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PRIVATE HEALTH SERVICE PLANS

AN OVERVIEW

A private health services plan (PHSP) is an insurance contract or plan that pays for hospital and medical expenses.¹ Individuals can buy insurance contracts to offset all or part of these costs. Employers can establish insurance plans to protect employees against hospital and medical expenses. This article discusses some of the tax laws governing PHSPs.

PLANS AND CONTRACTS

Individuals may own health insurance contracts (or policies) to protect them and their family members against the cost of hospital or medical expenses. An employer may establish an insurance plan by agreeing to reimburse employees for covered hospital and medical expenses. The employer may pay claims as they arise or establish a fund from which to pay claims. A PHSP can only reimburse the plan owner or employee for eligible hospital or medical expenses under the terms of the plan.²

An employer can also buy or pay for individual insurance policies covering each employee, or establish a group insurance plan. Under a group insurance plan an employer is the policy owner under a master policy and distributes certificates of coverage to all covered employees. Or an employer may

¹ Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA, subsection 248(1), c.f. "private health services plan", paragraphs (a) and (b).

² CRA Document 2011-0417671E5, June 7, 2012. The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the Income Tax Act and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

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own an individual policy on each employee, with benefits paid to the employee. Alternatively, each employee could own their own policy, but the employer pays the premiums.

The Income Tax Act (ITA) specifically excludes some types of plans from the definition of a PHSP:

- Provincial and territorial health insurance plans, like the Ontario Health Insurance Plan (OHIP), the Alberta Health Care Insurance Plan (AHCIP), and the Régime de l'assurance maladie du Québec (RAMQ), and
- Hospital and medical insurance plans established by an Act of Parliament or by regulation for members of the RCMP and their dependents and for members of Canada's armed forces appointed in Canada and serving abroad, and their dependents.³

This does not mean that provincial health insurance plans are disallowed as a matter of course. If the plan conforms to the requirements of a PHSP it does not matter that it is offered by a province.⁴

A PHSP IS AN INSURANCE PLAN

The Canada Revenue Agency (CRA) has defined a PHSP in "Interpretation Bulletin IT-339R2 – Meaning of a private health services plan," August 8, 1989.⁵

According to the CRA, a PHSP must be "a plan in the nature of insurance" and include the following five elements:⁶

- **An undertaking by one person:** When an individual buys an insurance policy to protect themselves against the risk of hospital and medical expenses, the insurance company is the "person" giving the undertaking. When an employer creates a PHSP for its employees,

³ ITA subsection 248(1), c.f. "private health services plan", paragraphs (c) and (d).

⁴ CRA Document 2014-052432117, July 30, 2014 – premiums paid to the New Brunswick Drug Plan are qualifying medical expenses pursuant to subsection 118.2(2) of the ITA.

⁵ The CRA has archived this page and will not be updating it. See: <https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/it339r2.html>.

⁶ Interpretation Bulletin IT-339R2 – Meaning of "Private Health Services Plan," August 8, 1989, paragraph 3.

whether it's an insured plan or not, the employer is the "person" giving the undertaking. The employer may or may not choose to buy insurance to make sure that it is able to satisfy its obligations to its employees under the plan.

- **To indemnify another person:** When an individual buys an insurance policy, the person indemnified is the policy owner. In the employment context, that person is the employee and the employee's family members. The indemnification is for the loss insured against.
- **For an agreed consideration:** For an individual policy owner, the agreed consideration is the premium the individual pays. In exchange for the premium, the insurance company covers the risks described in the policy. In the employment context, the agreed consideration is the employee's promise to provide services to the employer. In exchange for those services, the employer provides PHSP benefits (and other compensation, like salary and paid vacation).
- **For a loss or liability in respect of an event:** In either the individual or employment context, "the loss or liability in respect of an event" are the hospital or medical expenses covered under the insurance contract or plan.
- **The happening of which is uncertain:** The arrangement must include an insurance risk, defined as the risk of financial loss resulting from an event that is uncertain. If the event occurs, and the insured person suffers a loss, the contract will pay benefits. If the event does not occur, the insured person will receive nothing.

An employer does not have to buy group or individual insurance policies to have a PHSP. It may also contribute money to a PHSP for each of its covered employees. The employer can pre-fund the PHSP or set up a pay-as-you-go plan. It can administer the plan itself or ask someone else to do it. But the same principles just discussed apply.

In the individual context, the insurer is at risk to pay covered claims during the period of time set out in the policy. In the employment context, the employer is at risk until the employment contract is

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modified or ended.⁷ Coverage offered under a PHSP as part of the employment contract can last for as long as the person is employed.⁸

This does not mean that once an employer provides a PHSP it must continue to offer the plan on terms that can never change. Instead, an employee's right to coverage under a PHSP is as much a part of their employment contract as the right to a certain salary and working hours. Those terms can be changed, but they must be changed as part of a process of negotiating the employment contract, not by the employer's unilateral act.

With a union workforce, changing the terms of a PHSP would be accomplished as part of the collective bargaining process. With a non-union workforce, negotiations could be as simple as the employer announcing changes to the plan, effective as of a future date, such as the plan's next renewal. If the employees were still with the company as of that date they would be taken to have agreed with and accepted the plan changes.

From a non-union employee's perspective, the negotiation process may seem close to having to accept the employer's unilateral act. But the employer at least must give notice of changes it proposes to make. The CRA has said that if the employer has the right to terminate the plan without notice at any time, and at its sole discretion, the plan may lack the necessary element of risk, and fail to qualify as a PHSP.⁹

⁷ Part of the risk for an employer with group plans may be adjusted through contractual arrangements with the insurance company. In some cases, the insurance company may return a portion of the premiums if the employer's actual claims experience would have justified a lower rate.

⁸ CRA Document 9505255, June 29, 1995.

⁹ CRA Document 2010-0373091E5, September 15, 2010.

TAX TREATMENT OF PHSPS OFFERED AS PRIVATE INSURANCE CONTRACTS

Individuals may not deduct the premiums they pay for their personally owned PHSP insurance contract because the ITA treats insurance premiums as “personal or living expenses”,¹⁰ which are not deductible.¹¹ However, PHSP premiums do count towards an individual’s claim for the medical expense tax credit (METC).¹²

Individuals who are reimbursed for hospital or medical expenses from their PHSP may not include those expenses in a claim for the METC. However, an unreimbursed amount, like a deductible, co-payment or that part of a hospital or medical expense that exceeds the policy’s limits or is not covered under the policy may still count towards a claim for the METC. These issues are discussed in more detail in our article, “The Medical Expense Tax Credit.”

