

PRIVATE HEALTH SERVICES PLANS

PHSP OVERVIEW

The use of a “private health services plan” (“PHSP”) provides a tax-efficient method for business owners to offer supplemental health care coverage to their employees.

A major benefit of PHSPs is to improve the access that employees have to supplemental health care. Absent the favourable tax measures that exist within the PHSP regime, employees would be required to fund supplemental care using personal, after-tax funds. In many cases, a PHSP will make available supplemental care that employees might not otherwise obtain.

WHAT IS A PHSP?

The income tax rules define a PHSP as:

- ❖ A contract of insurance in respect of medical or hospital expenses; or
- ❖ A medical care or hospital care insurance plan.

The Canada Revenue Agency (“CRA”) takes the position that PHSPs must include the following elements in order to be a plan that is “in the nature of insurance”:

- ❖ an undertaking by one person,
- ❖ to indemnify another person,
- ❖ for an agreed consideration,
- ❖ from a loss or liability in respect of an event,
- ❖ the happening of which is uncertain.

Any plan that does not satisfy these criteria risks being characterized by the CRA as a plan that does not qualify as a PHSP, which could lead to negative income tax consequences. For example, if the CRA characterized a plan as an “employee benefit plan”, employees would be subject to tax on contributions made to the plan and the employer would not be permitted to deduct contributions.

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PHSPs are plans of short term insurance and generally provide insurance for a period of one year. If an employee's sickness extends beyond the year in which it is contracted, there would be no extension of coverage under a PHSP (and any continuation of coverage would result in a taxable benefit to the employee). This can be contrasted with the coverage ordinarily provided under long term disability plans, where an insurer would generally be obliged to continue covering an employee over the long term.

In order for a plan to constitute a PHSP, contributions must be for the benefit of an employee, the employee's spouse or any related member of the employee's household. While PHSPs are most often used by incorporated business owners, the strategy is also available to individual proprietors and partners, if certain criteria are met. Further comments regarding this possibility are provided under the heading "PHSPs for Proprietors and Partners" below.

PHSP TAXATION

An employer's contributions to a qualifying PHSP are a deductible expense for the employer and do not constitute a taxable benefit for the employee. PHSPs therefore convert what is ordinarily a non-deductible, personal expense into a fully deductible business expense without creating a corresponding personal taxable benefit.

The deductibility of employer contributions is subject to a general limit of reasonableness. Employers will be denied the ability to deduct any portion of PHSP contributions that is determined to be unreasonable in the circumstances.

PHSPs are restricted from covering premiums for basic health care coverage supplied by the provinces. If an employer pays for an employee's basic health care insurance premiums, a taxable benefit will arise to the employee. If this occurs under the terms of a PHSP, the entire plan could fail to qualify as a PHSP. Plans that are intended to qualify as PHSPs should avoid this possibility by expressly excluding such premiums from falling within the plan.

PHSPs are restricted to covering only expenses that would otherwise qualify as a medical expense for the "medical expense credit". The legislation states that amounts paid to "a medical practitioner, dentist or nurse or a public or licensed private hospital" are eligible expenses for this purpose. The CRA has taken the position that the term "medical practitioner" includes practitioners of any regulated health profession. Since the regulation of health professionals is a provincial matter, the eligibility of expenses for PHSP purposes will vary from province to province. Depending on your province of residence, qualifying expenses could include payments to acupuncturists, audiologists, chiropractors, chiropractors, dental hygienists, denture therapists, dieticians, massage therapists, naturopaths, occupational therapists, osteopaths, physiotherapists,

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podiatrists, psychoanalysts, psychologists, respiratory therapists, speech therapists, speech language pathologists and/or therapists (or therapists).

The tax rules set out a wide range of other expenses that are also eligible for the medical expense credit, including expenses for certain specific care arrangements and medical devices. The rules set out many categories of expenses and they are somewhat open to interpretation. If a PHSP does not specifically list the qualifying expenses under the plan it should include rigorous claims adjudication procedures, since the approval of unauthorized expenditures could cause the plan to fall offside qualification as a PHSP.

PHSP STRUCTURING

A variety of different health insurance plans may qualify as a PHSP. Which plan structure and funding methodology should be used in any particular circumstances depends on many factors.

“Major medical plans” (“MMPs”) and “Health Services Spending Accounts” (“HSSAs”) are two commonly used PHSP structures.

MMPs provide coverage for catastrophic events and inordinately high hospital or drug claims. MMPs typically include a specific list of medical conditions or pharmaceuticals that are covered under the plan.

