The Personal Tax Planning Review

THE INSURANCE AND TAXATION IMPLICATIONS OF HEALTH TRUSTS

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As a method of providing health care benefits to the employees of a company, a health trust has for some time now been seen as a workable alternative to the more common insurance contract with an insurer such as BUPA. The introduction of Insurance Premium Tax ("IPT") has seen increased interest shown in trusts of this type by companies seeking to limit their costs for supplying their employees with the benefits of private medicine. It should be stressed at the outset, however, that the technical difficulties of setting up a health trust must not be underestimated. Both authors have been closely involved with the development of such a health trust in conjunction with BUPA. This is referred to later in this article as the BUPA Health Trust.

1. Health Trusts

The basic trust arrangement entails the employer company (the "Company") setting up a trust (a "health trust") and appointing trustees who hold the trust fund upon trust to provide the employees (of the Company) with health care as needed.

We understand that in the corporate health insurance market schemes divide into those entirely funded by a Company and those to which the employees also make contributory payments. In the same way, health trust arrangements fall into two separate categories. The first category would involve a trust to which the Company alone makes contributions for the benefit of its employees, former employees and their dependants. The second category would involve a trust to which contributions are made not only by the Company but also by its employees. This second category of trust raises markedly more complex questions. Arguably, the arrangements would fall within the ordinary meaning of the word "insurance" although not constituting "insurance business" under the Insurance Companies Act 1982 (the "ICA").

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2. Problems in Outline

As with every new product, the potential pitfalls are legion. The employer will wish to make sure that any contributions he makes to the trust qualify for a tax deduction. The employee will wish to ensure that he is not taxed unduly harshly on any benefit he receives. While an employee may be content to pay income tax on an amount equal to the "Premium" paid by his employer, he will be much less ready to be prepared to pay tax on benefits received, even if this is in substitution for, rather than in addition to, tax on the "Premium".

The trust must be so structured that IPT is not in fact exigible.

Neither the employer nor the trustees must be carrying on unauthorised insurance business contrary to the ICA.

Inheritance tax must be borne in mind. The arrangement will almost certainly constitute a settlement for inheritance tax purposes. Even though the actual level of charge might be low there would be a disproportionate administrative burden if the trust were not exempt.

Capital gains tax must be borne in mind, especially if the trustees are to reinsure part of their "risk". Care must be taken to ensure that the beneficiaries are not liable to capital gains tax when they receive benefits from the trust. The position is complicated further if the trust actually holds chargeable assets.

Income tax is of relevance not only to the deductibility of payments made by a non-corporate employer and charges on employees under Schedule E, but also to charges on the trustees and beneficiaries under the rules relating to taxation of trust income. Again, in some cases, although the amount of tax may be relatively modest, there may be a wholly disproportionate administrative burden.

The strategy could be ruined if Class 1 National Insurance Contributions are payable in respect of amounts paid by the employer to the trust or amounts of benefits received by employees from the trust or both. The charge would be at least 10.2%.

One advantage of insurance is that it is exempt from value added tax at 17.5%. If the arrangements are so structured as not to amount to insurance for the purposes of the IPT or the ICA, the result may be to create a charge to VAT at 17.5%. Recoverability of VAT on supplies made to the trust, particularly management fees, must also be taken into account. How can matters be so structured that it is recoverable?

Finally, the essence of any tax planning strategy is the documentation, which must be in apple-pie order. A strategy which relies upon technicality to avoid a charge to tax will fail unless everything is technically in order. The low quality of drafting seen of insurance related products is a constant source of amazement. The drafting for complicated strategies of this type, especially the drafting of a complex trust instrument, is a time-consuming task of colossal difficulty. The number of those who feel themselves up to the task greatly exceeds the number of those who actually are.