TAX TREATMENT OF A PHSP OFFERED TO EMPLOYEES

Employers may deduct contributions to a PHSP as business expenses¹³ as long as they are reasonable.¹⁴ Employer contributions are not treated as income to the employee¹⁵ unless the employee resides in Quebec, where employer contributions to a PHSP (plus applicable taxes on those contributions) are included on the employee’s provincial (though not federal) income tax return.¹⁶

¹⁰ ITA subsection 248(1) c.f. “personal or living expenses”: “the expenses, premiums or other costs of a policy of insurance.”

¹¹ ITA paragraph 18(1)(h). We also discuss the denial of deductibility for insurance premiums in our article, “Individually Owned Health Insurance Policies”.

¹² ITA paragraph 118.2(2)(q). For more details about the METC, see our article, “The Medical Expense Tax Credit”.

¹³ ITA paragraph 18(1)(a).

¹⁴ ITA section 67.

¹⁵ ITA subparagraph 6(1)(a)(i), IT-339R2, paragraph 1.

¹⁶ Taxation Act, R.S.Q., chapter I-3, articles 37.0.1.2 and 37.0.1.3.

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An employee may also contribute to their employer's PHSP. The employee will pay contributions using after-tax dollars, and will not be able to deduct them. But any contributions they make will count towards a claim for the METC.¹⁷ The METC is calculated using the lowest federal/provincial rate, but an employee pays tax on income at their highest marginal rate. Therefore, any benefit an employee derives from counting their PHSP contribution towards a claim for the METC will almost certainly be offset by the extra tax the employee pays on the income used to make that contribution.¹⁸

The better approach may be for the employer to pay the employee's entire PHSP contribution. The employer will be able to deduct the PHSP contribution it makes just as it deducts the employee's salary, as long as the contribution is a reasonable business expense. But after tax, the employer's cost could be less.

EXAMPLE

	Paid to employee, employee pays PHSP	Employer pays PHSP, employee pays nothing
Tax consequences for employer		
Employer's payment	\$200	\$100
Employer's deduction (assumed 15% tax rate)	\$30	\$15
After-tax employer expenditure	\$170	\$85
Tax consequences for employee		
Employee's pre-tax income	\$200	\$0

¹⁷ ITA paragraph 118.2(2)(q).

¹⁸ IT-529 – Flexible Employee Benefit Programs, February 20, 1998, paragraph 18.

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Tax employee pays on pre-tax income (assumed 50% tax rate)	\$100	\$0
Net income to employee	\$100	\$0
Employee's PHSP premium	\$100	\$0
METC on PHSP premium (20%)	\$20	\$0
Cost after all deductions and credits (employer's and employee's)	\$150	\$85

Assume that PHSP premiums are \$100 per month, that the employer is a corporation paying tax at an assumed 15% rate, and that the employee is in the 50% marginal tax bracket. Also assume that the lowest personal federal/provincial tax bracket is 20%, and that the PHSP premiums will count towards a claim for the METC (assuming that the employee has enough other hospital or medical expenses to meet the thresholds for claiming the METC). The METC is calculated using the lowest federal/provincial tax rates. Finally, assume that when the employer pays PHSP premiums, the PHSP qualifies as such under ITA paragraph 6(1)(a), so that no part of the employer's premium is treated as income to the employee.

Let's consider the tax picture if the employer pays an income to the employee, who uses that income to pay their own PHSP premiums. An employee in an assumed 50% tax bracket will need \$200 in income before tax to cover this expense. The \$200 payment should be deductible to the corporation. Assuming a 15% corporate tax rate, the expenditure should generate \$30 in tax savings for the corporation (15% x \$200).

The employee will have to pay \$100 in tax on the \$200 of income they receive (\$200 x 50%). But if the employee has enough other expenses to qualify for the METC the \$100 PHSP premium will generate a \$20 METC (\$100 X 20%).

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When all is said and done, the employer has been able to deduct \$30, and the employee has claimed a \$20 tax credit, for a total of \$50. The total cost for the employer paying income to the employee so that the employee can pay their PHSP premiums is \$150.

But if the employer pays the PHSP premiums the cost goes down. Since PHSP premiums paid by the employer are not taxable to the employee, the employer has to spend only \$100. Assuming that the \$100 premium was a reasonable business expense, it would generate \$15 in tax savings for the employer ($\$100 \times 15\%$), resulting in an after-tax expenditure of only \$85. The employee would pay no tax on the PHSP premium the employer paid. Since the employee doesn't pay any premiums themselves, they won't qualify for an METC in respect of the premiums.

The CRA is sensitive to attempts to convert taxable income into tax-free contributions to a PHSP. If an employee is legally entitled to a salary, trading some of that salary for contributions to a PHSP will not make the PHSP contributions tax-free. Rather, the contributions will be treated as if they were made using after-tax income.¹⁹ The employer will still be able to deduct the contributions (provided they are reasonable business expenses), but the contributions will be taxable in the employee's hands. The only way for the employee to get any tax relief for the contributions would be to count them as medical expenses towards a claim for the METC. To avoid this type of adverse tax treatment, the employer would have to add a PHSP as a benefit for its employees, leaving their salary and wages alone.

METHODS ACCEPTABLE TO THE CRA FOR MANAGING RISK AND COST

An employer may limit its risk under a PHSP without having the plan lose its status as a PHSP. One way is to limit the amount it will reimburse for different services. For example, a PHSP may limit what it pays for dental services to \$1,000 per year per employee. Up to that amount, it is uncertain whether the employer may have to pay anything, and if so how much, so there is still an insurance risk.²⁰ If the plan doesn't limit the amount it will reimburse, the cost to provide benefits could become

¹⁹ CRA Document 2001-0080065, May 16, 2001.

²⁰ CRA Document 2003-0030991E5, January 19, 2005.

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so large that the employer might not be able to characterize the expense as reasonable, and could lose the right to deduct the expense.²¹

It's also acceptable to use different methods for managing the cost of a PHSP. An employer could use individual policies for key employees, but group insurance for the rank-and-file. As long as the benefits paid were the same for all, the CRA would still treat the plan as a PHSP.²²

WHO CAN BENEFIT FROM THE PLAN?

EMPLOYEES, THEIR SPOUSES AND MEMBERS OF THEIR HOUSEHOLDS

Any employee can benefit from a PHSP, as can their spouse or common law partner, and any member of the employee's household related to the employee by blood, marriage or adoption.²³

SURVIVORS OF EMPLOYEES

The CRA regards PHSP coverage for surviving spouses and dependents of a deceased employee as "an extension of the non-taxable benefit received by the employee while actively employed", and therefore not taxable to the surviving spouse or dependent:

When a private health services plan continues to provide coverage for a surviving spouse or dependant of a deceased employee or former employee that relates to coverage previously provided in respect of that individual while the employee or former employee was still alive, it is our opinion that the benefit arising from premiums paid on behalf of the survivors is not required to be included in that individual's income.²⁴

²¹ CRA Document 9928225, November 25, 1999.