HSSAs allow employees to be reimbursed for qualifying medical expenses, up to the amount of notional health services credits that have been allocated to them. The coverage for catastrophic events that is typically offered under MMPs is not usually provided through HSSAs, since reimbursements under HSSAs are limited to the credits that an employee has available.

PHSPs should not be confused with “flex benefit programs” or other employee incentive programs, which often include characteristics that fall offside the CRA’s administrative guidelines for PHSPs. For example, many flex benefit programs might permit an employee to cash out unused credits at the end of a year, but if such a feature was included in an HSSA, the plan would contravene the CRA’s administrative guidelines and trigger negative tax consequences.

PHSP FUNDING

Employers have several choices regarding how to fund a PHSP.

“Self-insured PHSPs” are essentially “unfunded” arrangements, where the employer retains the legal responsibility to pay all benefit claims. In some self-insured PHSPs an outside administrator will administer claims payments. Administrators will also adjudicate claims for employers, to allow employers to maintain a degree of independence in the claims adjudication process.

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Employers are not permitted to deduct contributions made to a self-insured PHSP until an employee's claim is actually paid.

A common form of self-insured PHSP where an employer retains an administrator to administer claims payments and/or adjudication is the "cost plus" plan. The administrator invoices the employer for the cost of benefit claims paid "plus" an additional fee for administrative services that the administrator rendered. Deductions are not allowed until claims are paid to employees (no deduction is permitted for funds that are simply advanced to an administrator as a float, for example).

"Insured PHSPs" are a second PHSP funding alternative. Under an insured plan, employers transfer the legal liability to pay benefit claims to an insurer and an insurance policy governs claims payment activity. Employers are permitted to deduct annual premiums that they pay to the insurer.

"Trusteed PHSPs" are the third funding option. Under a trusteed plan, employers transfer the legal liability to pay benefit claims to a trust that the employer is obliged to fund.

A trust created for this purpose must constitute a "health and welfare trust" ("HWT") or negative income tax consequences will arise. Employer contributions to HWTs are deductible and benefits paid to employees are non-taxable.

HWTs are not defined in the tax legislation, yet they are recognized administratively by the CRA. In order for a trust to qualify as an HWT, it must be restricted to funding PHSPs (or group sickness plans, accident plans or group term life insurance). A variety of additional administrative criteria must be satisfied in order for a trust to qualify as an HWT. For example, funds in an HWT are not permitted to revert to an employer and contributions in excess of amounts that are reasonably expected to provide health and welfare benefits in the year are not permitted.

HWTs can represent an opportunity to save funds for employers that are self-insuring a PHSP. In a typical "cost plus" plan where an employer uses an administrator, the administrator will charge the employer a fee for the administrative services that it renders (15% of premiums, for example). Using a qualifying HWT to administer the plan instead of an outside administrator provides employers with an opportunity to save the administration fee that they would otherwise incur in a "cost plus" plan.

PHSPs AND THE SHAREHOLDER BENEFIT RULE

Where an individual derives a benefit from a corporation by virtue of his or her status as a shareholder (instead of receiving the benefit as an employee), a taxable "shareholder benefit" can result. Taxable shareholder benefits are undesirable since they can give rise to double taxation: the benefit will be fully

taxable in the shareholder's hands and no deduction will be granted to the corporation that provided the benefit.

If PHSP benefits are extended to all employees, including employees who also are shareholders, the CRA will ordinarily consider the shareholders to have received the PHSP benefits as an employment benefit as opposed to a shareholder benefit.

However, in certain situations it is possible for plan benefits received by shareholders to be taxable shareholder benefits. In such a case, the corporation would not be permitted to deduct premiums or benefits it paid in relation to the PHSP and employees would be subject to tax on plan benefits that they receive.

The CRA generally takes the position that a shareholder benefit will arise if an employee, who is also a shareholder, is a plan member and the response to any of the following questions is "no":

- ❖ Was participation in the PHSP open to all employees and, if not, were there logical reasons to exclude certain employees?
- ❖ Are the same benefits made available for all employees?
- ❖ If all participating individuals are shareholders, is the coverage under the PHSP similar to that which is provided to non-shareholder employee groups of similar businesses?

However, the CRA has previously approved of a PHSP that granted coverage to an "executive class" of employees, notwithstanding that the executive class included only a small portion of the corporation's employees. In that case, each employee of the executive class received identical coverage under the plan.

The CRA has also confirmed that it is possible for PHSP benefits to not constitute taxable shareholder benefits in situations where all of a corporation's employees are also shareholders. However, the CRA limits the deduction available to the corporation in such situations to the level of deduction available to self-employed individuals (described below).

The Tax Court of Canada has stated that the test for determining whether a PHSP benefit constitutes a shareholder benefit is to review whether the arrangement would have been made available to key employees who were not shareholders. If the answer is yes, then no shareholder benefit will arise.

