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**health spending account**

**the evolution of health and dental care benefits ©**


## **Tax Act and CRA Rules**

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## Self-insured Private Health Services Plans

Self-insured Private Health Services Plans (Cost Plus Plans, Health Spending Accounts and Administrative Services Only Plans for Health and/or Dental), are "cost plus" plans ("cost" of claims "plus" an administration fee), as used in CRA Bulletin IT-339R2.

Plans qualifying as Private Health Services Plans facilitate the full amount of the Claim and Administration Fee being deductible business expenses, and benefits are received tax-free by the employee. The resulting tax advantage is subject to compliance with CRA requirements.

Self-insured Plans have "tax rules" that apply to unincorporated Owners, and Shareholders of corporations. Since there must be an "employer-employee relationship", participation by "unincorporated Owners" and plans for "Shareholder only" are not acceptable to CRA.

### Self-employed Unincorporated Owners

- É Owners of unincorporated businesses are not eligible.
- É Employees of unincorporated businesses are eligible for PHSP.

### Shareholders of Corporations

- É Private Health Services Plans cannot be exclusively for Shareholders.
- É Shareholders must be bona fide employees, and benefits reasonable.

If there are questions or concerns as to whether participation by "unincorporated Owners" and plans for "Shareholder only" are not acceptable, an Advance Income Tax Ruling can be obtained from CRA that will address specific described circumstances. See IC70-6R5.

This is an outline and discussion of the requirements of the Tax Act as interpreted by CRA. Documents are available at the Canada Revenue Agency website at: <http://www.cra-arc.gc.ca> and Tax Court of Canada judgements are available at: [http://www.tcc-cci.gc.ca/main\\_e.htm](http://www.tcc-cci.gc.ca/main_e.htm)

## Taxation of Self-insured Private Health Services Plans

- É In Ontario, HST of 13% is charged on Administration Fees.
- É In Ontario, Retail Sales Tax of 8% is charged on the Claims only.
- É In Ontario, Premium Tax of 2% is charged on Claims and Administration.

**note:** There are administrators who are unaware that Retail Sales Tax and/or Premium Tax must be collected and remitted to the Ministry of Finance for all the business done in Ontario. So, Employers must then self-assess and remit these Taxes.

## Definition of Self-insured Private Health Services Plans

CRA Income Tax Interpretation Bulletin IT-339R2, paragraph 6, states:

“In a cost plus plan, an employer contracts with a trustee plan or insurance company for the provision of indemnification of employee’s claims on defined risks under the plan. The employer promises to reimburse the cost of such claims plus a administration fee to the plan or insurance company. The employee’s contract of employment requires the employer to reimburse the plan or insurance company for proper claims (filed by the employee) paid, and a contract exists between the employee and the trustee plan or insurance company in which the latter agrees to indemnify the employee for claims on the defined risks so long as the employment contract is in good standing. Provided that the risks to be indemnified are those described in paragraphs (a) and (b) of the definition of private health services plan in subsection 248(1), such a plan qualifies as a private health services plan.”

## Eligible Deductible Expense for Employers

The following tests must be met for any expense to be considered a deductible expense:

É Section 18(1)(a) of the Income Tax Act states that no outlay or expense is deductible, in computing the income of a taxpayer from a business or property, except to the extent that it was made or incurred for the purpose of gaining or producing that income.

É Section 67 of the Income Tax Act states no deduction shall be made, except to the extent that an outlay or expense was reasonable in the circumstances.

If a cost plus payment is reimbursed under a Private Health Services Plan, IT339R2 states:

É “They are however, business outlays or expenses of the employer for purposes of paragraph 18(1)(a) of the Income Tax Act.”

## Eligible Non-taxable Benefit for Employees

If a cost plus plan qualifies as a Private Health Services Plan, according to IT-339R2:

É “Contributions made by an employer to or under a private health services plan, on behalf of an employee, are excluded from the employee’s income from an office or employment, by virtue of subparagraph 6(1)(a)(I) of the Income Tax Act.”

