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IT85R2 Health and Welfare trusts for employees

IT

INCOME TAX ACT

Health and Welfare Trusts for Employees

IT-85R2

July 31, 1986

Paragraph 6(1)(a) and section 104 (also subsections 6(4), 12.2(3), (4), and (7), paragraphs 6(1)(f), 56(1)(d), and (d.1), 60(a), 110(8)(a) and subparagraphs 148(9)(c)(vii) and (ix); also section 19 of the Income Tax Application Rules, 1971 (ITAR)).

This bulletin replaces and cancels IT-85R, dated January 20, 1975. Proposals contained in the Notice of Ways and Means Motion of June 11, 1986 are not considered in this release.

1. The general thrust of paragraph 6(1)(a) is to include in employment income the value of all benefits received or enjoyed in respect of an employee's employment. However, there are a number of specific exceptions many of which can be described as benefits relating to the health and welfare of the employee. In some cases, the scope of the excepted benefits and applicable tax treatment are well established by other provisions of the Act, (e.g., registered pension funds or plans, deferred profit sharing plans, supplementary unemployment benefit plans, the standby charge for the use of an employer's automobile, employee benefit plans and employee trusts). The treatment to be accorded to the other exceptions can be less clear, particularly when the benefits form part of an omnibus health and welfare program administered by an employer. The purpose of this bulletin is to describe the tax treatment accorded to an employee health and welfare benefit program that is administered by an employer through a trust arrangement and that is restricted to

(a) a group sickness or accident insurance plan (see 2 below),

(b) a private health services plan,

(c) a group term life insurance policy, or

(d) any combination of (a) to (c).

2. Paragraph 6(1)(f) sets out the treatment of periodic receipts related to loss of income from employment under three types of insurance plans to which the employer had made a contribution. These types of plans are sickness or accident, disability and income maintenance (also known as salary continuation). In the absence of any statutory definition, the Department generally accepts that an employer's contribution to any of the three types of plans will be a contribution to a "group sickness or accident insurance plan"

as described in subparagraph 6(1)(a)(i), provided that the particular plan is a "group" plan and an insured plan. This is based on the assumption that a "disability" resulting in loss of employment income would almost invariably arise from sickness or an accident and that an "income maintenance" payment would likely arise from loss of employment income due to sickness or an accident if not lay off (the latter reason justifying an exception under subparagraph 6(1)(a)(i) as a supplementary unemployment benefit plan). There may be situations where these assumptions will prove invalid but, subject to this caveat, 1(a) above may also be read as a "group disability insurance plan" or "a group income maintenance insurance plan that is not a supplementary unemployment benefit plan".

Employee Benefit Plans and Employee Trusts

3. Employee benefit plans are broadly defined in subsection 248(1) and can encompass health and welfare arrangements. However, funds or plans described in 1(a) to (d) above are specifically excluded in the definition and are thus accorded the tax treatment outlined in this bulletin. Health and welfare arrangements not described in 1(a) to (d) above (e.g., those not based on insurance) may be employee benefit plans or, less likely, employee trusts subject to the tax consequences outlined in IT-502.

4. Where part of a single plan could be regarded as a plan described in 1(a) to (d) above and another part as an employee benefit plan or an employee trust, the combined plan will be given employee benefit plan or employee trust treatment in respect of the timing and amounts of both the employer's expense deductions and the employees' receipt of benefits under the plan. However, if contributions, income and disbursements of the part of the plan that is described in 1(a) to (d) above are separately identified and accounted for, the tax treatment outlined in this bulletin will apply to that part of the plan.

Meaning of Health and Welfare Trust

5. Health and welfare benefits for employees are sometimes provided through a trust arrangement under which the trustees (usually with equal representation from the employer or employers' group and the employees or their union) receive the contributions from the employer(s), and in some cases from employees, to provide such health and welfare benefits as have been agreed to between the employer and the employees. If the benefit programs adopted are limited to those described in 1(a) to (d) above and the arrangement meets the conditions set out in 6 and 7 below, the trust arrangement is referred to in this bulletin as a health and welfare trust.

6. To qualify for treatment as a health and welfare trust the funds of the trust cannot revert to the employer or be used for any purpose other than providing health and welfare benefits for which the contributions are made. In addition, the employer's contributions to the fund must not exceed the amounts required to provide these benefits. Furthermore, the payments by the employer cannot be made on a voluntary or gratuitous basis. They must be enforceable by the trustees should the employer decide not to make the payments required. The type of trust arrangement envisaged is one where the trustee or trustees act independently of the employer as opposed to the type of arrangement initiated unilaterally by an employer who has control over the use of the funds whether or not there are employee contributions.

Employer control over the use of funds of a trust (with or without an external trustee) would occur where the beneficiaries of the trust have no claim against the trustees or the fund except by or through the employer.

7. With the exception of a private health services plan, two or more employees must be covered by the plan. Where a partnership seeks to provide health and welfare benefits for both the employees and the partners by means of a trust, two distinctly separate health and welfare trusts (one for the partners and one for the employees) must be set up to ensure that the funds of each are at all times identifiable and that cross-subsidization between the plans will not occur. The exception in subparagraph 6(1)(a)(i) will of course not apply to such a trust established for the partners.

Tax Implications to Employer

8. To the extent that they are reasonable and laid out to earn income from business or property, contributions to a health and welfare trust by an employer using the accrual method of computing income are deductible in the taxation year in which the legal obligation to make the contributions arose.

Tax Implications to Employee

9. An employee does not receive or enjoy a benefit at the time the employer makes a contribution to a health and welfare trust. However, subject to 10 below, the tax consequences to an employee arising from benefits provided under such a trust are as follows:

Group Sickness or Accident Insurance Plans

(a) Where a group sickness or accident insurance plan provides that benefits are to be paid by the insurer directly to the employee, the premium paid by the trustees to the insurer for the employee's coverage will not result in a benefit to be included in the employee's income.

(b) Where this type of group sickness or accident insurance plan existed before June 19, 1971 and the requirements of section 19 of the ITAR are met (see IT-54, "Wage Loss Replacement Plans"), the benefits paid to an employee by the trustees or the insurers under such a plan in consequence of an event happening before 1974 will not result in a taxable benefit to the employee. Where these requirements are not met and in all cases of payments for events happening after 1973, the wage loss replacement benefits will be taxable under paragraph 6(1)(f) (see IT-428, "Wage Loss Replacement Plans").

Private Health Services Plans (defined in paragraph 110(8)(a))

(c) Payment by the trustees of all or part of the employee's premium to a private health services plan does not give rise to a taxable benefit to the employee. Benefits provided to an employee under a private health services plan are also not subject to tax.

Group Term Life Insurance

(d) Payment by the trustees of a premium under a group term life insurance policy will not result in a taxable benefit to the employee unless the aggregate amount of the employee's coverage

under one or more group term life insurance policies exceeds \$25,000. (See IT-227R, "Group Term Life Insurance Premiums"). The provisions of section 12.2 which tax accrued amounts under a life insurance policy do not apply since a group term life insurance policy will be an exempt policy for that purpose.

(e) Where a group term life insurance policy provides for a lump sum payment to the employee's estate or a named beneficiary, the receipt of the payment directly from the insurer is not included in the recipient's income.

(f) Certain group term life insurance policies provide beneficiaries thereunder with an option to take periodic payments in lieu of the lump sum payment and others provide only for periodic payments to beneficiaries. Prior to the introduction of the accrual rules in section 12.2 for 1983 and subsequent taxation years, benefits thus paid by the insurer to a beneficiary, whether as a result of exercising the option or by the terms of the policy, were annuity payments that were income of the recipient (paragraph 56(1)(d)) who deducted the capital element of the annuity payment (paragraph 60(a) of the Act and Part III of the Regulations).

(g) For the 1983 and subsequent taxation years, paragraphs 56(1)(d) and 60(a) continue to apply to a beneficiary who is a holder and annuitant under an annuity contract if subsection 12.2(3) does not apply because of the exceptions in paragraphs 12.2(3)(c) to (e) or the application of subsection 12.2(7). Generally speaking, this will occur where the annuity contract

- (i) is a prescribed annuity contract as defined in Regulation 304,
- (ii) was acquired before December 2, 1982 under which annuity payments commenced before December 2, 1982,
- (iii) is an annuity contract that was received as proceeds of a group term life insurance policy which was itself neither an annuity contract nor acquired after December 1, 1982, or
- (iv) was acquired before December 2, 1982, can never be surrendered and in respect of which the terms and conditions have not been changed

and is not the subject of an election under subsection 12.2(4).

(h) For annuity contracts other than ones described in (g) above, the annuitant is required by subsection 12.2(3) for the 1983 and subsequent taxation years to include in income accrued amounts on every "third anniversary" of the contract. In addition, in any year that does not include a "third anniversary", paragraph 56(1)(d.1) requires the inclusion of amounts in respect of annuity payments received during the year under the contract. As an alternative to the application of subsection 12.2(3) and paragraph 56(1)(d.1), the annuitant may elect under subsection 12.2(4) (before annuity payments commence) to include accrued amounts on an annual basis. In each instance, the issuer will provide the annuitant with a T-5 information slip indicating the amount of income to be reported in respect of the annuity contract.