²² CRA Document 2006-0214141E5, February 12, 2007. Since the key employees tend to be older in many organizations than the rank and file, it can be less expensive to cover the key employees with individual policies rather than include them in the group.

²³ IT-339R2, paragraph 1.

²⁴ CRA Document, 9613345, July 2, 1996.

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SHAREHOLDER/EMPLOYEES

As long as shareholders receive PHSP benefits from the plan as employees, and not because they own the company, the company may deduct the contributions it makes to the plan. Furthermore, PHSP benefits that a shareholder receives from the plan as an employee are tax-free.²⁵

Whether shareholders actually receive their benefits as employees is a different and more difficult question. The CRA presumes that shareholders who can significantly influence business policy receive their benefits because they own the business, not because they are employed in it.²⁶ Therefore, any benefits a shareholder receives from their company are received in their role as a shareholder. Shareholder benefits are taxed as income and are not deductible by the company. Because the company may not claim a deduction, double taxation results because the same money is taxed to the corporation and then to the shareholder.

The CRA is willing to treat benefits paid to a shareholder as employee compensation if certain conditions apply. Although each case depends on its own facts, the following factors may help persuade the CRA to treat PHSP premiums as tax-free employee compensation, not shareholder benefits:²⁷

- the shareholder must be actively engaged in the business as an employee,²⁸
- all benefits must be reasonable in the circumstances, and
- at least one of the following must apply:
 - the benefits enjoyed by the shareholder must be comparable in amount and nature to what non-owner employees at similar firms with similar responsibilities receive,²⁹

²⁵ CRA Document 2005-0163771E5, March 14, 2006.

²⁶ CRA documents 2003-0034505, December 9, 2003; 2005-0163771E5, March 14, 2006; 2016-0635351E5, January 11, 2017; and Income Tax Folio S2-F3-C2, Benefits and Allowances Received from Employment, October 12, 2016, at paragraph 2.3.

²⁷ CRA Documents 2011-35103625 and 2008-0277981E5, January 11, 2011 and August 8, 2008.

²⁸ CRA Document 2003-0050541E5, January 6, 2004.

²⁹ Reference could be made to human resource consulting firm surveys for this information.

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- the benefits offered to the shareholder/employee must be part of a reasonable compensation package,³⁰ or
- shareholders and non-owner employees must be offered equivalent benefits.

Note, however, that if PHSP benefits are provided through an Employee Life and Health Trust (ELHT), specific rules govern the level of benefits that can be paid to “key employees”, a category that includes shareholders. We discuss this issue in our article, “Employee Life and Health Trusts”.

SHAREHOLDER BENEFITS

Two court decisions are relevant on this question: *O’Flynn v. R.*³¹ and *Spicy Sports Inc. v. R.*³² In *O’Flynn*, the Court found that the plan provided tax-free employee benefits even though no employees accepted the employer’s offer of coverage under the plan. Only shareholder/employees benefited from the plan. Still, the Court found that the plan did not provide a shareholder benefit. In *Spicy Sports*, the shareholder was the only participant in the plan. The Court found that the plan provided a shareholder benefit.

The judges in both cases found the following factors were relevant:

- The plan’s purpose must be to offer benefits to employees. One reason to offer benefits is to attract and retain good people. There can be other reasons.
 - However, there is usually no need to offer a benefits package to attract and retain shareholders – they stay with the business for other reasons.
- The plan must be offered to employees, though it need only be offered once.
 - Plans offered only to shareholders will be treated as shareholder benefits.
 - If a plan offered to non-owner employees is too expensive for them to afford, you can’t say that it has been offered to them.

³⁰ CRA Document 2006-0174121C6, May 9, 2006.

³¹ [2005] 2 C.T.C. 2534, 2005 D.T.C. 556.

³² [2004] 5 C.T.C. 2090, 42 C.C.P.B. 316.

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- Even if only shareholder/employees accept the plan, the plan can still be a tax-free employee benefit (if it has been sincerely offered to the employees).
- Plans that provide benefits that are disproportionately generous when compared with employee salaries and other benefits may attract the CRA's suspicions.
- Plans that are exceptionally generous, and restricted to a small portion of the workforce, are more likely to be treated as taxable shareholder benefits than plans that pay less generous benefits but are offered to everyone in the business (even if only the shareholders accept the plan).

The CRA has said that where a shareholder/employee receives benefits under a PHSP, and equivalent benefits are not available to all employees, the shareholder/employee will be in receipt of a taxable shareholder benefit.³³

Whether a taxable shareholder benefit has been conferred is a question of fact. To avoid a dispute with the CRA, it is very important for clients to consult with their tax and legal advisors.

KEY EMPLOYEES

An employer may want to give enhanced benefits to its key employees, those who make a greater contribution to the success of the business than the rank-and-file employees. If the key employees are not shareholders, it's important to offer them a sufficiently generous compensation package, including benefits, to attract and retain them.

Shareholders may also count themselves as key employees of the business, and may want to provide themselves with more generous benefits than the rank-and-file. One way to do this, and to rebut the CRA's assertion that the shareholders receive their benefits because they own the company, not because they are employees, is to include non-owner key employees in the benefits plan. It's important to make sure that the benefits offered to the group of key employees are comparable in nature and generosity to those offered by other businesses to their non-owner employees.

³³ CRA Document 2005-0139551E5, October 6, 2005.

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The CRA has suggested that giving more generous benefits to a group of employees could be acceptable.³⁴ In 1991 guidance, the CRA was asked this specific question, and gave the following response:

- Question: Can a health plan qualify as a PHSP if it provides coverage for a select group of employees?
- Answer: Where a PHSP is self-insured (i.e., the consideration for the “insurance” is regarded as the employees’ covenants in their contract of service with the employer), it is the Department’s view that the plan should cover all employees (or all employees within a specific category) in one plan with the same coverage for each employee.³⁵

It's important to remember that this guidance pre-dates the addition of ELHTs to the ITA. The sections of the ITA governing ELHTs contain specific rules governing the size of benefits that key persons (as defined) may receive under an ELHT.