## Meaning of the “Nature of Insurance”

CRA Income Tax Interpretation Bulletin IT-339R2, paragraph 3, states:

“A private health services plan qualifying under paragraphs (a) and (b) of the definition in subsection 248(1) is a plan in the nature of insurance. In this respect, the plan must contain the following elements:

- (a) an undertaking by one person
- (b) to indemnify another person
- (c) for an agreed consideration
- (d) from a loss or liability in respect of an event
- (e) the happening of which is uncertain.”

**An undertaking by one person to indemnify another person,** described in CRA Tax Interpretation Letter 2001-0101935 as:

“A PHSP exists if the employer is obligated under the employment contract to reimburse such expenses incurred by the employees or their dependents.”

**For an agreed consideration** - between the employer and an insurer, described in CRA Technical Interpretation Bulletin IT-339R2, paragraph 5 as:

“If the agreed consideration is in the form of cash premiums, they usually relate closely to the coverage provided by the plan and are based on computations involving actuarial or similar studies. Plans involving contracts of insurance in an arm’s length situation normally contain the elements outlined in 3 above.”

**For an agreed consideration** - between the employer and the employee, described in CRA Technical Interpretation Bulletin IT-339R2, paragraph 7 as:

“An arrangement where an employer reimburses its employees for the cost of medical or hospital care may come within the definition of a private health services plan. This occurs where the employer is obligated under the employment contract to reimburse such expenses incurred by the employees or their dependents. The consideration given by the employee is considered to be the employee’s covenants as found in the collective agreement or in the contract of service.”

## Cost Plus Claims on a “One-time” Basis

To be considered a PHSP in accordance with section 248(1) of the Income Tax Act, there must be a contract or insurance plan in place. Because “unique” or “ad hoc” cost plus plans are paid outside of any contract or plan, they do not meet the definition of a PHSP.

In addition to IT-339R2 paragraphs 5 and 6, the 1991 Corporate Management Tax Conference article by CRA, entitled “Flexible Employee Benefit Arrangements” states:

“There should be some formal structure to the arrangement. If a bona fide plan exists, its terms and conditions and benefits available under it, should be made known to the qualifying employees, and such employees should have legal access to coverage and benefits under the plan.”

CRA Tax Interpretation Letter 2001-0101935 states:

“A PHSP normally has a ceiling in respect of the amounts that may be reimbursed. In our view, a plan that has no limits may be subject to section 67 of the Act. Section 67 of the Act provides that, in order to qualify as a deduction from income, an outlay or expense must be reasonable in the circumstances.”

## Tax Issues Relating to Self-employed Business Owners

According to CRA, a “cost plus” plan cannot be a deductible business expense for the plan sponsor or a non-taxable benefit for the plan member when the plan is used for a self-employed business owner. However, an “insured” plan would qualify.

CRA Tax Interpretation Letter 2001-0101935 states:

“A PHSP requires an undertaking by one person to indemnify another person. A cost plus plan for a self-employed business person with no employees is not a PHSP because there is no basic insurance plan in effect.”

CRA Tax Interpretation Letter 2002-0127485 states:

“As stated in Technical Interpretation Letter 9904155, dated April 28<sup>th</sup>, 1999, it continues to be our view that a plan which consists of a contract between a proprietor and an administrator, under which the administrator agrees to reimburse the proprietor, his or her spouse and members of his or her household for actual medical and hospital expenses and receives, as consideration, an amount equal to the amount reimbursed plus an administrative fee, does not qualify as a PHSP since it does not contain the necessary elements of insurance.”