Shared Contributions

10. In 9 above the trustees are assumed to be receiving contributions only from the employer to pay for the cost of benefits under the trust plan. However, the trustees may also receive employee contributions to pay a part of the cost of the benefits being provided under the plan. If the plan does not clearly establish that the trustee must use the employee contributions to pay all or some part of the cost of a specific benefit, then it will be assumed that each benefit

under the plan is being paid out of both the employer and the employee contributions. If the benefit in question is otherwise taxable to the employee, then in these circumstances a part of it is non-taxable. The non-taxable part is that proportion of the benefit received by the employee for the year that the total of employee contributions received by the trustees in the year is of the aggregate of the employer and employee contributions received by the trustees in the year. The above treatment will not apply if the benefit must be reported as income according to paragraph 6(1)(f) (see 9(b) above). However, the employee's contributions to plans referred to in 9(b) may be deductible for tax purposes from benefits received from the plan. See IT-428 for details.

Taxation of Trust

11. A trust which invests some of the contributions received and earns investment income, or has incidental income (other than contributions from employers and employees which are not included in computing income of the trust), is subject to tax under section 104 on the amount of such "trust income" remaining after the deductions discussed in 12 below. Where gross income (i.e., the aggregate of its income from all sources) exceeds \$500 in the taxation year (and in certain other circumstances indicated on the form), the trustee is required to file form T3 (Trust Information Return and Income Tax Return).

12. In computing trust income subject to tax, the trust is allowed to deduct, to the extent of the gross trust income, the following expenses, premiums and benefits it paid, and in the following order:

- (a) expenses incurred in earning the investment or other income of the trust,
- (b) expenses related to the normal operation of the trust including those incurred in the collection of and accounting for contributions to the trust, in reviewing and acquiring insurance plans and other benefits and for fees paid to a management company to administer the trust, except to the extent that such expenses are expressly not allowed under the Act,
- (c) premiums and benefits payable out of trust income of the current year pursuant to paragraph 104(6)(b). Benefits that are paid out of proceeds of an insurance policy do not qualify. Other benefits paid are normally regarded as having been paid first out of trust income of the year. However, premiums and benefits that would not otherwise be taxable in the hands of the employee by virtue of paragraph 6(1)(a) may be treated at the trustee's discretion as having been paid out of prior year's funds or current year's employer's contributions, to the extent that they are available, to avoid the application of subsection 104(13).

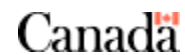
The remainder of the income of the trust is subject to income tax under section 122 of the Act. As an inter vivos trust, the taxation year of the trust coincides with the calendar year.

13. For administrative simplicity, payments of taxable benefits by the trustee to or on behalf of employees are to be reported on Form T4A by the trustee and not on the T3 Supplementary. Information on the completion of Form T4A is contained in the "Employer's and Trustee's Guide". Although the trustee is required to withhold income tax from taxable benefits paid to employees, these amounts will not be subject to either Canada Pension Plan contributions or unemployment insurance premiums when paid by the trustee.

14. Although actuarial studies of the trust may recommend the establishment of "contingency reserves" to meet its future obligations, transfers to such reserves are not deductible for tax purposes by the trust.

Setting up a Plan

15. There is no formal registration procedure for a health and welfare trust and no requirement that the trust agreement be submitted to the Department for approval prior to the implementation of the plan. However, the advice of the District Taxation Office may be requested where there is any doubt as to the acceptability of the trust agreement as a health and welfare trust. Full particulars of the arrangement including a copy of all pertinent documents should accompany the request.

The logo for the Government of Canada, featuring the word "Canada" in a serif font with a small red maple leaf icon to the right of the letter 'a'.

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This issue contains issues of current interest that were discussed at a panel at the annual conference of the **Canadian Tax Foundation** on September 30, 2002, in Toronto by Roy Shultis, Deputy Assistant Commissioner, Income Tax Ruling Directorate, Policy and Legislation Branch, Mike Hiltz, Director, Reorganizations and Resources Division, Income Tax Rulings Directorate, Policy and Legislation Branch and Marc Vanasse, Director, Business and Partnerships Division, Income Tax Rulings Directorate, Policy and Legislation Branch, Canada Customs and Revenue Agency.

E-Commerce

In 1998, the Minister of National Revenue, in response to a report “*Electronic Commerce and Canada’s Tax Administration*” prepared by the Minister’s Advisory Committee on Electronic Commerce, established a framework for the study of electronic commerce.

The CCRA’s study dealt with the effect of E-Commerce on all aspects of Canada’s tax administration: goods and services tax, customs duties and tariffs and income tax. The income tax matters included compliance and collection concerns as well as interpretive issues. The latter issues related to non-residents carrying on business in Canada, residents carrying on business abroad, transfer pricing and the characterization of electronic transactions for withholding tax and treaty purposes. The income tax interpretive study benefited from the advice of a group of eminent Canadian income tax specialists and took into account the continuing work of the Organization for Economic Co-operation and Development (OECD) with respect to electronic commerce and permanent establishments, attribution of income to permanent establishments and characterization of payments made in an E-Commerce context.

The study considered the circumstances under which a non-resident who transacts with Canadians through a Web site may be considered to be carrying on business in Canada. The factors relating to this determination will be relevant not only to non-residents carrying on business in Canada but also to foreign affiliates of Canadian residents and residents of Canada carrying on business in other countries.

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It was concluded that, in some circumstances, a Web site located on a server situated in Canada can constitute a permanent establishment of a non-resident. This conclusion is consistent with the recent amendments to Article 5 of the OECD Model Convention.

The attribution of income or loss to a permanent establishment in an E-Commerce context raises difficult issues. There is no consensus among the member countries of the OECD concerning the application of Article 7 to traditional forms of commerce. The current CCRA interpretation of Article 7 of the Model Convention does not always produce a result that is consistent with the arm's length principle as developed in the Transfer Pricing Guidelines. The working hypothesis developed by the OECD to apply the Transfer Pricing Guidelines by analogy to permanent establishments is under discussion at the OECD. Given this uncertainty on this difficult issue, the CCRA will continue its current interpretation of Article 7 and will apply its interpretation in the E-Commerce environment.

The characterization of E-Commerce payments is difficult because the distinction between the different "things" that may be purchased will be elusive in many situations. The general principles of characterization set out in the *Report to Working Party No. 1* of the OECD Committee on Fiscal Affairs are instructive and will be of benefit to the CCRA in the determination of the character of payments.

The most important aspect of the E-Commerce study concerns the purchase or licensing of digital products. The CCRA is of the opinion that the existing Canadian jurisprudence can be applied to the purchase or licensing of digital products. In the case of the purchase of a digital product, the CCRA considers that the customer makes the payment to acquire the ownership of data transmitted in the form of a digital signal. Any use of copyright involved in downloading the product is not an important part of the total consideration paid by the purchaser. For this reason, the payment for the product would not be considered a royalty as defined in Article 12 of Canada's treaties that follow the OECD Model Convention.

Similarly, a payment for the use of, or right to use, a digital property would not be for the use of copyright and would not be a royalty for the purposes of Article 12. Until recently, the CCRA considered a payment for the use of, or right to use, custom computer software to be a payment for a secret formula and within the definition of royalty in Article 12. Canada had an

observation on this point in respect of Article 12 of the OECD Model Convention. The Department of Finance withdrew the observation on March 28, 2002. As a result, such a payment would now be considered to be within Article 7 of Canada's treaties that follow the OECD Model Convention.

It is important to appreciate that this conclusion would not apply to those of Canada's treaties that include in Article 12 a reference to a payment for the use of or right to use intangible property. In such cases, the payment for the use of or right to use a digital property would be a payment for the use of intangible property and therefore a royalty.

In summary, the CCRA should, in general, be able to apply the same principles of taxation to E-Commerce transactions that it has applied to conventional commerce. The CCRA's view of the law is generally consistent with the view of the OECD as expressed in the amended Commentary to the OECD Model Convention and the *Report to Working Party No. 1* referred to above.

Finally, the CCRA welcomes any queries you may have with respect to any interpretive aspect of E-Commerce. The CCRA is prepared to deal with them as interpretations or rulings, in the case of proposed transactions. In short order, the CCRA will include the results of its study in an Interpretation Bulletin.

Reasonable Expectation of Profit

This year the Supreme Court of Canada rendered its decision in two cases that concerned the application of the reasonable expectation of profit (REOP) test, *Brian J. Stewart v. The Queen*¹ and *The Queen v. Jack Walls and Robert Buvyer*².

In the *Stewart* case:

- The taxpayer acquired four condominium units as part of a syndicated real estate development for \$1,000 cash each. The balance of the purchase price was financed.
- Projections for rental income and expenses contemplated a negative cash flow. It turned out that actual rental losses were greater than projected.
- For the taxation years 1990 to 1992, the taxpayer claimed rental losses on the properties.