RETIREES AND TERMINATING EMPLOYEES

A PHSP can also extend coverage to retired employees: “Employer-paid premiums to a PHSP on behalf of retirees and the reimbursement of eligible expenses under the terms of the plan, are not taxable benefits for the retirees.”³⁶

A PHSP also can offer terminating employees the right to enter into an individual plan offering coverage similar to the employer’s PHSP at standard rates without verifying insurability. Such a

³⁴ CRA Document 9505265, June 26, 1995: the fact that a PHSP has different annual maximum benefit limits for different employee groups does not disqualify it as a PHSP. CRA Ruling 9601643, 1996: a plan where the maximum benefit for each employee was 20% of that employee’s income was a PHSP, even though employees would receive different maximum levels of coverage.

³⁵ July 1991-336 – “Discussion paper on the tax treatment of flexible benefit plans including salary deferral arrangements, retirement compensation arrangements, employee benefit plans and private health services plans,” page 10.

³⁶ CRA Document 2004-0105181E5, January 24, 2005.

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coverage option would be available for an extra charge from the insurance company providing current benefits for employees.³⁷

ELIGIBLE EXPENSES

The CRA's view used to be that only hospital or medical expenses that qualified for the METC could be paid from a PHSP.³⁸

If the expenses covered by the plan were not confined to those listed in ITA subsection 118.2(2) and Regulation 5700 the CRA said that the entire plan would fail to qualify as a PHSP.³⁹ Instead, the plan would be treated as an employee benefit plan (EBP). See generally the discussion on EBPs in our article, "Group Sickness and Accident Insurance Plans."

In November 2015 the CRA announced a change in its position.⁴⁰ For calendar year 2015 and subsequent tax years, all or substantially all of the premiums paid under the plan would have to relate to hospital or medical expenses that were eligible for the METC in order for the plan to qualify as a PHSP. The CRA said that "all or substantially all" meant at least 90%. The CRA clarified in later guidance that for insured plans it would not matter if the benefits paid for non-METC eligible claims fell below the 90% threshold as long as at least 90% of the premiums paid under the PHSP related to METC eligible expenses.⁴¹ According to the same guidance, plans that did not use insurance would satisfy the rule if at least 90% of the benefits paid under the plan were for METC-eligible expenses.

What about the remaining 10%? The CRA has said:

³⁷ CRA Document 2010-0366161E5, July 7, 2010.

³⁸ IT-339R2, paragraph 4.

³⁹ CRA Document 2010-0373091E5, September 15, 2010.

⁴⁰ www.canada.ca/en/revenue-agency/services/tax/businesses/topics/payroll/benefits-allowances/private-health-services-plan-premiums/private-health-services-plan.html

⁴¹ CRA Document 2016-0651291E5, January 24, 2019.

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Expenses included in the 10% coverage must be a medical or hospital expense or an expense that is incurred in connection with a medical or hospital expense ("connected expense"). However, the connected expense must be incurred within a reasonable time period following the medical or hospital expense.⁴²

The CRA added that whether a given expense is a medical, hospital or connected expense, and whether it was incurred within a reasonable time of the medical or hospital expense, are questions of fact. It gave as an example a person who suffered an illness while travelling out of country. The person's insurance coverage included transporting their automobile home after they suffered a serious illness, and therefore could not drive home themselves. Though transporting an automobile would not normally be considered a medical expense, in this case it would be treated as connected to hospital and medical expenses, and therefore allowed as a "connected expense."

The important part of the CRA's guidance is that it did not require that the medical expenses be referred to under ITA subsection 118.2(2) or Regulation 5700.

Notwithstanding the CRA's guidance, there remains some controversy over whether the CRA is correct in saying that substantially all the expenses covered by a PHSP (i.e. at least 90%) must also be ITA subsection 118.2(2) or Regulation 5700 expenses. In defining a PHSP, ITA subsection 248(1) refers only to hospital or medical care, or expenses. It does not restrict benefits that a PHSP can pay to those listed under subsection 118.2(2) or Regulation 5700.

Since the ITA is a highly technical law, it's reasonable to take a technical approach to interpreting it. Following that approach, if Parliament had wanted to restrict PHSPs only to hospital or medical expenses referred to in subsection 118.2(2) or Regulation 5700, it would have said so. But subsection 248(1) does not say that. The CRA cannot read in a restriction to the ITA that the language in the ITA does not support.

However, in administering the ITA, the CRA must apply a limit of some sort to the expenses that a PHSP may cover. Limiting expenses to those contained in ITA subsection 118.2(2) and Regulation

⁴² CRA Document 2016-0636871E5, September 25, 2018.

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5700 relieves the CRA from having to create and justify a different list of allowable expenses, and removes any suggestion that the CRA may be developing its own tax policy at odds with the ITA.

It's also an open question for insured plans as to how the CRA will decide that a given amount of premium relates to a given expense covered by the plan, and therefore constitutes a sufficient premium expense to put the plan offside. Determining a premium amount requires a consideration of risk. Different insurers can reach different conclusions on the same risk, depending on their experience. Premiums are also affected by the benefit offered and the group to whom it's offered. Nor do different insurance policies specify how much of the premium is allocated to a specific risk.

The CRA also acknowledged the difficulty in determining what a medical expense was when the expense was not an expense found in ITA subsection 118.2(2) or Regulation 5700:

The term medical expenses is defined in the Act only for purposes of the METC and the definition PHSP does not refer to the METC. Where the legislation does not define a term, we generally rely on case law and the ordinary meaning (e.g., dictionary definition). It is a question of fact whether expenses that are not eligible for the METC are medical expenses or connected expenses for purposes of determining the 10% coverage.⁴³

Unfortunately, without a court ruling deciding what expenses a PHSP can and cannot cover, there is no way to resolve these differing views. Regardless of whether you agree with the CRA's views, it's important to take the Agency's opinion into account as part of a client's planning process.

DIFFERENT TYPES OF PHSPS

As the chart below shows, there are different ways for an employer to deliver benefits, yet still qualify for PHSP tax treatment:

⁴³ CRA document 2016-0643141E5, February 19, 2019.

Different ways for an employer to deliver PHSP benefits

Transfer both risk and administration to insurance company

- Employer owns and pays premiums for a group insurance policy
- Employees have certificates of coverage
- Employees claim insurance benefits from policy

Retain both risk and administration

- Employer establishes and regularly contributes to a fund created to pay claims
 - Employer pays claims as they arise using fund withdrawals
- Or
- Employer does not establish a fund, but pays claims as they arise using company cash flow

Transfer risk to insurance company but retain administration

- Employer owns and pays premiums for individual policies it owns on each employee
- Employer pays claims using insurance benefits from policies

Or

- Employees own their own policies
- Employer pays premiums
- Employees claim insurance benefits from policies

Retain risk but transfer administration to third party*

- Third party administers plan but accepts no insurance risk, evaluates and pays claims as they arise
- Employer reimburses third party for its expenses and for claims it has paid on employer's behalf

* Third party could be an insurance company providing administrative services only, or a benefits consultant.