3. Insurance Business

Arrangements for the supply of health care to employees under these health trusts should not be, or be seen as, "insurance business". It is an offence for an unauthorised person to carry on "insurance business" as defined under the ICA. "Insurance business" is divided into long term business and general business, being business in any class specified in Schedules 1 and 2 to the ICA, respectively. Apart from the effecting and carrying out of tontines, the remaining 23 categories so specified involve the effecting and carrying out of **contracts**. The statutory definition of "insurance business" in section 95 of the ICA is clearly not intended to be an actual definition of the term. It serves to clarify that certain cases fall within the term "insurance business". The essential element of insurance business is, therefore, the existence of a contract. The ICA prohibits only the entering into of **contracts** of insurance otherwise than by an authorised person.

It is unlikely that any person would seek authorisation from the Department of Trade and Industry (the "DTI") to carry on insurance business unless absolutely necessary. This is because, in the case of a company, the Insurance Companies Regulations 1981 (SI 1981 No. 1654) provide that a company seeking authorisation must comply with the prescribed margin of solvency which authorised insurance companies must maintain at all times, submitting detailed information to the DTI. Once authorised, the company would be constrained by continuing regulation. Certain unincorporated persons who seek to carry on insurance business, such as Lloyd's underwriters, friendly societies and other similar bodies, are exempt from the authorisation and regulation provisions which apply to insurance companies, but instead are subject to regulation and governed by their own statutory schemes.

4. Health Trusts and Insurance Business - Contractual rights

(1) Discretionary or non-discretionary trust?

The rights of beneficiaries under a **discretionary** trust are unlikely to arise under a contract of insurance. The leading case in this area is *Medical Defence Union Ltd v Department of Trade* [1979] 2 All ER 421 on the facts of which there was no clear element of insurance at all. The member's contractual rights consisted of no more than rights to require the MDU to consider whether to provide assistance to the member in response to his request. The MDU had discretion as to whether or not to provide assistance and this discretion was properly exercised. Megarry V-C stated at page 429: "When a person insures I think that he is contracting for the certainty of payment in specified events, and not merely for the certainty of proper consideration being given to his claim that a discretion to make a payment in those events should be exercised in his favour."

A discretionary trust structure may not be acceptable to a Company. There are inherent disadvantages in presenting any arrangement to employees offering them benefits which are dependent on the exercise of a discretion by a third party (the trustees of the health trust). Moreover, if the trustees consistently exercise their discretion in favour of the employees then arguably no discretion exists.

Where arrangements are made by way of a non-discretionary trust it is important to analyse closely the constituents of the trust arrangements and the constituents of a contract of insurance. Being outside the scope of the clear ruling in the *Medical Defence Union* case, it is most important to ensure that the non-discretionary arrangements do not constitute a contract of insurance. If a non-discretionary trust is used, the beneficiaries will, on making an application to the trustees, be entitled to receive health benefits under the trust. Although this entitlement under the trust is easier to understand, it does raise problems on the nature of insurance. In particular, where the employees themselves contribute to the health trust, the arrangements look more like "insurance".

(2) Is there a contract?

To constitute a contract, there must of course be offer and acceptance, and consideration. As with all contracts, there must be an unconditional acceptance by one party of the offer made by the other. It is difficult to see the right which a beneficiary has (arising under the terms of the trust) as being more than an equitable right, even if it is not dependent upon the exercise of the trustees' discretion. The employee's rights under such a health trust are those of any absolutely entitled beneficiary but enforceable under trust law and not in contract. Any implied contract which may arise should be expressly excluded under the terms of the trust.

(3) Is there a contract of insurance?

There is no accepted definition of a contract of insurance. However, it is generally accepted that Channell J in *Prudential Insurance Co Ltd v IRC* [1904] 2 KB 658 at 663 sets out a useful initial statement. A contract of insurance is one bearing a number of characteristics:

> It must be a contract between two persons, being the Insurer and the Insured, whereby for some consideration, **usually** but not necessarily periodical payments called Premiums, you (the Insured) secure to yourself

some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event, from the Insurer.