¹ 2002 DTC 6969; [2002] 3 CTC 421

² 2002 DTC 6960; [2002] 3 CTC 439

- These losses were disallowed on the basis that the taxpayer had no REOP and therefore, no source of income for the purpose of section 9 of the *Income Tax Act* (the “Act”).
- Both the Tax Court of Canada and the Federal Court of Appeal upheld the reassessments.

In the *Walls* case:

- The taxpayers were limited partners in a partnership that purchased a mini-warehouse for \$2,200,000, payable in the form of \$1 in cash and the balance in the form of an agreement for sale with interest payable at 24% per annum.
- In addition to the interest on the debt obligation, the partnership also paid the vendor management fees and 50% of the net operating profit of the venture under a management and services agreement.
- The taxpayers deducted their proportionate share of the partnership losses incurred in 1984 and 1985.
- These losses were disallowed on the basis that the taxpayer had no REOP and therefore, no source of income for the purpose of section 9 of the Act.
- It was also argued that the losses should be decreased by:
 - reducing the purchase price of the mini-warehouse to reflect a fair market value of \$1,180,000; and
 - reducing the interest expense by decreasing the debt in excess of the fair market value and lowering the interest rate to 16%.
- The taxpayers filed notices of objection, but the Minister confirmed the reassessments.
- The Federal Court, Trial Division, dismissed the appeals and upheld the Minister’s position with respect to REOP.
- The Federal Court of Appeal set aside the judgment, holding that the trial judge erred in applying REOP since the taxpayers did not have a personal motivation. It remitted the matter to the trial judge for a determination of the outstanding issues of whether the transaction was arm’s length and at fair market value.
- The issue of whether the storage park operation constituted a source of income for the purpose of section 9 of the Act was appealed to the Supreme Court.

In both cases, the Court ruled in favor of the taxpayers. In its decision in *Stewart* (the analysis from which also formed the basis for the decision in *Walls*), the Court

stated the REOP test is not supportable by law as a basis to determine if a taxpayer’s activities constitute a source of income under the Act.

Question 1

Before getting into the impact of the decisions, could you briefly explain the basis for the CCRA’s previous position that a business or property that had no REOP was not a source of income under the Act?

Response 1

The CCRA’s previous position was based mainly upon the Supreme Court decision in *William Moldowan*³. While the *Moldowan* case involved the determination of whether a taxpayer’s chief source of income was farming, the court noted that in order to have a source of income under the Act, the taxpayer must have a profit or a REOP. Further, in determining if a taxpayer has a REOP, the following criteria should be considered:

- the profit and loss experience in past years;
- the taxpayer’s training;
- the taxpayer’s intended course of action; and
- the capability of the venture, as capitalized, to show a profit after charging capital cost allowance.

Question 2

What impact will the Court’s decision have on the CCRA’s use of the REOP test?

Response 2

The Court has stated that the REOP test should not be accepted as a basis to determine if a taxpayer’s activities constitute a source of income under the Act. The courts have suggested a two-stage approach:

- The first stage is to determine whether a taxpayer’s activity is undertaken in pursuit of profit that results in a source of income under the Act, or is a personal endeavour. This first stage is only relevant where there is some personal or hobby element to the activity. The venture will be considered a source of income only if it is undertaken in a sufficiently commercial manner.
- In the second stage, pursuit of profit has been established and the taxpayer’s activity is clearly commercial in nature. It then becomes a matter of determining whether the source of the income is from business or property for purposes of the Act.

³ 77 DTC 5213; [1977] CTC 310

Question 3

Does this mean that the REOP test is no longer applicable in determining if a taxpayer has a source of income under the Act?

Response 3

- The REOP test, as it previously applied, will no longer be used to determine if there is a source of income under the Act.
- The CCRA will, however, question whether a taxpayer is operating in a sufficiently commercial manner when the activity has some personal or hobby element.
- At this point, a taxpayer's venture will be reviewed and criteria, including those set down in *Moldowan*, will be considered in determining if the taxpayer intends to carry on an activity for profit and the overall evidence supports that intention.

Question 4

Assuming a taxpayer's activity is commercially viable, but there is a personal element, how will the CCRA account for the expenses related to the personal element?

Response 4

- It is the CCRA's view that a calculation will have to be made using some reasonable basis, to determine the amount of the business expenses that may be deducted in calculating the income from the commercial activity.
- Thus, where there is both a personal and business element to the expenses incurred and they are not otherwise restricted under the Act, some reasonable basis of proration will have to be used to determine the portion that relates to the business activity.

Question 5

Could you comment on the part of the Court's decision in which it was stated that the realization of an eventual capital gain may be taken into account in determining whether a taxpayer's activity is commercial in nature?

Response 5

- The Court has stated that the motivation of capital gains accords with the ordinary businessperson's understanding of "pursuit of profit."
- Thus, the CCRA accepts that there may be situations where the realization of an eventual capital gain will be a factor in assessing the commerciality of the taxpayer's overall course of conduct.

- However, it is emphasized that the mere acquisition of a property in anticipation of a capital gain does not provide a source of income.

Question 6

Do you have any concerns that these comments seem to imply that a capital gain may be considered to be part of a source of income that is from a business or property?

Response 6

- As noted above, the acquisition of a property in anticipation of a capital gain does not provide a source of income under the Act.
- The proposition that a capital gain is now included in calculating income that is from a business or property source would be contrary to the overall scheme of the Act.

Question 7

If a taxpayer's loss is not from a source of income under the Act because the activity in question is not carried on in a sufficiently commercial manner, say for example in the case of a recreational property, will the expenses that generated the loss be deductible in calculating a capital gain from the disposition of a property?

Response 7

No.

- Pursuant to paragraph 40(1)(a) of the Act, only outlays and expenses incurred for the purpose of disposing of a property will be deductible in the calculation of the gain.
- The courts have stated that the phrase "for the purpose of" in subparagraph 40(1)(a)(i) means "for the immediate or initial purpose of" and not the eventual or final goal which the taxpayer may have in mind⁴.
- Therefore, if a taxpayer's activity is not of a commercial nature, the annual expenses incurred in relation to that property may not be carried forward and deducted in the calculation of a capital gain or loss when it is disposed of.

Question 8

If a taxpayer's involvement in a venture is motivated by tax considerations, will this be viewed as a personal element such that it could affect the determination of whether the activity has a sufficient degree of

⁴ See the Federal Court of Appeal decision in *Avis Immobilien G.M.B.H. v. The Queen* (1997 DTC 5002)

commerciality to be considered a source of income under the Act?

Response 8

If a taxpayer is motivated by tax considerations when he or she enters into a business or property venture, this will not detract from the venture's commercial nature or characterization as a source of income under the Act.

Health and Welfare Trusts

Background

For a number of years, the CCRA has been allowing employers to operate their health and welfare programs through a "trust" arrangement. The CCRA's position on the income tax implications for such arrangements, known as health and welfare trusts, is set out in Interpretation Bulletin IT-85R2, dated July 31, 1986, *Health and Welfare Trusts for Employees*.

The types of benefits administered by an employer through health and welfare trust arrangements are restricted to:

- (a) group sickness or accident insurance plans
- (b) private health services plans
- (c) group term life insurance policies, or
- (d) any combination of a) to c).

Essentially, the CCRA allows these trusts to be treated as conduits: an employee does not receive or enjoy a benefit at the time the employer makes a contribution to a health and welfare trust. Further, any income tax advantage that an employee would otherwise get is not affected because of the health and welfare trust. For example, payment by the trustees of health and welfare trusts of all or part of an employer's contribution to a private health services plan, does not give rise to a taxable employment benefit. The legislative exemption in subparagraph 6(1)(a)(i) flows through to the employees.

Employers can deduct contributions to health and welfare trusts in the year the legal obligation to make the payment to the trust arises, to the extent they are reasonable and laid out to earn business or property income.

The bulletin describes the tax implications for the trust. In general terms, none of the receipts from an employer are taxable, nor are the payments deductible in the trust. However, the trust is taxed as an inter vivos trust on any investment income generated because of investments made in the course of managing the employee benefit

programs. The minimum tax rules must be considered as they could also have application.

In recent months, there has been a significant issue related to the funding of health and welfare trusts and the quantum of the deductions that an employer can claim when money is invested in the trust to fund the employees' benefits.

Question 1

What is the legal basis for a health and welfare trust under the *Income Tax Act*?

Response 1

Health and welfare trusts are not specifically defined or described in the Act. They became recognized administratively by the CCRA in the manner set out in IT-85R2, after extensive consultations with the tax community and employee benefits consultants in the 70s.

Question 2

Since the last version of the bulletin was issued in 1986, have there been any significant changes to the CCRA's position on health and welfare trusts?

Response 2

No, there have been no major changes to the CCRA's overall administrative positions set out in the bulletin. There have, however, been changes to the law that make some of the explanations of the income tax rules in the bulletin outdated. For example, the bulletin still has the discussion on the former \$25,000 exemption for coverage under a *group term life insurance policy*. We will update the bulletin to reflect current law.

