

Manulife Group Benefits

Cost Plus Q&A

This question and answer series responds to questions regarding the tax implications of a Cost Plus program.

Manulife's Cost Plus program allows plan sponsors to provide their employees with additional health and dental coverage not generally offered under existing Group Benefits plans. If the plan qualifies as a Private Health Services Plan (PHSP) under the Income Tax Act, the full amount of the claim and administration fee are deductible business expenses.

In addition, if reimbursing medical and dental expenses is part of the contract between the plan sponsor and plan members, the cost of claims becomes a non-taxable benefit for plan members. Plan sponsors must be aware that special tax rules apply to claims submitted for business owners and shareholder-managers.

Please note: The information in this document is not intended as tax advice for plan sponsors. Plan sponsors are strongly advised to consult their tax advisor(s) before submitting claims through Cost Plus. Manulife does not know the specific details of an individual's or company's tax and legal situation. As a result, the information provided in this document is generic in nature.

1 What is the technical definition of a Cost Plus plan?

The Canada Revenue Agency (CRA) 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 employees' claims on defined risks under the plan. The employer promises to reimburse the cost of such claims plus an 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."

2 When is Cost Plus considered a deductible business expense for employers?

The following tests must be met for any expense to be considered a deductible business expense under the Income Tax Act (ITA).

- Section 18(1)(a) of the ITA 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.
- Section 67 of the ITA 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 (PHSP), IT-339R2 paragraph 9 states:

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

3 When is Cost Plus considered a non-taxable benefit for plan members?

Cost Plus benefit payments are considered a non-taxable benefit for plan members if the Cost Plus plan qualifies as a Private Health Services Plan.

“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.” For more information, refer to IT-339R2.

4 What is a Private Health Services Plan (PHSP)?

The definition of a PHSP appears in subsection 248(1) of the Income Tax Act and a detailed CRA summary is provided in Interpretation Bulletin IT-339R2.

The following statement outlines the type of expenses that must be covered by a PHSP.

“Generally, coverage under a PHSP must be for medical expenses that qualify under subsection 118.2(2) of the Act when determining the medical expense tax credit (e.g. amounts paid for prescription drugs or dental services). If a particular plan provides coverage for expenses other than those described in subsection 118.2(2) of the Act, the plan will not qualify as a PHSP.” (Reference: CRA Tax Interpretation Letter 2002-0165695.) For additional information on a PHSP, consult the Interpretation Bulletin IT-339R2, under meaning of a ‘Private Health Services Plan’.

5 What does the “nature of insurance” mean in the PHSP guidelines?

According to CRA Interpretation Bulletin IT-339R2 paragraph 3:

“A private health services plan qualifying under paragraphs (a) or (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 basic 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.”

Here is additional background information from Canada Revenue Agency describing the basic elements of a PHSP.

An undertaking by one person to indemnify another person

“A PHSP exists if the employer is obligated under the employment contract to reimburse such expenses incurred by the employees or their dependants.” For more information, refer to CRA Tax Interpretation Letter 2001-0101935.

For an agreed consideration between the employer and the insurance company

“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 basic elements outlined in 3 above.” For more information, refer to IT339R2 – Paragraph 5.

For an agreed consideration between the employee and the employer

“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 dependants. 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.” For more information, refer to IT339R2 – Paragraph 7.

6 Are “unique” or “ad hoc” Cost Plus claims paid on a one-time basis considered a deductible business expense or non-taxable benefit to the claimant?

In order 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.

“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.” For more information, refer to IT339R2 – Paragraph 6.

“Plans involving contracts of insurance in an arm's length situation normally contain the basic elements outlined in 3 (PHSP definition) above.” For more information, refer to IT339R2 – Paragraph 5.

“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.” Refer to the 1991 Corporate Management Tax Conference article by CRA entitled ‘Flexible Employee Benefit Arrangements’.

“A PHSP normally has a ceiling in respect of 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.” For more information, refer to CRA Tax Interpretation Letter 2001-0101935.