TRANSFER RISK AND PLAN ADMINISTRATION TO AN INSURANCE COMPANY

If the employer decides to transfer the risk, it can do so through either group insurance or individual plans. With a group insurance plan, the employer buys a group insurance policy, and distributes certificates of coverage to individual employees. Employees do not receive certificates of coverage as individuals, but as members of a class of insured persons. All covered employees within the same class receive the same coverage under the plan. The insurance company adjudicates and processes claims; the employer pays the premiums. Employees may or may not contribute.

An employer may also create a plan under which they buy individual insurance policies for each covered employee. The employer owns the policy and pays the premiums. Benefits are paid to each individual employee. Alternatively, an employer may create a plan where it pays the premiums for individual policies that each employee owns. These latter two options may appeal to companies with

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a small number of employees. Administering a large number of individual insurance policies could soon become too much work for a business.

When the employer transfers the risk to the insurance company it also transfers responsibility for adjudicating and processing claims. The insurance company, not the employer, uses its expertise to determine whether a claim is covered under the insurance contract.

Whether group or individual, insurance policies are only a means through which an employer transfers the risk of a PHSP. While an employer may transfer the risk that the plan entails, it still must have a plan.

RETAIN RISK AND ADMINISTRATION

An employer may decide that it would rather not pay insurance premiums, preferring instead to retain the risk. If it chooses that route, it can establish a fund from which it will draw money to pay claims, or pay claims from current cash flow. It will also need to establish a process for evaluating claims, and for dealing with appeals from employees who believe that they have a valid claim.

RETAIN THE RISK BUT TRANSFER ADMINISTRATION

An employer may want to retain the risk, but may lack the expertise or resources needed to administer the plan. In such cases the employer may wish to retain the services of an insurance company or trustee to administer the plan.

Using a third party does not change the employer's obligations to its employees or shift any of the insurance risk away from the employer. The employer remains responsible for delivering the promised benefits under the PHSP, and retains the insurance risk.⁴⁴

Under such an arrangement the employer asks an insurance company or trustee to administer the plan. The insurance company or trustee charges a fee, and uses their expertise to evaluate

⁴⁴ CRA Document 9928225, November 25, 1999.

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employees' claims and pay benefits using the employer's funds.⁴⁵ The CRA does not care which functions the employer delegates to an insurance company or trustee as long as the plan still meets the definition of a PHSP under ITA subsection 248(1).

Crucial to maintaining the plan as a PHSP is a requirement that the employer contribute to the plan. If the employer continues to contribute to the plan, it can allow the insurance company or trustee to operate it.⁴⁶ The employer may establish an account that the insurance company or trustee can draw on to pay claims. Any money on account with the insurance company or trustee will still be treated as the employer's money. Funds will be held in trust until a claim is approved and made. Once it approves a claim, the insurance company or trustee can pay the employee, or whoever is designated in the PHSP's claims procedure (such as the service provider).⁴⁷ Only after the money is paid can the employer deduct it. Further, any fees that the insurance company or trustee charges for its services can be deducted by the employer, provided they are reasonable.⁴⁸

The employer can satisfy its obligation to fund a PHSP in one of several ways:

- Establish an account with the insurance company or trustee. Funds in the account remain the property of the employer until paid as a claim. The size of the fund is at the employer's discretion. It can be based on actuarial projections,⁴⁹ or even on the employer's previous experience.
- The employer could also maintain an account with the insurance company or trustee and transfer funds to the account as claims are made.
- Pay claims in arrears. The insurance company or trustee would pay claims from their own resources, and bill the employer for the claims paid.

⁴⁵ IT-339R2, paragraph 6, CRA Document 2003-0024565, September 19, 2003.

⁴⁶ CRA Documents 2003-0024565 and 2004-0056871E5, September 19, 2003 and April 19, 2004.

⁴⁷ CRA Document 2003-0024565, September 19, 2003.

⁴⁸ CRA Document 2005-0155961E5, April 6, 2006.

⁴⁹ CRA Document 9613915, May 28, 1996.

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FLEXIBLE BENEFIT PLANS

A PHSP can be offered as one of the benefits in a flexible benefit plan (also known as a flex plan or cafeteria plan). Instead of offering a one-size-fits-all plan, a flex plan allows employees to select their benefits from a menu containing different choices.⁵⁰ The flex plan's menu may offer taxable and non-taxable benefits. As long as the employer respects the rules governing the non-taxable benefits, an employee's right to buy taxable benefits will not affect the tax treatment of the non-taxable benefits.⁵¹ Specifically, the employer must maintain separate accounting systems for each type of benefit plan, and must account separately for money going into and coming out of each plan.

The employer gives each employee a specific number of flex credits that the employee may use to "buy" the specific benefits they want. An employee may choose to buy some benefits, but not others, and may choose to upgrade the quality of benefits they purchase.

Although we use the term "buy" to describe how an employee uses flex credits, flex credits have only a notional value. They have no intrinsic value beyond the right an employee has to use them to select employee benefits from among the employer's benefits offering.⁵²

To the extent that an employee does not use their entire allocation of credits during the enrollment process, they may convert those credits into taxable income. This right applies only to credits that the employee does not use during the enrollment period.

Once the benefit year begins, an employee cannot convert unused flex credits into cash. A plan that guarantees that unused flex credits could be saved and later converted into cash will turn any tax-free benefits that the credits purchase into taxable benefits.⁵³ If an employee does not expect to use all their credits, they can elect to take the cash equivalent before the beginning of the plan year, although they will have to include the cash equivalent value in income.⁵⁴

⁵⁰ IT-529.

⁵¹ IT-529, paragraph 5.

⁵² IT-529, paragraph 7.

⁵³ IT-529, paragraph 8.

⁵⁴ IT-529, paragraph 8.

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An employee's benefit choices under a flex plan must be made before the beginning of the benefit year, and, with limited exceptions, are irrevocable. Exceptions include life events such as a change in employment or marital status, the birth or death of a dependent, or the loss of coverage under a spouse's plan.⁵⁵

A plan can offer a default allocation without jeopardizing the tax advantages in the plan.⁵⁶

HEALTH SPENDING ACCOUNTS

The ITA contains no definition of a health spending account (HSA). To offer benefits in a tax advantaged way, an HSA must conform to the requirements of a PHSP, and in effect, must be a PHSP. A flexible benefits plan may offer an HSA as one of its options. Alternatively, the employer may offer an HSA on a stand-alone basis. Provided the HSA conforms to the requirements of a PHSP, employer contributions to the HSA can be deducted by the employer and will not be considered taxable income (except in Quebec, and then only for provincial income tax purposes).