Question 3

Have any important issues arisen recently that would be of interest to administrators/trustees of health and welfare trusts?

Response 3

Yes, a significant issue has been considered over the last few months in connection with the funding of the cost of long-term disability benefits under "group sickness and accident plans" that are administered by employers through a health and welfare trust.

Question 4

Before getting into the issue on funding, could you briefly comment on the CCRA's general position in regard to the funding of a health and welfare trust?

Response 4

Yes, the CCRA's general position on funding is described in paragraph 6 of IT-85R2, which states that an employer's contributions must not exceed the amount required to provide the health and welfare benefits, and that the payments cannot be made on a voluntary or gratuitous basis. In this regard, we would like to emphasize that this means the "current" cost of paying out the benefits for a particular year. This is usually based on an actuarial determination where the employer has engaged a carrier to provide the health and welfare benefits.

Question 5

Could you now explain recent developments in regard to the cost of funding benefits in a health and welfare trust?

Response 5

The main issue has been with what we have referred to as the over-funding of benefits through lump sum payments by employers to a health and welfare trust. By this, we mean that employers were proposing to fund 100% of the estimated value of all future benefits payable with respect to insured claims under the long-term disability benefits provided under a health and welfare trust. That is, the employer would contribute a lump sum amount to a health and welfare trust that would finance not only the current benefits payable under the plan, but the estimated cost of the benefits that would be payable over a number of years.

Question 6

Could you describe the CCRA's position relating to the so-called over-funding of the benefits by the payment of a lump sum amount, including the effect on the deductions that may be claimed by the employer as well as any consequences for health and welfare trusts that otherwise meet the criteria outlined in IT-85R2?

Response 6

The CCRA's position is that, in those situations where an employer's contributions to a health and welfare trust are for future benefits, subparagraph 18(9)(a)(iii) of the Act applies to the deductibility of such contributions by employers. That is, the lump sum amount will be regarded as having been made or incurred as consideration for insurance for a period after the end of a taxation year. We have also concluded that contributions of lump sum amounts to fund future benefits would not, in and by itself, disqualify a trust as a health and welfare trust. However, the contributions must still be based on

actuarial determinations of amounts needed to fund the future health and welfare obligations.

Question 7

In the course of considering the over-funding issue, there has been some discussion on the impact of the *Canadian Pacific Limited*⁵ decision and whether it would support the full deduction in a taxation year, of the lump sum amounts paid to fund future benefit obligations in a health and welfare trust. This is based on the reasoning that, since the Court supported the position that the lump sum in question in that decision was held to be a legitimate business deduction and not prohibited by paragraph 18(1)(e) because it was contingent, the full amount should be a legitimate business deduction in a taxation year.

Could you outline the CCRA's position on the impact, if any, of the CP decision on the deduction by employers of lump sum amounts contributed to a health and welfare trust to fund current and future obligations?

Response 7

The CCRA has accepted the outcome in *Canadian Pacific* that the amounts set aside for the future payment of benefits were not "contingent" in nature. For health and welfare trusts, this means that contributions for actuarially required contributions by an employer to a health and welfare trust will not be denied as a deduction under paragraph 18(1)(e) as noted above. However, as also noted, subparagraph 18(9)(a)(iii) applies. In this regard, audit officials in the tax services office have already issued reassessments applying this rule.

Refreshing losses

An article in *Canadian Tax Highlights* in April of this year⁶ raised the question of whether the opening summary statement attached to a published CCRA advance income tax ruling (doc. no. 2001-0090213) indicates a shift in the CCRA's administrative policy concerning "in-house" loss-consolidation transactions.

The article set out the concern as follows:

"The ruling involves Lossco, with non-capital losses, lending at interest to its profitable sub (Profitco), which subscribes for preferred shares of a new Lossco sub, which on-lends the funds back to Lossco interest-free. Profitco reduces its taxable income via

⁵ *Canadian Pacific Limited v. The Minister of Revenue (Ontario)*, (now the Minister of Finance), 99 DTC 5286; [2000] 2 CTC 331, (Ontario Court of Appeal).

⁶ Dean Gresdal, "Loss Refreshing Abusive?" in *Canadian Tax Highlights*, vol. 10, no. 4, April 23, 2002.

the interest paid to Lossco, which uses its non-capital losses to shelter that interest income. The CCRA summary statement says that if an affiliated group undergoes a tax-loss consolidation and a group member (Profitco) deducts interest expense and thereby incurs a non-capital loss, the newly created loss is abusive: it ‘effectively allow[s] the affiliated group to refresh one of its member’s [sic] existing non-capital losses, which is beyond the scope of a tax loss consolidation.’”

- 1) Could the CCRA provide clarification as to when a loss-consolidation transaction that has the effect of “refreshing” losses might be considered to be abusive?
- 2) Can a loss-consolidation transaction be implemented for the purpose of using non-capital losses of Lossco from a **prior** taxation year (as opposed to non-capital losses that are anticipated to arise in Lossco in the **current** or **future** taxation years)?

CCRA Position

- 1) The summary statements attached to published CCRA rulings and interpretations are merely intended to provide a very brief synopsis as an aid to the reader in determining whether the main document is of relevance or interest. As the article indicates, it can be misleading to read the summary statement without a complete understanding of the document itself and the circumstances behind it.

Loss-consolidation transactions involving a “Lossco” lending at interest to an affiliated “Profitco” that subscribes for preferred shares of Lossco (or a subsidiary of Lossco) will not necessarily be considered to result in an abuse, within the meaning of subsection 245(4), merely because the interest deduction results in a non-capital loss in Profitco. In particular, the CCRA would not ordinarily consider an abuse to result solely because the non-capital loss so created is carried back to a previous taxation year of Profitco in accordance with section 111. Furthermore, the CCRA would not ordinarily consider an abuse to result solely because the non-capital loss so created has a carryforward period that extends beyond the original carryforward period for Lossco’s losses, provided that it is deducted within the original carryforward period.

Losses may be considered to be “refreshed” in a loss-consolidation transaction in which Lossco transfers depreciable property, on which there is unrealized recapture, to affiliated Profitco, thereby allowing Lossco to deduct losses before they expire and Profitco to acquire the depreciables at an increased undepreciated capital cost. However, such a transaction would not ordinarily be considered to result in an abuse solely because it avoids the expiry of a non-capital loss, since the loss is deducted against income (the recapture) that arose in the original loss carryforward period.

It should be noted, of course, that a loss-consolidation transaction that seeks to circumvent other loss-limitation rules, such as those in subsection 111(5), could be considered to result in a misuse or an abuse⁷.

- 2) Yes.

Replacement Property Rules and Business Expansions

We understand that the CCRA has received a number of inquiries on how the replacement property rules are affected by business expansions. The inquiries have arisen because of the statement in ¶ 15 of Interpretation Bulletin IT-259R3, *Exchanges of Property*, that the replacement property rules are not intended to encompass business expansions.

Recently, you have been asked to consider whether a farmer could use the replacement property rules on the voluntary disposition of real property when the existing farmland is replaced with a substantially larger piece of land. Reasons for selling the existing farmland could include its proximity to an urban area where the land is very valuable compared to a more remote area. If existing farmland is replaced with a larger farm, the question arises as to whether the new farmland could be considered a replacement property, or be regarded as a business expansion and therefore, excluded by virtue of your position in the bulletin.

Question 1

Could you briefly explain the basis for the concern about the use of the replacement property rules in relation to business expansions?

⁷ See the Department of Finance *Technical Notes* with respect to the introduction of subsection 245(4) in Bill C-139, June 30, 1988.

Response 1

In general terms, the replacement property rules in the *Income Tax Act* require that it be reasonable to conclude that a new property will be acquired to replace a former property. As such, there must be a correlation or causal relationship between the acquisition of the new property and the disposition of the former property.

Question 2

In light of this particular requirement in the Act, could you expand on the bulletin position as it relates to business expansions?

Response 2

The statement in ¶ 15, that the replacement property rules are not intended to encompass business expansions was made in the situation where it could not be readily determined whether one particular property is actually being replaced by another. Hence, it is important to consider the example given. The comments were made in the context of a taxpayer who was in the process of expanding a retail operation by opening and closing a number of locations. The new properties acquired during this type of “business expansion” were not considered replacement properties because there was no correlation or causal relationship between their acquisition and the disposition of the existing properties.

Question 3

Are there any other important considerations when a particular property is purchased under a business expansion?

Response 3

Transactions surrounding these cases are often not straightforward and have peculiarities that are specific to a taxpayer’s business. A determination of whether a newly acquired property can reasonably be considered a replacement property under these rules can only be made after considering all the facts and circumstances surrounding a particular situation.

In conclusion, it is difficult to envision all situations where property purchased under a business expansion will not qualify as a replacement property. However, the example given in the bulletin can be a useful guide. I would therefore like to point out that the fact that a property is purchased under a business expansion will not, in and by itself, mean that the property cannot be considered a replacement property.

Question 4

Will Interpretation Bulletin IT-259R3 be changed to clarify the comments on business expansion?