The event must involve some element of uncertainty either as to whether it will ever happen or not or, if the event is one which must happen at some time, there must be uncertainty as to the time at which it will happen.[2]

The Insured must have an insurable interest in the event upon which the insurance contract depends. In the case of conventional health insurance, the Insured would have an interest through the Insurer's promise to indemnify him for the medical expenses which he incurs as a result of his illness.

Given that contractual arrangements constitute "insurance business" within the ambit of regulation under the ICA, arrangements which are non-contractual in nature should not fall within the ambit of the ICA. We are firmly of the opinion that no contract of insurance need arise under a properly drafted health trust.

It is quite possible that a contract of insurance may in fact be created through insufficient attention to detail or, subsequently, through lack of care. That contract would still have to be a **contract of insurance** for there to be "insurance business" under the ICA.

It was decided in *Department of Trade and Industry v St Christopher Motorists' Association Ltd* [1974] 1 All ER 395 that it was not necessary for the Insured to receive a money payment but rather it was sufficient that the Insurer paid a sum of money to a third party to cover the cost of providing the benefit. In the case of a health trust, the fact that the trustees would make payments directly to the supplier of medical services does not therefore of itself counter the argument that the arrangements, where contractual in nature, may amount to the conduct of insurance business.

Let us say that if a contract of insurance were created, the parties to that contract under the health trust arrangements would be the beneficiaries (as the Insured) and the trustees or the Company (as the Insurer).

(i) The Company-funded health trust

This is most unlikely to be an arrangement which constitutes insurance.

2 For example, death.

In the case of a health trust funded by the Company alone, it is the Company and not the Insured which will be paying the money to the trustees.

Insurance is essentially a speculative contract and this is not the situation envisaged under a health trust. Generally, the amount of Premium paid under a contract of insurance is not intended to be equivalent to the value of the Insurer's actual performance but is calculated in relation to the likelihood that performance will be required. This characteristic distinguishes contracts of insurance from certain others. *MacGillivray and Parkington on Insurance Law*[3] suggests that a contract by which an engineer undertakes to repair a machine whenever it breaks down is not a contract of insurance if the engineer is to be remunerated in accordance with the work done. If, however, his remuneration is fixed without regard to the amount of work done, it is suggested that this is consideration of the type of an insurance premium and the contract may be one of insurance.

In the case of a health trust to which only the Company makes contributions, it is anticipated that only the amounts anticipated to be necessary to meet the projected medical expenses incurred will be paid to the health trust. Thus the payments to be made by the Company are unlikely to have the characteristics of a Premium. A Premium is to some extent a payment with a bargaining or speculative element based on the risk taken by an Insurer. There is no relationship under a health trust between the contributions paid by the Company and any "risk" taken.

(ii) The Company-funded and/or employee-funded health trust

Where employees make contributions to a health trust in addition to or instead of the Company, the features of an insurance contract must be considered more carefully.

It is clear that the trustees (acting to some extent in the same role as an Insurer) are providing some benefit. If the employee is entitled to that benefit only if he has made a contribution, it might be argued that the provision of the benefit by the trustees is in return for the contribution from the employee. The contribution may thus be perceived as a Premium and the employee as the Insured. The Premium is the price for which the Insurer undertakes his liabilities or, under the trust, obligations to provide health care to the Company's employees, former employees and their dependants. There is uncertainty as to whether or not an employee will ever need to make a claim.

Where the employees make contributions, then the Premium paid by each employee is unlikely to be equivalent in value to the actual provision of health care. Although collectively it is anticipated that only the amounts necessary to meet the cost of medical services will be provided, from an individual point of

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[3] Eighth Edition, 1988 at 1-2.

view the situation closely resembles insurance. This kind of trust is likely to be less popular as a means of making health care available to employees, notwithstanding that there is no contract of insurance. This is because in order to prevent the arrangement being deemed to be insurance business, the employees must have no contractual right to receive a benefit from the trust. The human resource problems in presenting this to employees may prove insurmountable in some cases: (a) employees making contributions may well find it very difficult to understand that they have no enforceable contractual right to be paid out of the trust fund when the time comes to make a claim; and (b) their contracts with the employing company will obviously need alteration to ensure that no obligation arises on either the company or the trustees to fund the employees' medical expenses. Were this not to be done, then, arguably, there would be a contract of insurance in existence.

