines are altered by the CRA.

We would be pleased to meet with the appropriate Finance representatives to discuss the issues in further detail.

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

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

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September 12, 2005

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

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 surplus[1] , 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.

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[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.