Response 4

The bulletin will be amended to clarify that the emphasis will be placed on whether a correlation or causal relationship exists between the acquisition of the new property and the disposition of the existing property when determining if a particular property is a replacement property, and not simply on the fact that the new property is acquired because of a business expansion.

Question 5

Can a taxpayer get certainty on the tax implications when contemplating the purchase of a replacement property?

Response 5

As discussed in Information Circular 70-6R5, *Advance Income Tax Rulings*, the CCRA provides an advance income tax ruling service to promote voluntary compliance, uniformity and self-assessment by providing certainty with respect to the income tax implications of proposed transactions. In fact, the CCRA has issued rulings in the past involving the application of the replacement property rules to a business expansion. Therefore, provided all the facts are presented in the ruling request in accordance with the procedure outlined in the circular, the CCRA will consider a request for an advance income tax ruling on proposed transactions involving the replacement property rules in a business expansion.

Foreign Exchange Losses

The following issue has to do with the recharacterization of a foreign exchange loss to an amount deductible under Paragraph 20(1)(f) of the *Income Tax Act* (the “Act”). The corporate taxpayer incurred foreign exchange losses on the repayment of long-term debt denominated in US currency because the US dollar appreciated against the Canadian dollar over the period between the borrowing of the money and the repayment of the debt. The corporate taxpayer issued US dollar obligations but not at a discount. The borrowed money was used for capital purposes. The taxpayer has requested that the foreign exchange losses sustained on the repayment of debt may be claimed as a deduction from income under paragraph 20(1)(f) of the Act.

Legislative Context

Paragraph 18(1)(f) provides that “in computing the income of a taxpayer from a business or property no deduction shall be made in respect of an amount paid or payable as or on account of the principal amount of any obligation described in paragraph 20(1)(f) except as expressly permitted by that paragraph”.

Paragraph 20(1)(f) reads in part as follows:

“(f) an amount paid in the year in satisfaction of the principal amount of any bond, debenture . . . or similar obligation . . . on which interest was stipulated to be payable, to the extent that the amount so paid does not exceed,

(i) in any case where the obligation was issued for an amount not less than 97% of its principal amount, and the yield from the obligation . . . does not exceed 4/3 of the interest stipulated to be payable on the obligation, expressed in terms of an annual rate on

(A) the principal amount of the obligation, if no amount is payable on account of the principal amount before the maturity of the obligation, or

(B) the amount outstanding from time to time as or on account of the principal amount of the obligation, in any other case,

the amount by which the lesser of the principal amount of the obligation and all amounts paid in the year or in any preceding year in satisfaction of its principal amount exceeds the amount for which the obligation was issued, and

(ii) in any other case, ½ of the lesser of the amount so paid and the amount by which the lesser of the principal amount of the obligation and all amounts paid in the year or in any preceding taxation year in satisfaction of its principal amount exceeds the amount for which obligation was issued:”

In subsection 248(1) of the Act, “principal amount”, in relation to any obligation, means “the amount that under the terms of the obligation or any agreement relating thereto, is the maximum amount or maximum total amount, as the case may be, payable on account of the obligation by the issuer thereof [...]”

CCRA Position

The issue is whether the “principal amount” of a debt denominated in a foreign currency is based on the foreign currency rate on the date of issue of the obligation, the spot rate at the time the debt is paid or the average of fluctuating rates from time to time. This is also relevant for the application of the 97% test and the yield test in paragraph 20(1)(f). There is no indication either in paragraph 20(1)(f) or the definition of “principal amount” in subsection 248(1) **when** the “principal amount” is to be determined in respect of a foreign currency obligation. If the “principal amount” is to be determined at the time of issue, there is no discount since the amount of foreign currency exchange loss would not be ascertained at that time. Since the term “principal amount” in the Act does not specify the time at which the “principal amount” has to be determined, the time of determination is dependent on the context of the wording of a particular provision and the intent and purpose of that provision.

Other provisions of the Act contemplate foreign currency situations. For purposes of section 80 of the Act, paragraph 80(2)(k) states, “where an obligation is denominated in a currency (other than Canadian currency), the forgiven amount at any time in respect of an obligation shall be determined with reference to the relative value of that currency and Canadian currency **at the time the obligation was issued**”. As such, foreign currency fluctuations after the time an obligation is issued are ignored for the purposes of section 80 of the Act. Also, paragraph 15.1(7)(b) refers to “the total of all amounts each of which is the principal amount outstanding immediately after that time”.

The CCRA has stated in Interpretation Bulletin IT-361R3, dealing with subparagraph 212(1)(b)(vii), that where an obligation is in foreign currency, any fluctuation in the Canadian dollar relative to the foreign currency is not a factor in determining whether at a particular time the Canadian borrower is obliged to pay more than 25% of the principal amount of the loan.

It is the CCRA’s position that for purposes of paragraph 20(1)(f) of the Act, the time at which the “principal amount” is to be determined should be at the time of issue and this is the relevant time at which the discount, if any, should also be ascertained. The “97% test” and the “yield test” should also be applied at the time of issue of the debt. Any loss should be governed by subsection 39(2) of the Act.

Dividend Reinvestment Plans

A “Dividend Reinvestment Plan” or “DRIP” is an arrangement under which the common shareholders of a public corporation are entitled to direct that cash otherwise receivable by them as regular dividends be used to purchase additional common shares of the corporation, usually at a discount from their market price. DRIPs sometimes also have an “Optional Purchase” component under which participants under the DRIP are entitled to purchase a limited number of common shares, in addition to those purchased with reinvested dividends, usually at market price.

Question

What is the CCRA’s position with respect to whether participants under such reinvestment plans can be assessed taxable benefits?

Response

In our view, a corporation that permits a shareholder to use dividends to purchase additional shares of the corporation for an amount less than their fair market value confers a benefit on the shareholder in the amount of the discount at the time that the shares are purchased. Consequently, subsection 15(1) is potentially applicable to rights under DRIPs.

Paragraph 15(1)(c) provides that subsection 15(1) does not apply where the corporation confers on all owners of common shares identical rights to acquire additional shares of the corporation. However, the CCRA understands that the paragraph 15(1)(c) exception is not available with respect to most DRIPs, since foreign securities laws may prevent the corporation from permitting non-resident shareholders to participate under the plan.

Nevertheless, it is the longstanding administrative practice of the CCRA that a subsection 15(1) benefit will not be assessed in respect of a benefit arising from the reinvestment of dividends in additional shares under a DRIP, provided that the amount paid for the additional shares is not less than 95% of their fair market value. However, this administrative practice will not be applied in respect of a benefit arising from the acquisition by a shareholder of additional shares of the corporation for an amount that is less than their fair market value pursuant to an Optional Purchase component of a DRIP.

Silicon Graphics Ltd. v. The Queen, 2002 DTC 7112; [2002] 3 CTC 527 (FCA)

Alias Research Inc., a predecessor of the taxpayer, claimed enhanced SR&ED benefits under subsection

127(10.1) and section 127.1 in its 1992 and 1993 taxation years. During those years, the common shares of Alias were publicly traded on the NASDAQ exchange in the United States. The common shares were widely-held and more than 50% of those shares were owned by non-residents. Alias’ principal place of business was in Toronto, and a majority of the board of directors and the entire management team were residents of Canada. The management team annually prepared a slate of people to be elected to the board, which was always accepted by the shareholders.

In December 1991, Silicon Graphics Ltd., a U.S. public corporation, agreed to advance up to \$5 million to Alias in consideration of a security interest in Alias’ assets and the issuance of warrants to acquire common shares of Alias. The loan was outstanding for seven weeks, during which time Silicon Graphics Ltd. approved daily cash forecasts and determined which creditors of Alias would be paid. Silicon Graphics Ltd. also made financial contributions to Alias for software development and marketing. Certain directors and officers of Alias were formerly associated with Silicon Graphics Ltd. and Alias software only operated on hardware of Silicon Graphics Ltd.

The issue before the Tax Court of Canada was whether Alias was “controlled, directly or indirectly in any manner whatever, by one or more non-resident persons” within the meaning of the “Canadian-controlled private corporation” (CCPC) definition in subsection 125(7) and the extended meaning of control in subsection 256(5.1). The Tax Court of Canada concluded that the non-resident shareholders had *de jure* control of Alias because they held the simple majority of voting shares, notwithstanding that there was no common connection between them. Because of this finding, the Tax Court of Canada found it was unnecessary to consider whether non-residents had *de facto* control of Alias.

Silicon Graphics Ltd. appealed to the Federal Court of Appeal. On the issue of *de jure* control, the Federal Court of Appeal equated the phrase “control by one or more persons” in the CCPC definition with the phrase “control by a person or group of persons”, and, based on prior case law, agreed with Silicon Graphics Ltd. that in order for a group of persons to be in a position to exercise *de jure* control, a common connection must exist between the shareholders. As there was no evidence of a common connection, the Federal Court of Appeal overturned the Tax Court of Canada’s decision. In reaching its conclusion, the Federal Court of Appeal referred to the 1998 legislative amendment to the CCPC

definition, adding paragraph (b) of the CCPC definition, prior positions taken by the CCRA on control by groups and the policy underlying tax advantages given to CCPCs.