There are many terms that are used to describe an HSA: Health Care Spending Account (HCSA), Health Care Expense Account (HCEA), Health Care Expense Spending Arrangement (HCESA) and Health Care Reimbursement Account (HCRA), to name a few. For convenience, we'll refer to such plans as HSAs.

With an HSA, the employer reimburses its employees for the cost of eligible hospital, medical or dental expenses up to a limit. The limit is set by the amount of money contributed to the HSA. In Quebec, an HSA cannot be provided on a stand-alone basis unless it also provides coverage under the Régie de l'assurance maladie du Québec (RAMQ).

An employer has some choice as to how it funds an HSA. It can post a specific amount of money to each employee's HSA at the beginning of the year, or it can deposit funds at regular intervals as the year progresses. Or the employer may not want to post any funds at all, preferring instead to pay

⁵⁵ IT-529, paragraph 6.

⁵⁶ CRA Document 2007-0227881E5, February 21, 2008.

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claims from current income during the year. Once the employee reaches their limit, the employer's obligation stops.

A credit in an HSA is not the same thing as a flex credit. Flex credits may be used to buy credits in an HSA during the annual enrollment, but if not used before the beginning of the plan year, cannot be used to put any more money into an HSA. The only exception is a change justified by a life event.

The amount that an employer puts into an HSA can change from year to year, depending on the employer's ability or willingness to pay for this benefit.

To preserve the element of risk that the ITA requires for an insurance plan, an allocation to an HSA cannot be carried forward indefinitely. PHSP plan participants must accept that they will not necessarily receive benefits from their plan equal to their employer's contributions. However, there is some flexibility on the receipt of plan benefits. The CRA allows unused credits or eligible expenses to be carried forward for up to but not longer than one year.⁵⁷ Thereafter all unused amounts and credits are forfeited.⁵⁸

To allow an indefinite carry forward or one that extends for more than one year would, in the CRA's view, make a PHSP resemble a savings plan more than an insurance plan.⁵⁹ If a credit or expense cannot be used in the following year, it is forfeited – there can be no cash refund for unused credits or allowance for expenses that cannot be claimed.⁶⁰

Just as the CRA will not allow an employee to carry forward amounts in a PHSP beyond one year, it will not allow an employee to carry back expenses to a previous year,⁶¹ or transfer unused expenses from one allocation (like vision care) to another (like prescription drugs).⁶² The reasoning behind both prohibitions is to maintain an element of risk. The exceptions are changes justified by a life event and

⁵⁷ CRA Document 2010-0355181E5, June 23, 2010.

⁵⁸ IT-529, paragraph 16.

⁵⁹ CRA Document 9311525, August 9, 1993.

⁶⁰ IT-529, paragraph 15.

⁶¹ CRA Document 2005-0126211E5, November 24, 2005.

⁶² CRA Document 2005-0126211E5, November 24, 2005.

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transfers to another PHSP.⁶³ The CRA interprets the right to transfer funds restrictively. For example, the right to transfer PHSP money to a group insurance plan would disqualify the PHSP.

There is some flexibility on the CRA's part. For example, a one-time change to a plan's carry forward rules from a carry forward of unused credits to one of unclaimed expenses will not change the plan's tax treatment, though an annual right to change from unused credits to unclaimed expenses would.⁶⁴

Before 2013 the CRA allowed employees to direct their anticipated bonuses to the following year's PHSP without the bonus being treated as taxable income. However, as of January 1, 2013 when an employee redirects some or all their future bonus to acquire additional flex credits in an HSA, the CRA will treat the allocation as forgone cash remuneration, and therefore taxable employment income for the year the additional flex credits are credited to the employee's HSA.⁶⁵

ADDITIONAL COSTS

There are additional costs associated with a PHSP, such as provincial and harmonized sales taxes and premium taxes, but a discussion of them is beyond the scope of this article.

SELF-EMPLOYED PERSONS (SOLE PROPRIETORS AND PARTNERS)

Sole proprietors without employees can only provide a PHSP for themselves through an insurance policy. To provide a self-insured plan the sole proprietor must have at least one employee in addition to the proprietor.⁶⁶ If the only person working in the business is the sole proprietor, there is no risk pooling. You can't have an insurance plan where you insure only yourself.⁶⁷ If such a plan were allowed, the sole proprietor could put money into an account with a third party administrator, pay for

⁶³ IT-529, paragraph. 17, and CRA Document 2013-0498001E5, October 15, 2013.

⁶⁴ CRA Document 2010-0355181E5, June 23, 2010.

⁶⁵ CRA Document 2011-0426571C6, November 29, 2011.

⁶⁶ CRA Documents 2011-0400311E5 and 2004-0056871E5, June 20, 2011 and April 19, 2004.

⁶⁷ CRA Document 2003-0012351E5, April 23, 2004.

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hospital or medical services, plus the administrator's fees, claim the expense, and deduct the amount paid to the administrator. The CRA has said that it will not allow such an arrangement.⁶⁸

Yet a corporation controlled by a sole shareholder/employee may create such a PHSP and receive PHSP benefits tax-free, provided the shareholder/employee receives those benefits as an employee.⁶⁹ The CRA has said:

In the case of a PHSP established for the benefit of a corporation's sole shareholder or employee, it is a question of fact whether the resulting benefit is derived by virtue of the individual's shareholdings or by virtue of his or her employment. The presumption is that the benefit is received by the individual in his or her capacity as a shareholder. However, provided that the individual is actively engaged as an employee of the corporation and the benefits under the PHSP (including the applicable limits) are reasonable and consistent with the benefits that would be offered to an arm's length employee performing similar services, it is our general view that the benefit would be derived by virtue [of] the individual's employment.

In this case the employer proposed setting aside a certain amount of money per month or year, from which allowable medical expenses would be paid, up to a pre-determined ceiling. The CRA considered a different case involving a cost-plus plan and a sole shareholder/employee, and came to a different conclusion. According to CRA guidance, a cost-plus plan is one where "the employer contracts with a trustee plan or insurance company for the provision of indemnification of employees' claims on defined risks under the plan."⁷⁰ The "cost" is the amount reimbursed to the employee claiming under the plan, while the "plus" is the fee the trustee or insurance company charges for administering the plan. The CRA noted that it did not think that a business with one shareholder/employee could establish a cost-plus PHSP for the following reasons:

Effectively, the sole employee-shareholder is paying for the personal hospital and medical expenses for himself or herself and his or her household members through his or her solely-

⁶⁸ CRA Document 2002-0158495, December 20, 2002.

⁶⁹ CRA Document 2005-0163771E5, March 14, 2006. See also CRA Document 2017-0703871C6, September 14, 2017.