öIn this situation, no person has undertaken to indemnify another person. Rather, the proprietor has assumed all of the risk for the personal hospital and medical bills. In our view, even though a proprietor enters into a contract with an administrator to pay medical and hospital expenses, this is not sufficient to conclude that the plan is a PHSP.ö

### **Tax Issues Relating to Shareholders**

CRA Tax Interpretation Letter 2001-0106815 states:

öWhere a particular benefit is made available only to shareholders, there is a presumption that the benefit is made to the individual in his or her capacity as a shareholder. In such a case, the premiums paid to insurance and/or health services plans are not deductible by the employer pursuant to paragraph 18(1)(a) of the Act and the exclusions in subparagraph 6(1)(a)(I) of the Act do not apply. In such a case, the premiums would be included in the income of the shareholder under subsection 15(1) of the Act. In addition, payments made in respect of a shareholder would not be deductible in computing the corporation's income.ö

öIf coverage under a PHSP is received by an individual by virtue of his or her employment, the related benefits are not taxable and payments made by the employer pursuant to the PHSP would be deductible. It is a question of fact whether benefits are received by an individual by virtue of being a shareholder or employee.ö

CRA Tax Interpretation Letter 2003-0050541 states:

öUnless a shareholder is actively engaged as an employee of a company, any benefit derived by the shareholder as a result of PHSP coverage is not exempt under subparagraph 6(1)(a)(i) of the Income Tax Act (the Act), but rather is taxable under subsection 15(1) of the Act. However, if a shareholder is actively engaged as an employee of the company, and the benefits received by the shareholder under the PHSP (including the applicable limits) are reasonable having regard to all of the circumstances, it is our general view that the benefits would be derived by virtue of the individual's employment and exempt under subparagraph (6)(1)(I).ö

Allowing non-qualifying shareholders to participate in an otherwise qualifying self-insured PHSP for employees, results in a ötainted planö which includes a non-qualifying shareholder. Claims processed for such shareholders are taxable income transferred to such shareholders.

### **Communicating the Benefits to Employees**

In the 1991 Corporate Management Tax Conference article by CRA, entitled öFlexible Employee Benefit Arrangementsö it states:

öThere should be some formal structure to the arrangement. If a bona fide plan exists, its terms and conditions and benefits available under it should be made known to the qualifying employees and such employees should have legal access to coverage and benefits under the plan.ö

## Carry Forward Provisions

There are some administrators who indicate that the unused deposits or eligible medical expenses can be carried forward indefinitely until all funds are used or expenses are paid. There are only two carry forward options available, and both are limited to 12 months.

1. Carry forward of the unused deposits into the Health Spending Account, or
2. Carry forward of the eligible (Health and/or Dental) medical expenses.

CRA Income Tax Interpretation Bulletin IT-529, paragraph 16, states:

“While a plan which includes a carry forward provision undoubtedly reduces the risk of loss to the employee, a plan which permits the carry forward of either the unused allocation or eligible medical expenses (but not both) up to a maximum of 12 months will not be disqualified as a private health services plan solely by reason of the carry forward provision in the plan.”

## Withdrawal or Transfer of Funds

Allocations to a Health Spending Account, can not be withdrawn by the Employee. Allocations (deposits or notional maximums) can only be used for eligible expenses under a Private Health Services Plan, including Health Spending Accounts or insured plans.

Unused allocations (made as deposits) are returned to the Employer at the end of the benefit period, or at the end of the 12 month carry forward (if a carry forward is included in the plan). Unused allocations can not be specified/designated for transfer to an RRSP.

CRA Income Tax Interpretation Bulletin IT-529, paragraph 17, states:

“If an employee is able to withdraw or transfer an amount from a health care spending account (other than as a premium payable in respect of another private health services plan), the health care spending account will not be a private health services plan and all amounts received out of the account, including reimbursements of eligible medical expenses, will be included in the employee’s income under paragraph 6(1)(a).”

“For example, if an employee is able to reallocate an amount which was previously applied to a health care spending account to another benefit option such as a group RRSP, the health care spending account will not qualify as a private health services plan because a contribution to an RRSP is not a qualified medical expense. However, the ability to reallocate credits to another private health services plan, such as a vision or dental plan will not affect the status of the health care spending account as a private health services plan.”