With respect to the second issue, the Federal Court of Appeal stated that in order for there to be finding of *de facto* control, “. . . a person or group of persons must have a clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.” In the Federal Court of Appeal’s view, there was no evidence to show that Silicon Graphics Ltd. satisfied those criteria. Instead, the Federal Court of Appeal found that *de facto* control remained in Canada.

Question 1

In the Revenue Canada Forum at the 1994 Canadian Tax Foundation conference, the CCRA expressed the view that since the CCPC definition in subsection 125(7) did not refer to control by a “group of persons”, it was meant to mean ownership of that number of shares that would constitute control⁸. Contrary to this position, in *Silicon Graphics Ltd.*, the Federal Court of Appeal took the position that the reference to “one or more” in the CCPC definition essentially meant “group of persons”, and therefore, there must be a common connection between the non-resident shareholders in order for them to have *de jure* control.

Does the CCRA accept the Federal Court of Appeal’s findings, and if so, what are the implications?

Response 1

Yes. We accept the findings on this issue and have not sought leave to appeal to the Supreme Court of Canada. In the context of the CCPC definition, the findings are largely of historical interest given that paragraph (b) of the CCPC definition would apply, for years after 1995, to deny CCPC status in widely-held situations, such as that which existed in *Silicon Graphics Ltd.*

Question 2

Will the CCRA interpret control by “one or more persons”, as used in other sections of the Act, to mean “group of persons” in accordance with *Silicon Graphics Ltd.*? For instance, this wording appears in paragraphs 83(2.2)(c) and (d) and paragraphs 83(2.4)(c) and (d),

relating to capital dividends, and in the following definitions: “capital dividend account” and “private corporation” in subsection 89(1), “financial institution” in subsection 142.2(1), “restricted financial institution” and “term preferred share” in subsection 248(1) and “eligible corporation” in subsection 5100(1) of the *Income Tax Regulations*.

Response 2

Yes. There is no basis for limiting the findings in *Silicon Graphics Ltd.* on this issue to the CCPC definition.

Question 3

Have there been any other developments regarding the interpretation of the CCPC definition in subsection 125(7)?

Response 3

Yes. There is one new development regarding the application of paragraph (b) of the CCPC definition to multi-tiered corporate structures similar to that which existed in *Parthenon Investments Ltd. v. The Queen*⁹. Recall that in *Parthenon*, the Federal Court of Appeal held that control meant ultimate control, with the result that CCPC status was not denied to the corporation at the bottom of the corporate chain by reason of the interposition of a non-resident corporation in the middle of the corporate chain, when ultimate control lay with a Canadian resident at the top of the corporate chain. For taxation years that begin after November 1999, subsections 256(6.1) and (6.2) apply to override the position taken by the Federal Court of Appeal in *Parthenon*.

The *Parthenon* case only dealt with the application of what is now paragraph (a) of the CCPC definition. The CCRA is of the view, however, that paragraph (b) of the CCPC definition would apply to deny CCPC status in factual situations similar to that which existed in *Parthenon* for years after 1995. Paragraph (b) requires shares, not only of the corporation in question, but those of all corporations, owned by a non-resident person, a public corporation (other than a prescribed venture capital corporation), or a corporation described in paragraph (c) of the CCPC definition, to be attributed to a hypothetical person. If the hypothetical person would directly or indirectly control the corporation in question, the latter would not be a CCPC.

For illustrative purposes, consider the following scenario: Canco1 is a Canadian corporation that is

⁸ See also Issue No. 3 of the *Income Tax Technical News*, dated January 30, 1995.

⁹ 97 DTC 5343; [1997] 3 CTC 152 (FCA).

controlled by a Canadian resident. Canco1 owns more than 50% of the voting shares of Pubco, a Canadian public corporation, which in turn owns more than 50% of the voting shares of Canco2, a Canadian corporation. In determining Canco2's status as a CCPC, in the CCRA's view, paragraph (b) would apply to attribute the shares of Canco2 held by Pubco to a hypothetical person. Because this hypothetical person would then directly control Canco2, CCPC status would be denied notwithstanding the fact that ultimate control of Canco2 lay with a Canadian resident. As noted above, paragraph (b) will also apply if control by the hypothetical person is indirect. This would arise if, instead of owning the shares of Canco2 directly, Pubco owned 100% of the voting shares of Holdco, a Canadian corporation, which in turn owned more than 50% of the voting shares of Canco2. In this case, Canco2 would not be a CCPC because paragraph (b) would apply to attribute the shares of Holdco to the hypothetical person, who would then have indirect control of Canco2.

Question 4

The Federal Court of Appeal set out circumstances in which a person or group of persons would be considered to have *de facto* control. These circumstances are narrower in scope than those set out by the CCRA in ¶ 21 of Interpretation Bulletin IT-64R4, *Corporations: Association and Control*, dated August 14, 2001. How does this decision affect these views?

Response 4

The CCRA is not presently considering any change to the criteria contained in ¶ 21 of Interpretation Bulletin IT-64R4 as a result of the *Silicon Graphics* decision. There are two cases involving the application of subsection 256(5.1) that have been appealed to the Federal Court of Appeal: *Mimetix Pharmaceuticals Inc. v. The Queen* and *Rosario Poirier Inc. v. The Queen*¹⁰. The CCRA is of the view that the Tax Court of Canada decision in *Mimetix*¹¹ seems to suggest that the circumstances in which *de facto* control may arise may not be as narrow as those set out in *Silicon Graphics*. For instance, it is noted that the Tax Court of Canada in *Mimetix* found that a non-resident shareholder had *de facto* control of the appellant in part because the non-resident shareholder exercised the powers of the appellant's board of directors, which is not a situation cited by the Federal Court of Appeal in *Silicon Graphics*. Given the uncertainty surrounding the scope

of *de facto* control, the CCRA intends to wait for the Federal Court of Appeal's decisions in *Mimetix* and *Rosario Poirier* prior to considering whether any change is necessary to our position on *de facto* control in Interpretation Bulletin IT-64R4.

Partnership Issues

Background

In broad terms, the *Income Tax Act* (the "Act") is structured to tax the income of individuals, corporations and trusts. The Act provides for definitions for each of these terms.

Unlike the above-mentioned terms, a "partnership" is not defined in the Act. Moreover, in general, a partnership is not considered a "person" for purposes of the Act notwithstanding the fact that certain provisions in the Act refer to a "person" to include a partnership.

It is a question of fact and law as to whether a partnership exists. The Courts¹² have now established the following general criteria (which is based on the definition of partnership under the relevant provincial law) when determining whether a partnership exists:

- there must be a business;
- this business must be carried on by 2 or more persons;
- there must be a view to profit.

Once it is established that a partnership does exist, subsection 96(1) of the Act generally provides that a partnership is a "flow-through" entity, with income computed at the partnership level (as if the partnership is a separate person) and allocated to the members of the partnership. Each member of a partnership, in turn, reports and pays tax on their proportionate share of such income. The sources of income retain their character when flowed from the partnership to the members of the partnership.

Question 1

The CCRA's position provides that a partnership is a contractual relation between persons and therefore not a legal entity. In recent years, legislation has been established in the US [such as the *Delaware Revised*

¹⁰ Court file No. A-63-02 and Court file No. A-378-02, respectively.

¹¹ 2001 DTC 1026; [2002] 1 CTC 2188 (TCC).

¹² See the Supreme Court of Canada decisions in *Continental Bank Leasing Corporation v. The Queen* (98 DTC 6505; [1998] 4 CTC 119), *Spire Freezers Ltd v. The Queen* (2001 DTC 5158; [2001] 2 CTC 40) and *Backman v. The Queen* (201 DTC 5149; [2001] 2 CTC 11). More recently, *Stanley Witkin v. The Queen* (2002 DTC 7044; [2002] 3 CTC 184) reinforced the criteria established in the foregoing cases.

Uniform Partnership Act (DRUPA)] to allow the creation of “partnerships” that are separate legal entities. This appears to contradict the CCRA’s position. Can you provide any comments with respect to this matter?

Response 1

The CCRA announced in the June 14, 2001 *Income Tax Technical News* (No. 20) that it is its view that generally the attributes of an entity formed under the DRUPA and carrying on business in common with a view to a profit more closely resemble those of a Canadian general partnership under our common law. This approach has been followed by the Courts, in particular, *Backman*, *Spire Freezers*, and *Continental Bank*.

Question 2

Under provincial partnership laws, partnerships must have a “view to profit”. Under DRUPA, legal entities may be created for non-profit purposes. Would these DRUPA entities be partnerships for Canadian purposes?

Response 2

No. It is the CCRA’s view that entities governed by the DRUPA that are not created to carry on business with a view to a profit under common law principles would not resemble Canadian partnerships. Consequently, such entities would not be considered partnerships for the purposes of the Act.

We have received requests with respect to the determination of the Canadian tax status of foreign partnerships formed in other jurisdictions. The determination of whether a partnership exists for Canadian tax purposes is a matter of common or civil law and can only be made in the context of an advance tax ruling request.