⁷⁰ IT-339R2, paragraph 6.

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owned corporation without any risks being assumed by the Plan administrator. Therefore, it is our view that a cost-plus plan for a sole employee-shareholder would not likely constitute a plan in the nature of insurance.⁷¹ The CRA also noted that a PHSP could be created for a company's sole employee who dealt at arm's length with the employer.⁷²

ITA section 20.01 was added to the ITA in 1998 to help address the differing tax treatment between those who operate as incorporated businesses and those who are self-employed. Under section 20.01, a self-employed person may buy private health insurance for themselves and their immediate family members. Assuming that the insurance qualifies as a PHSP, the self-employed person may deduct some or all of the premiums.

In order to qualify for the tax treatment offered under section 20.01, an individual first must be self-employed. The ITA has two tests for self-employment. The first test requires half of the person's income to come from self employment. If the individual does not meet that test, they still qualify if their annual income from sources other than self-employment does not exceed \$10,000.

Section 20.01 also sets out differing tax treatment for a self-employed person depending on whether they have employees, and whether those employees are arm's length, as discussed below.

SELF-EMPLOYED WITH NO EMPLOYEES

Under ITA paragraph 20.01(2)(c) a self-employed person with no employees may deduct PHSP premiums they pay for coverage for themselves, their spouse and members of their household. However, deductibility is limited to the following amounts:

- \$1,500 each for the self-employed person, their spouse, and members of their household who have reached age 18 before the payment period begins.

⁷¹ CRA Document 2014-0521301E5, June 25, 2014.

⁷² CRA Document 2016-0633741C6, May 3, 2016.

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- \$750 each for any members of their household under age 18 before the payment period begins.⁷³

These amounts are proportionately adjusted for the amount of time that the self-employed person is in business during the year. For example, if the business started half-way through the year, the deduction limits would be \$750 and \$375 respectively. Premiums in excess of these limits may not be deducted, but may count towards a claim for the METC if they otherwise qualify. On the other hand, if the actual premiums paid fall below the limits, deductibility is limited to the actual premiums paid.

Recent CRA guidance may have added some confusion to this point. Responding to a taxpayer's question, the CRA said that a self-employed person with no employees may not deduct PHSP premiums:

As required by paragraphs 20.01(2)(b) and (d) of the Act, one of these conditions essentially requires an equivalent coverage to be offered to arm's length employees. Therefore, a sole proprietorship with no employees would not be allowed a deduction from income for PHSP premiums.⁷⁴

If this guidance means that a self-employed person with no employees may not deduct PHSP premiums under any circumstances, it contradicts other published guidance from the CRA. Specifically, "Canada Revenue Agency Guide T4002 – Business and Professional Income" discusses the requirements for PHSP premium deductibility, and gives two examples of a sole proprietor with no employees deducting some of their PHSP premiums.⁷⁵

However, if this guidance is confined to situations covered under paragraphs 20.01(2)(b) and (d), PHSP premium deductibility is still available for a sole proprietor with no employees under ITA paragraph 20.01(2)(c).

⁷³ ITA paragraph 20.01(2)(c).

⁷⁴ CRA Document 2011-0406101M4, June 14, 2011.

⁷⁵ <http://www.cra-arc.gc.ca/E/pub/tg/t4002/README.html>, pages 28 - 29.

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CRA guidance also allows two sole proprietors who are married to each other, and who establish their own PHSPs, to deduct their premium payments up to the maximum amounts in ITA section 20.01, even though each plan provides overlapping coverage for both spouses.⁷⁶

SELF-EMPLOYED AND AT LEAST HALF THE EMPLOYEES ARE ARM'S LENGTH

Things get more complicated when the self-employed person has arm's length employees. A non-arm's length employee is a family member employed in the business, or a non-family member employed in the business who owns enough of the business to control it. Every other employee is an arm's length employee.

The first step in determining deductibility is to compare the number of arm's length employees to the total number of employees in the business, including all people who work in the business in any capacity (owners, non-owners, full and part-time, permanent, casual, temporary, or in any other capacity).

If the business provides health coverage for more than half of the full-time, permanent, arm's length employees (and they have been employed for at least three months) the self-employed person can deduct premiums for their own coverage (and for their spouse's and family members' coverage) equal to the lesser of the actual premiums paid or the cost of equivalent coverage. The \$1,500 and \$750 limits referred to above do not apply.⁷⁷

The cost of equivalent coverage is the amount the self-employed person would pay for coverage if they had the same coverage as that of their least covered employee. For example, if the self-employed person provides "gold level" coverage for themselves and their family, but less expensive "bronze level" coverage for their least covered employee, the self-employed person's deduction

⁷⁶ CRA Document 2015-0581431E5, August 18, 2015.

⁷⁷ ITA paragraph 20.01(2)(b).

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would be limited to the amount they would have to pay for "bronze level" coverage for themselves and their family, not what they in fact paid for "gold level" coverage.

Deductibility is further limited by any cost sharing arrangement between the self-employed person and their employees. For example, if the self-employed person pays only half of their employees' premiums, their deduction would be limited to half the cost of equivalent coverage. Additionally, deductibility is limited by any time during the year that the self-employed person is not in business.

Premiums that exceed the deduction limits may count as medical expenses towards a claim for the METC.

SELF-EMPLOYED AND AT LEAST HALF THE EMPLOYEES ARE NON-ARM'S LENGTH

ITA paragraph 20.01(2)(d) limits deductibility to the least of the actual premiums paid, the \$1,500 and \$750 limits referred to above, and the cost of equivalent coverage. These limits are reduced in proportion to any cost sharing arrangement the self-employed person has with their employees, and further reduced if the self-employed person has not been in business for the full year.

GENERAL DEDUCTIBILITY RULES

These rules apply only to amounts that a self-employed person may deduct for PHSP coverage purchased for themselves and members of their household. They have no impact on the deductibility rules covering the cost of providing PHSP coverage for employees. As long as the cost of providing PHSP coverage for employees is a reasonable business expense, the self-employed person may deduct it. Further, as long as the coverage qualifies as a PHSP, the employee need not include that cost in income (except in Quebec, and then only for provincial income tax purposes).

Appendix A contains a decision tree that may help clarify the rules surrounding a self-employed person's right to deduct PHSP premiums they pay for their coverage, and that of their spouse or common-law partner, or member of their household.