Due to the negative tax implications that result when the shareholder benefit rule applies, special care must be taken to avoid the rule when structuring a PHSP. The determination of when a benefit constitutes a "shareholder benefit" is an evolving area of the law. Your professional advisors should carefully review the

possible application of the shareholder benefit rule in your circumstances if you are considering implementing a PHSP.

PHSPs FOR PROPRIETORS AND PARTNERS

Proprietors and partners do not fit squarely within the general tax rules that apply to PHSPs. However, special rules allow proprietors and partners to benefit from planning using PHSPs.

Provided that certain conditions are met, proprietors and partners may deduct from their business income any premiums or contributions paid under a PHSP for their benefit, or for the benefit of their spouse, common-law partner or a member of their household.

In order to achieve the deduction, proprietors or partners must:

- ❖ Be actively engaged in the business on a regular and continuous basis;
- ❖ Earn greater than 50% of their income for the year from the business (or earn less than \$10,000 from other sources); and
- ❖ Pay PHSP amounts pursuant to a contract entered into with certain designated persons, including licensed insurance providers or private health services plan administrators.

Limits are placed on the deduction available to proprietors and partners. The provisions are somewhat complex and permit different levels of deductions depending on the level of PHSP coverage (if any) that is offered to arm's length employees in the business or partnership. Generally, for years throughout which less than 50% of PHSP participants act at arm's length to the proprietor or partner, the deduction is limited to \$1,500 for spouses and adult members of the individual's household and \$750 for other household members. If the amount paid to cover arm's length employees or partners is less than those thresholds, the permitted deduction will be reduced. If 50% or more of the plan participants act at arm's length with the proprietor or partner and have at least three months of service in the business, the deduction limit is based on a calculation that takes into consideration the cost of the least amount of coverage that is provided to an arm's length employee.

Proprietors and partners should claim qualifying PHSP expenses that exceed their permitted threshold as medical expenses for purposes of the "medical expense credit".

PHSPs AND CANADA REVENUE AGENCY

A wide range of CRA administrative positions and interpretations exist in connection with PHSPs, perhaps the result of the meager amount of legislation

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that governs these plans. The CRA administrative positions are largely untested and, when taken together, form a complex web of administrative rules. The following represent some of the more fundamental administrative positions that the CRA has taken regarding PHSPs:

- ❖ Plans in respect of dental care and expenses qualify as PHSPs.
- ❖ Forgoing salary or bonus for PHSP benefits will cause immediate taxation.
- ❖ The purpose of a PHSP must be to provide health insurance, not to avoid tax.
- ❖ PHSPs may not provide retroactive coverage. Expenses incurred prior to an employee's participation in a PHSP are not permitted to be reimbursed under a PHSP.
- ❖ While a PHSP must be a plan in the nature of insurance, PHSPs are not restricted to plans underwritten by insurance companies.
- ❖ PHSPs must be documented. (While the CRA has noted that a simple clause in an employment agreement requiring an employer to reimburse qualifying expenses could constitute a PHSP, preparation of formal plan documentation is recommended in order to achieve greater certainty that a plan will qualify as a PHSP.)
- ❖ PHSPs are not required to be extended to multiple employees. A PHSP may be established for only one of an employer's employees or for different classes of employees. (However, this could give rise to a shareholder benefit issue where employees involved in the plan also own shares in the corporation, as described above.)
- ❖ Funds that an employer notionally sets aside for paying PHSP benefits under a self-insured PHSP belong to the employer. The employer does not relinquish legal interest in such funds until benefits are paid.
- ❖ The ability of employees to accumulate HSSA credits must be subject to documented limits. If no limits exist the plan risks being characterized as unreasonable, which would cause contributions to the plan to be non-deductible to employers and taxable to employees.
- ❖ Employers are not required to fund (i.e. pre-fund) notional HSSA credits.
- ❖ Limits exist on the ability to carry forward unclaimed health care expenses and unused HSSA credits from year to year, which, if not observed, could cause plans to fall offside the CRA's qualification criteria.

CONCLUSION

PHSPs represent an opportunity to engage in tax-efficient planning where an intention exists to provide supplemental health care coverage to employees. In the right circumstances, PHSPs can assist incorporated business owners as well as proprietors and partners.

When structuring a PHSP, care must be taken to ensure that it complies with applicable tax rules and CRA administrative policy and to avoid creating a situation that will attract the shareholder benefit rule. In light of the complex CRA administrative regime that exists regarding PHSPs, professional advice should be obtained when structuring a PHSP in order to ensure that proper tax treatment will result.