Question 3

Similarly, legislation in the U.S. allows for the creation of Limited Liability Companies (LLCs), to operate as separate legal entities and allows business profits (or losses) to be allocated and taxed in the hands of the members.

What is the CCRA position with respect to these entities?

Response 3

The CCRA has reviewed the provisions of the legislation with respect to LLCs in some States. Based on the review, it is generally the CCRA’s position that an LLC is considered a corporation for Canadian tax purposes.

Question 4

One of the criteria of a “partnership” is that the particular business is carried on with “a view to a profit”. Does the CCRA consider this to mean a “reasonable expectation of profit” (REOP) as established in *Moldovan*?

Response 4

No. The “view to a profit” test that determines if a partnership exists is a common or civil law issue, while the REOP test is a determination of whether there is a business or source test under the *Income Tax Act*. The Courts have established that in order for a partnership to exist, there must be a “relation between persons carrying on a business in common with a view to a profit”. The Courts have established that this test is different from the more difficult REOP test. Whether there exists a “view to a profit” requires an inquiry into the intentions of the parties entering into the alleged partnership. This determination is generally a finding of fact and law for each particular case.

Question 5

Now moving away from the issue of whether a partnership exists and to the computation of income for a partnership.

Interpretation Bulletin IT-138R provided an example with respect to a partnership agreement that provides for the allocation of an annual salary paid to one partner, after which the partners divide the income (or loss) of the partnership.

This position appears to contradict recent comments made in a recent CCRA technical interpretation.

Can you clarify the CCRA’s position with respect to a “salary” paid to an individual partner?

Response 5

The CCRA is of the view that salaries paid to individual partners are not deductible in computing the partnership’s income for income tax purposes. This concept is an extension of the general criteria established under the provincial Partnerships Acts. As an example, section 24, paragraph 6 of the *Partnership Act* of Ontario specifically states “no partner is entitled to remuneration for acting in the partnership business.” Consequently, any amounts paid and deducted as such in the financial statements of the partnership as such must be added back when computing partnership income.

The CCRA wishes to clarify that Interpretation Bulletin IT-138R has been withdrawn in 2000 since much of the information it contained was out of date. Information

with respect to the computation of income for partnerships can be found in the *Guide for the Partnership Information Return (T4068)*.

Question 6

The next question deals with the “partnership interest”.

A limited partnership may issue different units of the partnership. Does the CCRA accept that the ACB of the different partnership units be computed separately, in the same manner that one computes the ACB of shares they hold in a corporation (preferred, common)?

Response 6

No. It is the CCRA position that a taxpayer’s interest in a limited partnership is considered **one capital property**. Consequently, in a disposition one would compute the ACB of the partnership interest as the aggregate of the units. In a partial disposition, the ACB of the partial interest disposed would be determined pursuant to subsection 43(1) of the Act.

The Joint Committee on Taxation of
The Canadian Bar Association
and The Canadian Institute of
Chartered Accountants

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September 12, 2005

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Dear Mr. Jolie:

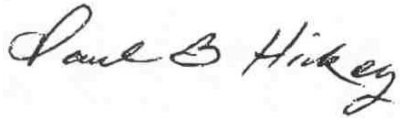
Draft IT-85R3 – Health & Welfare Trusts

We are pleased to provide you with our comments on draft Interpretation Bulletin IT-85R3 relating to health & welfare trusts. We trust that you will find our comments and recommendations helpful.

Our submission identifies a number of concerns with the draft IT. The principal concern is with the CRA's application of the prepaid expense rule in subsection 18(9) of the *Income Tax Act*. It appears to us that the application of this rule is based on a fundamental misunderstanding of the nature of insurance. The CRA's view, as we understand it, is that insurance is considered to be provided when benefits are paid. The correct view, we submit, is that insurance is considered to be provided in respect of a period if an event occurring in the period would give rise to an entitlement to benefits. The submission explains this in detail.

We would be pleased to meet with you and your colleagues to discuss any of the concerns raised in the submission. We would also be pleased to assist in revisions to the draft IT. Should you wish us to do so, please contact Bill Holmes at 604.402.4224 or holmes@thor.ca.

Yours truly,



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**Submission of the
CICA-CBA Joint Committee on Taxation
Regarding
Draft Interpretation Bulletin IT-85R3**

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**Submission of the
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Regarding
Draft Interpretation Bulletin IT-85R3**

A. Use of Term “Health and Welfare Trust”

Draft Interpretation Bulletin IT-85R3 (the “Draft IT”) uses the term “health and welfare trust” in two different ways. Paragraph 1 states that a health and welfare trust is any trust arrangement used in administering an employer’s health and welfare benefits under the specified types of plans and policies. On the other hand, paragraph 8 sets out the conditions that must be met for a trust to qualify as a health and welfare trust for purposes of the bulletin. The Summary uses the term with both meanings. The use of the term “health and welfare trust” with two different meanings leads to some confusion.

Recommendation:

We recommend that the term “health and welfare trust” be limited to trusts to which the bulletin is intended to apply. Those places in which the term is used with a broader meaning should be revised to avoid this confusion.

B. Tax Implications to Employer

We have several concerns with the discussion in paragraphs 10 to 13 of the Draft IT.

Terminology

Plans are characterized in paragraphs 10 to 12 as “self-insured plans” and “insured plans”. While unclear, it appears that the first term is used to refer to an arrangement under which the health and welfare trust has the obligation to make the benefit payments itself, and the second term to an arrangement under which the benefits are provided by an insurance company pursuant to a group insurance contract acquired by the trustees of the health and welfare trust.

Normally, a reference to a “self-insured plan” would mean that the employer itself has a direct liability to pay the plan benefits. If that is the intended meaning, then the use of this term would be inappropriate for many uninsured health and welfare arrangements. Health and welfare trusts are often established to provide benefits to all employees in a particular industry in a specific region. Employers generally contribute to such trusts pursuant to collective bargaining agreements, and there may be a large number of employers who contribute. The employers in such a multi-employer arrangement have no direct liability to pay any of the health and welfare benefits. Thus, it would not be appropriate to refer to such arrangements as “self-insured” in the sense just described.

Furthermore, some arrangements involve hybrid approaches: one or more benefits are provided under insurance contracts, and the remaining benefits are provided directly by the trust. It would clarify the discussion to explain what is meant by “self-insured”, or to use a different term, and also to recognize the use of hybrid approaches.

A further point regarding terminology concerns the reference in paragraph 11 to a pay-as-you-go plan. The term “pay-as-you-go” is used to describe benefit arrangements, primarily certain pension and long-term disability plans, under which no funds are set aside to pay benefits that have accrued. Thus, this term is not synonymous with “self-insured”, if self-insured is used to mean that a health and welfare trust is directly liable to pay benefits. Benefits provided directly by a health and welfare trust could be funded. We suggest that this reference to “pay-as-you-go” be deleted.

Statement Regarding Funding

Paragraph 10 states that “an employer will normally be required to fund a H&WT with an amount that is equal to the current year’s cost of providing health and welfare benefits” plus administrative costs. The purpose of this statement is unclear. It does not appear to be intended to impose a condition for a trust to qualify as a health and welfare trust (the conditions are imposed by paragraph 8). Rather, it seems to be an observation on what happens in practice. If so, it is probably not an accurate description for many trusts. Employers contributing to multi-employer health and welfare trusts are often required to contribute a negotiated amount expressed on a cents per hour basis (that is, the employer’s contributions are determined by multiplying the number of hours worked by employees in each time period by a rate per hour).

We suggest that this statement be deleted. The last sentence of the paragraph (funding to pay benefits in future years) also seems to be an observation on what happens in practice, and so we suggest that it be deleted as well.

Linking Deductions to Benefits Paid

Our principal concern is with the position taken in paragraph 11 regarding the timing of the deduction of employer contributions. The CRA’s view is that contributions made in an employer’s taxation year are deductible only to the extent that the contributions are made to fund benefits that may reasonably be expected to be paid out in the year, plus administrative costs. (The paragraph is confusing because the first sentence expresses a different position: it states that contributions are deductible when incurred. Given the remainder of the paragraph, we have assumed that this is not the intended position.) The basis stated by the CRA for its view is that contributions made in a year in excess of these amounts are regarded as consideration for insurance in respect of a period after the end of the year, and so the deduction of such contributions is prohibited by paragraph 18(9)(a) of the Income Tax Act (the “Act”).

We submit that the CRA's view as to the application of paragraph 18(9)(a) is based on a fundamental misunderstanding of the nature of insurance. Insurance consists of an undertaking to make payments on the occurrence of specified events. Insurance coverage for a particular period is an undertaking to pay insurance proceeds if any of the specified events occurs in the period. To say that insurance is in respect of a period (the language used in subparagraph 18(9)(a)(iii)) means that insurance proceeds will be payable if an insured event occurs in that period.