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CONCLUSION

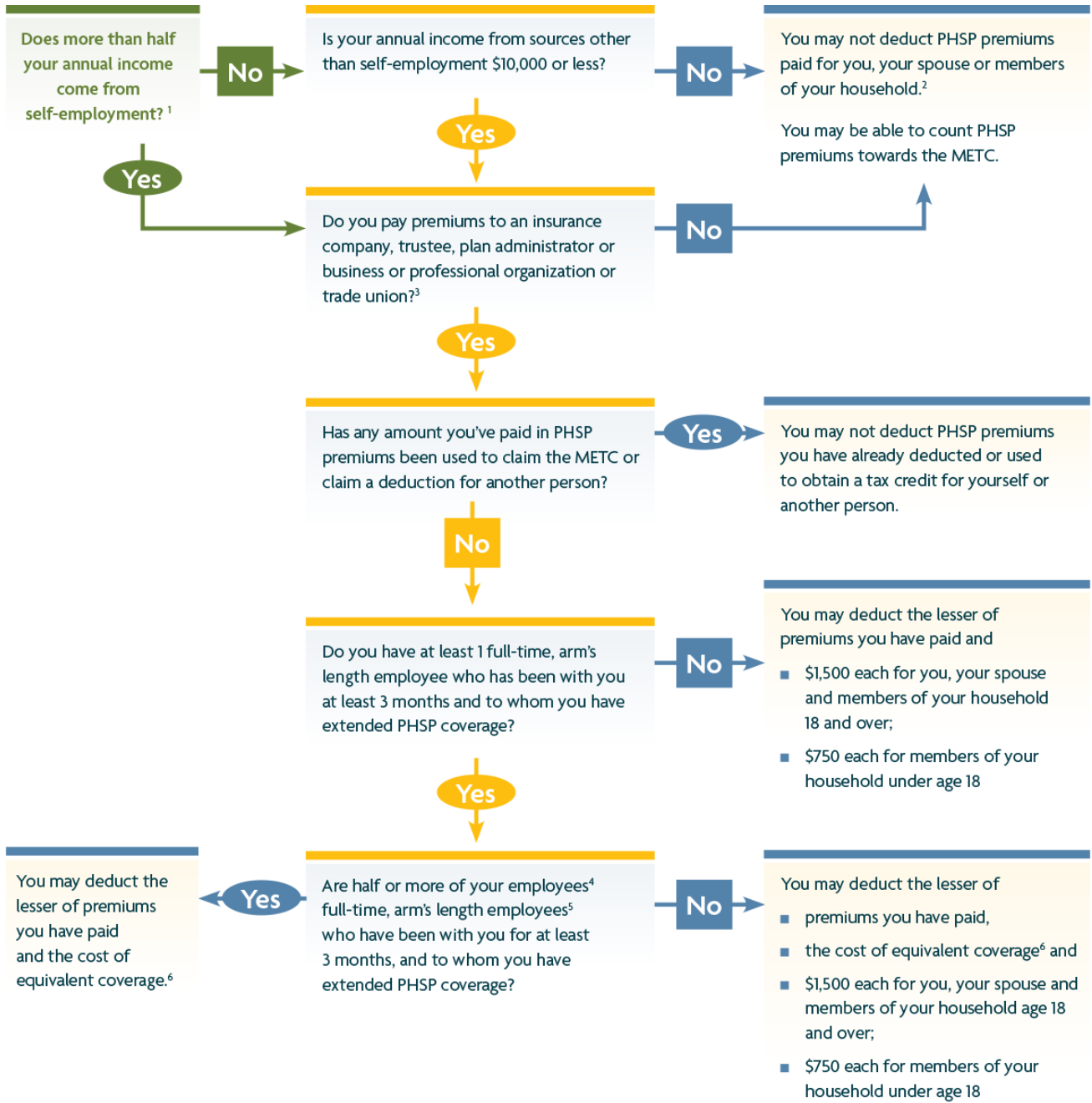
The general rule for employee benefits is that an employer can deduct the cost of the benefits it provides, but the employee must include the value of those benefits in income. But this rule does not apply to PHSPs. The employer can deduct the cost of providing a PHSP for its employees, and, except in Quebec, employees need not include the cost of the benefit in income. Further, in all provinces, any eligible expenses that the PHSP reimburses to the employee are not included in income.

This favourable tax treatment makes a PHSP an extremely valuable employee benefit. It's therefore important to understand the rules to help clients get the best from this benefit.

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PHSP PREMIUM DEDUCTIBILITY DECISION TREE FOR A SELF-EMPLOYED PERSON



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NOTES

- *"Income" is income from a business where the business' fiscal period ends in the current or preceding taxation year.*
- *There is no definition of "member of a household" in the ITA. The CRA has said that an adult son who was employed by his father (the self-employed person) but who lived on his own, was an employee, not a member of the self-employed person's household (CRA Document 2005-0120351E5, July 7, 2005).*
- *The insurance company and trustee must be licensed to do business in Canada or a province. A business or professional organization could be a chamber of commerce or a professional organization that the self-employed person belongs to.*
- *Include as employees all those who work in the business in any capacity – as owners, non-owners, full-time, part-time, permanent, temporary, casual, or contract workers. Also include those who are employed in any business the self-employed person operates as a sole proprietor, as a partnership where the self-employed person is the majority partner, or in any business operated by a corporation with which the self-employed person is affiliated.*
- *Whether someone deals at arm's length with someone else is a question of fact. However, generally speaking there are at least two groups of non-arm's length employees. One group is family members. The other group is non-family members who own enough of the business to control it. You don't have to own more than 50% of a business to control it. If you own less than 50% of the business, but can rely on the support of other owners to get your way, you control the business. All other employees probably deal with the business owner at arm's length.*
- *The cost of equivalent coverage is the amount you would pay for coverage if you had the same coverage as that of your least covered employee. For example, if you provide "gold level" coverage for you and your family, but less expensive "bronze level" coverage for your least covered employee, your deduction would be limited to the amount you would pay for "bronze level" coverage, not what you paid for "gold level" coverage.*

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ADDITIONAL INFORMATION

- *These rules apply only to what may be deducted for the PHSP coverage provided for the self-employed person, their spouse or common-law partner, and members of their household. Self-employed persons may also be able to deduct amounts that they pay for their employees' PHSP coverage if those amounts are reasonable business expenses.*
- *If someone was not self-employed for the entire year, they must reduce their deduction amounts by the proportion that the amount of their time as a self-employed person bears to the taxation year. For example, if someone started in business as a self-employed person at the end of March, they would count only three quarters of the amount they could otherwise deduct. If they started at the end of June, they would count only half.*
- *If you paid only part of your employees' PHSP premiums, you must further reduce your deduction amounts by the proportion of the premium expense you shared with your employees. For example, if you paid half of your employees' premiums, you would have to reduce by half the deductible amounts you paid for your coverage (and that of your spouse or common-law partner and members of your household).*