(4) Insurable Interest

In establishing whether an insurance contract exists there remains the question whether the employee, who is a beneficiary under the health trust, has an insurable interest.

We are not proposing to examine the problems which are raised by the question as to whether an "insurable interest" exists. Suffice to say, there is some doubt as to whether a valid "insurable interest" is in existence in either category of health trust or indeed under any contract of health insurance. However, the point is unlikely to be taken.

In practice, it is anticipated that under the BUPA Health Trust scheme the trustees will themselves take out a stop loss insurance policy to cover any shortfall which may arise should applications exceed the value of the trust fund. The insurance company underwriting the risk is most unlikely to take the point that a valid insurable interest does not exist.

(5) The Company as Insurer?

The trustees under the terms of a health trust are responsible for providing the benefits to the beneficiaries. There is, however, an additional problem that the Company must not itself be regarded as entering into any contract of insurance. If the Company is under a contractual obligation to its employees to make payments to a health trust or in any way obliges itself to cover its employees for the costs of their medical care, there must be an argument that the Company is entering into a contract of insurance with each employee. The terms of employment of employees and the presentation of arrangements made by the Company should therefore be scrutinised closely in any case where a health trust is perceived as a suitable means of making private health care available to employees.

(6) Department of Trade and Industry

As indicated above, it is the DTI who are responsible for the regulation of the insurance industry and they have indicated in discussions with BUPA that they will look beyond the form of any health trust arrangement to see if it will constitute insurance business.

The DTI would be particularly concerned about the role of the Company and the nature of any agreement or contract which exists between it and its employees. They may take the view that if the Company has by any such contract or agreement undertaken to meet the cost of medical expenses incurred by its employees, then the Company would be carrying on insurance business. This would be so even if the Company had arranged to meet its obligations through the medium of a trust. The DTI would be concerned that the Company would be bearing the risk and therefore carrying on insurance business. If the Company makes a commitment this must be limited to procuring insurance cover or performing some other non-risk bearing obligation, if the Company is not to be seen as carrying on insurance business.

First, the Company must make it clear to its employees that it is not responsible for the provision of the cost of medical expenses. Secondly, the Company must not commit itself to pay into the health trust whatever funds are necessary to meet the claims arising. The presentation of the arrangements to a Company's employees is of paramount importance. As indeed are the taxation considerations.

5. Taxation

(A) Deductibility of Employer's Contributions

Normally, contributions by the employer are tax-deductible only if:

a) The employer is carrying on a trade and the payments are made wholly and exclusively for the purpose of the trade; or

b) The employer is an investment company and the contributions rank as expenses of management.

In a group situation, it is very important that the correct company makes the contribution. If the holding company whose subsidiary employs the employees itself makes a contribution, it will normally obtain no deduction.

The payments must be of an income and not of a capital nature. An initial contribution may well not be tax-deductible, especially if it is larger than any subsequent payments. It is sometimes advisable to make a token initial payment. Similarly, the costs of setting up the trust would arguably be of a capital nature.

This problem could be overcome by a strategy whereby the costs were spread over several years.

Should the employer be under a legal liability to make the contributions? Quite apart from considerations of insurance law, it would probably fall into a tax trap. If the payments were periodic, as is likely, they would run the risk of constituting "annual payments" taxable under Schedule D Case III. Annual payments are not normally deductible in computing trading profits. Instead, they have their own rules for deductibility. Put shortly, annual payments made by way of gift otherwise than to a charity are not tax-deductible. The same result follows if the employer receives a non-taxable consideration. Worse still, if the payments do constitute annual payments in the hands of the trustees, then they will be liable to income tax. Purely voluntary payments will not.