7 What are the tax issues for Cost Plus relating to a business owner?

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 exclusively for a business owner.

“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.” For additional information, refer to CRA Tax Interpretation Letter 2001-0101935.

“As stated in technical interpretation letter #9904155, dated April 28, 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. In 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.” For more information, refer to CRA Tax Interpretation Letter 2002-0127485.

A self-employed (sole proprietor) can have an insured PHSP plan for himself covering hospital or medical expenses. Agreed consideration in this case is cash premiums (paid by him to the insurer).

“Medical and hospital insurance plans offered by ... various life insurers, for example, are considered private health services plans within the meaning of subsection 248(1)... Therefore, payments made by an individual under any such plan qualify as medical expenses by virtue of paragraph 118.2(2)(q).” For more information, refer to IT339R2 – Paragraph 8.

8 What are the tax issues for Cost Plus relating to a shareholder?

CRA has made the following comments on Cost Plus tax issues relating to shareholders.

“Unless 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)(a)(i).” For more information, refer to CRA Tax Interpretation Letter 2003-0050541.

“Where 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.” For more information, refer to CRA Tax Interpretation Letter 2001-0106815.

“If 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.” For more information, refer to CRA Tax Interpretation Letter 2001-0106815.

9 If the plan only covers the president of a company who is not a shareholder or an owner, can the president be considered a category?

According to CRA, one person can be considered a category.

“There is no need to have two or more employees covered by the PHSP plan.” For more information, refer to CRA Tax Interpretation Letter 2001-0101935.

However, all expenses must be reasonable...

“...if coverage under a PHSP (Cost Plus or otherwise) 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 such coverage constitutes a reasonable amount. The limits available to self-employed individuals that have no arm's length employees under section 20.01 of the Act could, in our (CRA's) view, be considered reasonable. However, such a determination can only be made considering all the specific facts of the particular situation.” Refer to CRA Tax Interpretation Letter 2001-0106815 for additional information.

10 Can I set up a Cost Plus plan for a category of employees but not tell them and only use it to pay for a shareholder or business owner's claims?

According to CRA, plan sponsors must advise their employees about the Cost Plus plan.

“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.” For additional information, refer to the 1991 corporate tax management conference article by CRA entitled 'Flexible Employee Benefit Arrangements'.

Case studies

We've included actual client situations where Canada Revenue Agency audits resulted in additional tax payments because Cost Plus was not used in compliance with the Income Tax Act.

ABC Company

ABC Company submitted several Cost Plus orthodontic claims for two plan members' dependants. In a CRA audit, \$24,000 in orthodontic claims were not allowed as business expenses and were considered taxable expenses for plan members because members received the benefit in their capacity as indirect shareholders, not employees.

XYZ Company

XYZ Company submitted Cost Plus claims for expenses incurred for a plan member's reconstructive knee surgery in the United States. In a CRA audit, \$35,000 in claims were not allowed because the plan member was the controlling shareholder and the expense was considered a personal or living expense.

For more information on the tax implications of a Cost Plus plan, talk to your tax or legal advisor or your Manulife Account Executive.

References:

Canada Revenue Agency (CRA) – Income Tax Act (ITA) - Interpretation Bulletin 339R2 - Meaning of private health services plan (1988 and subsequent taxation years).

<http://www.cra-adrc.gc.ca/E/pub/tp/it339r2/it339r2-e.html>

Canada Revenue Agency (CRA) tax interpretation letters

Private Health Services Plan-Cost Plus Plans -
Document number: 2001-0101935

Cost Plus Health Plans -
Document number: 2002-0127485

Private Health Services Plan - Reasonable Amount -
Document number: 2001-0106815

Employee Group Insurance Plan –
Document number: 2002-0165695

Self-Administered PHSP –
Document number: 2003-0050541

1991 Corporate Management Tax conference article by CRA entitled "Flexible Employee Benefit Arrangements".

For more information on the references noted above please contact your tax advisor

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