One solution is so to structure the arrangement that the payments made by the employer to the trustees do not constitute annual payments, which must represent "pure income profit", but trading receipts. That, however, is likely to produce problems of insurance law and, possibly, value added tax. The simple solution is for the payments made by the employer to be voluntary, i.e., not made under a legal obligation.

(B) Insurance Premium Tax

The tax is exigible only in respect of premiums paid under a contract of insurance. If one can avoid any contract of insurance, then one can avoid the tax. The essence of the strategy is thus to ensure that there is no relevant contract and that the entitlement of employees to benefits is not contractual but arises by virtue of their equitable rights as beneficiaries of the trust. Their claim should be proprietary rather than contractual.

The existence of a trust is not incompatible with the co-existence of one or more contracts. As we have already noted, any implied contract or contractual term which might amount to a contract of insurance must be expressly excluded.

(C) Inheritance Tax

The beneficial ownership of the income and capital of the trust will, albeit for a relatively short time, be held in suspense pending the making and satisfaction of claims. The property will thus in our view constitute settled property for inheritance tax purposes and prima facie also constitute "relevant property", subject to periodic and exit charges. Put less accurately but more shortly, the trust would be taxed as a discretionary trust.

It is a moot point as to who the settlor or settlors of the trust would be. The view the Capital Taxes Office is likely to take is that it is only the employer who is the settlor. Another tenable view is that it is the employees who are the settlor as they are indirectly providing funds for the purpose of the settlement, the employer making the contributions not out of any desire to confer a benefit on the employee but as a reward for their services. Even if there is only one settlor, namely the employer, calculations for the inheritance tax charge may well need to be made in respect of each and every benefit conferred on the beneficiary! The calculations would become horrendously complicated if the employees were held to be the settlors.[4]

In our view, the solution will be to make the trust qualify as an employee trust within section 86 of the Inheritance Tax Act. If this can be done, the settled property will not longer constitute relevant property and will in effect be free from any charge to inheritance tax. Section 86 is a most curiously worded provision. It is much easier than is generally supposed to bring the terms of a trust within it. There is certainly no necessity that all employees of a given employer should actually benefit from it. While it is possible to include as beneficiaries wives, widows and family dependants of an employee, it may also be possible to cover other persons such as a common law spouse who is not dependent on the employee.

While care should be taken to ensure that contributions made to the trust do not themselves constitute transfers of value, this is unlikely to constitute a problem in the vast majority of cases.

(D) Capital Gains Tax

The trustees will be liable to capital gains tax on any chargeable gains they realise, but at what rate? This will depend upon who is the settlor of the settlement and whether he retains an interest under the settlement. It would be as well for the employer to be entirely excluded from any benefit under the settlement. If the employees are held to be settlors, tax would be exigible at their marginal rates. The calculations could be horrendous.

In general, therefore, it is wise to avoid the trustees holding chargeable assets. Could the contract of reinsurance be regarded as such? If so, payments made under it by the insurer could give rise to a chargeable gain. It should be possible to avoid this difficulty by very careful drafting.

Will the beneficiaries be liable to capital gains tax in respect of benefits received? Provided the trust is UK resident and their interests have not been purchased from other beneficiaries, it should be possible to avoid any problem.

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4 This article does not consider the much more complicated situation where it is the employees themselves who make the contributions.

(E) Income Tax

The income tax liability in respect of trust income is extremely complex. One must firstly ascertain whether any of the settlement provisions apply, e.g., because the settlor has retained an interest under the settlement. This involves firstly determining who is the settlor. If it is the employer, then the employer should be excluded from any benefit. If it is the employees, then the calculations become horrendous.

Provided matters are properly structured and the contributions made by the employer are voluntary, they should not constitute taxable income in the hands of the trustees. It is only if the trustees invest them so as to produce taxable income that a problem arises. If the settlor provisions do not apply, then one must wait and see whose income the income becomes. It is well settled that if trustees of a discretionary trust apply trust income so as to confer a benefit in kind on a beneficiary, then the beneficiary becomes taxable on the income so applied. Hence, if there were a trust income and the settlor provisions did not apply, one would have to calculate how the trust income was apportioned amongst the beneficiaries who received benefits from the trust! Again, the calculations would be expensive and time-consuming.

It is possible for trust capital to be paid to or for the benefit of a beneficiary in such a way that it constitutes taxable income in his hands. While care should be taken to ensure that this rule is not brought into play, it should not present a problem in the normal case.

The taxability of the employee under Schedule E is highly speculative. In the case of directors and higher-paid employees, the Revenue apparently take the view, probably correctly, that they are taxable on the contribution made by the employer to the trust insofar as it is attributable to them. The Revenue apparently also take the view that they will not tax further under Schedule E any benefit received by the employee from the trust which has effectively been paid for by that contribution.

In the case of other employees, the argument that they are liable to tax under Schedule E the moment the contribution in respect of them is made by the employer to the trust is a very much weaker one. The Revenue appear to accept that there is no charge. What is not clear, however, is whether the Revenue would also be content to accept that there was no charge when a benefit was conferred by the trustees on a beneficiary when a health care benefit was actually conferred. If the benefit takes the form of a cash payment, the argument that it is taxable under Schedule E is very high. If the payment simply takes the form of conferring a benefit in kind, e.g., the trustees contracting with the surgeon to procure an operation for the employee/beneficiary, then the question whether the benefit is taxable under Schedule E will be theoretical as its convertibility value will be nil.

(F) Class 1 National Insurance Contributions

Class 1 National Insurance Contributions will be exigible in respect of relevant earnings "paid to or for the benefit of" a relevant employee. It is not necessary that the employer makes the payment to the employee; it is sufficient if the employer makes the payment to a third party for his benefit. Prima facie, therefore, Class 1 contributions will be exigible. The only escape will be to rely upon the 'benefit in kind' exception in the Contributions Regulations. If the benefit the trustees confer on the beneficiary is a benefit in kind, e.g., an operation, then there should in our view be no liability. If, on the other hand, the employee/beneficiary contracts for the operation himself and the trustees either pay him a cash sum in reimbursement of the expense or settle his bill directly, then in our view there must be a forceful argument that what the beneficiary has received is not a payment in kind. It is a payment in cash or that which has always been held to be the equivalent of cash, namely the discharge of one's debt. It is a moot point whether Class 4 contributions would be exigible on the amount paid by the employer or upon the benefit received by the employee.

(G) Value Added Tax

Value Added Tax is exigible in respect of a supply. With certain very limited exceptions, which one must ensure do not apply, nothing can be a supply unless it is done for a consideration. Hence, provided the employer is not obliged, either vis-à-vis the employees or the trustees, to make the contributions to the trust and the trustees receive no consideration in return for the benefits they confer on the employees, none of them should be making supplies.[5]

6. Conclusion

Clearly, the Company-funded trust is much less likely to be seen as an arrangement which is in the nature of "insurance" than the trust to which both employees and the Company contribute. Under the latter type of trust all the requirements for insurance seem to be in place. Greater reliance must be placed on the fact that the rights of the employees/beneficiaries under the health trust do not constitute an insurance contract and therefore no insurance business is being carried on by the trustees.

Health Trusts can, if properly structured, be effective in avoiding ITP. Enormous care is required, however, to make sure that charges to other taxes are not

[5] It is just possible that there might be "consideration" for value added tax purposes, even though there is no contract. In that case, the supply would be one of insurance which, in our view, would be exempt under the Sixth Directive, albeit not under the terms of the United Kingdom value added tax legislation.

precipitated and/or compliance burdens imposed which would render the arrangement counter-productive.