Assume that a health and welfare trust provides medical and dental insurance benefits to the employees of an employer, and that the employer's taxation year is the calendar year. As with all such insurance, employees become entitled to insurance proceeds upon incurring qualified medical or dental expenses. Qualified expenses incurred, for example, in 2005 will result in the payment of insurance proceeds because insurance is provided in respect of 2005. Hence, no portion of the contributions made to the trust by the employer in 2005 to fund the claims arising from qualified expenses incurred in 2005 constitutes a prepaid expense. The contributions are solely for insurance in respect of 2005. Contrary to the view expressed by the CRA, the fact that particular claims may not be paid until 2006 does not alter the timing of the insurance. In other words, it is completely irrelevant to the application of subparagraph 18(9)(a)(iii) when insurance proceeds are actually paid.

The CRA's position regarding the application of the prepaid expense rule in subsection 18(9) is particularly problematic for long-term disability (LTD) benefits, in view of the fact that benefit payments may be made over many years. According to the CRA, employers can deduct contributions made to a health and welfare trust in a particular year to fund an LTD plan only to the extent that the contributions are expected to be used to pay LTD benefits in the year. As we have explained above, the application of the prepaid expense rule to produce this result seems to be based on a misunderstanding of insurance. The event in respect of which the LTD insurance is provided is the incurral of a disability. This is the event that results in the obligation to make benefit payments. If a disability occurs in 2005, for example, benefits are payable because insurance coverage has been provided in respect of 2005. Thus, there is no element of prepaid insurance if an employer makes contributions to fund the full amount of benefit payments expected to be made as a result of disabilities occurring in 2005.

This may be easier to see by considering LTD insurance provided by an insurer. Assume that an employer acquires a group insurance policy under which the insurer provides LTD insurance to the employer's employees. If an employee becomes disabled in the first policy year, the insurer will be obligated to make payments to that employee for the duration of the disability (or to a maximum age), regardless of whether the employer renews the policy at the end of the first year. Hence, the insurer will require the employer to pay sufficient premiums in the first year so that, on an actuarial basis, the premiums are expected to be sufficient to pay all claims in respect of disabilities occurring in that year (plus the insurer's administrative costs and a profit margin). Clearly, in paying the premiums for the first year, the employer is buying insurance for that one year, i.e. insurance in respect of the year. The fact that disability payments will

be made in subsequent years does not alter this. The same is true of the premiums paid for each subsequent year.

We see no substantive difference between contributions made by an employer to a health and welfare trust in respect of LTD insurance for its employees, and premiums paid by the employer under an LTD insurance policy. Contributions made in a year to a health and welfare trust to fund the benefits payable from the trust as a result of disabilities occurring in the year are made to acquire insurance on a current basis, not to acquire insurance for future years, just as no portion of the premiums paid to an insurer in a year for LTD insurance in respect of the year represents the prepayment of insurance coverage.

Another way to see why subsection 18(9) should not have application is to compare the situation where a health and welfare trust provides the LTD insurance directly (i.e., the trust has the obligation to make LTD payments) with the situation where a health and welfare trust acquires an insurance policy under which the LTD insurance is provided. In this latter situation, paragraph 12 of the Draft IT implicitly recognizes that no part of the contributions payable by employers in a year to a health and welfare trust to enable the trustees to pay premiums for the year under an LTD policy would be regarded as a prepaid expense. The only difference between the two situations is in who is liable to make the benefit payments – the trust or an insurance company. It cannot possibly make any difference to the application of the prepaid expense rules whether the insurance is provided directly by the trust or under an insurance policy acquired by the trust. From the perspective of employers, in both cases contributions are made to acquire the same insurance for their employees.

Actuarial Reserves

It is unclear what sorts of reserves are contemplated by paragraph 13. We think this paragraph is intended to describe the amounts that a health and welfare trust must have on hand at the end of a fiscal year in order to pay claims that have been incurred before the end of the year. For example, if dental benefits are provided by a health and welfare trust, the reserve in respect of such benefits would equal the sum of the claims that have been reported to the end of the year but not paid (the “unpaid claims reserve”) and the claims incurred in the year that have not been reported by the end of the year (the “incurred but not reported reserve”). These reserves would be relatively small in relation to the annual contributions to fund the dental benefits. If LTD benefits are provided through a health and welfare trust, the primary reserve at the end of a year would be the disabled life reserve, which is the present value of benefits to be paid in the future to employees who have become disabled before the end of the year and whose disabilities have been reported to the trustees. The total amount of this reserve for all disabled lives (i.e., those who have become disabled in the current year and those who have become disabled in previous years) could be substantial relative to the annual cost of the disability coverage. There would also be a much smaller reserve in respect of benefits payable to those who may have become disabled before the end of the year but have not reported their disabilities (referred to as an incurred but not reported reserve).

Assuming that our understanding of the reserves contemplated by paragraph 13 is correct, then we take issue with the assertion in the paragraph that contributions to fund the reserves are made for insurance in respect of future periods, and hence the deduction of such contributions is prohibited by the prepaid expense rule. Where benefits are payable in the future because of events that have occurred, the insurance has already been provided. What remains is for the trust to pay the benefits to which employees have become entitled and which the trust has become obligated to pay. The payment of the benefits does not constitute the provision of insurance. Thus, contributions to fund such reserves would not be regarded as amounts paid in respect of insurance for a future period. This point is closely related to the discussion of the position taken in paragraph 11 of the Draft IT regarding the deduction of contributions.

It is possible that something else is intended by the references to “reserves” in paragraph 13. If so, then this should be clarified. In this case, whether the prepaid expense rule could apply depends on the types of “reserves” the CRA has in mind.

Administrative Costs

In referring to contributions made to a health and welfare trust, paragraphs 10, 11 and 12 mention the administrative costs of the employer. It is unclear why such costs are mentioned. An employer would normally pay its administrative costs directly, and would not be reimbursed by the trust. We recommend that it be clarified why such costs are mentioned or, alternatively, that the references be deleted.

Recommendations:

We urge the CRA to reconsider its position on the application of subsection 18(9). The position reflected in the Draft IT is, we submit, based on a confusion between the provision of insurance and the payment of insurance proceeds.

In addition, we recommend that the changes suggested above be made to paragraphs 11 to 13 of the Draft IT.

C. Surplus

With respect to subparagraph 8(c), it is not apparent why the conditions for a trust to qualify as a health and welfare trust include a condition regarding surplus. As discussed in section D of this submission, status of a trust as a health and welfare trust is irrelevant in determining whether contributions to the trust are deductible. Furthermore, investment income earned by a health and welfare trust is subject to tax, either in the trust or, if the income is used on a current basis to pay benefits, in the hands of the beneficiaries. Thus, we request that the CRA reconsider whether there is any reason for imposing a condition with respect to surplus.

If the CRA concludes that it is necessary to retain a condition regarding surplus, then we have several concerns with the condition contained in the Draft IT. A general concern is that the condition is so vague that it will frequently be impossible to determine whether it is satisfied. Thus, it does not provide adequate guidance regarding the CRA's administrative position.

One specific concern is with the discussion of "temporary" and "permanent" surplus. It is unclear to us which, if any, surpluses are to be regarded as permanent surpluses. Moreover, it is unclear what difference it makes whether a surplus is regarded as permanent or temporary. The CRA's position appears to be that steps must be taken to eliminate both types of surpluses within a reasonable period of time.

Another specific concern is that the concept of surplus is undefined. Thus, it is unclear what the CRA regards as a surplus. While paragraph 13 of the Draft IT provides some assistance, in that it states that a reserve to meet future obligations would not be considered a surplus¹, the problem is that there is not a positive statement as to what the term "surplus" is intended to mean. Since health and welfare trusts provide insurance, we suggest that surplus be defined in an appropriate manner for insurance. Also, since surplus is a balance sheet concept, it should be defined at the end of a fiscal year. We propose that the surplus of a health and welfare trust at the end of a year be defined as the amount, if any, by which the trust's assets at the end of the year (excluding any amounts received by the trust as contributions for insurance for the first part of the following year) exceed the actuarial liabilities of the trust, determined at the end of the year, in respect of claims that have arisen before the end of the year. For this purpose, actuarial liabilities may be determined with a reasonable margin for adverse experience (i.e., to allow for the fact that amounts actually paid may exceed the estimated amounts to be paid). We suspect that this definition is close to what the CRA has in mind in using the term "surplus".

A further concern is that subparagraph 8(c) does not take into account the fact that claims can fluctuate from year to year. This is particularly so for long-term disability coverage, since the incidence of the occurrence of disability is low while the magnitude of individual claims (the present value of benefits to be paid) can be quite large. Where an insurer provides insurance on an experience-rated basis (i.e., the employer or other policyholder bears some or all of the financial risk of the insurance), the insurer will often maintain "claims fluctuation reserves" to protect against year-to-year variations in claims. Health and welfare trusts should be permitted to establish similar reserves, which would be treated like actuarial liabilities in determining if there is a surplus. In making this proposal, we are assuming that the types of reserves referred to in paragraph 13 of the Draft IT would not include claims fluctuation reserves. If this assumption is wrong, then it needs to be clarified in the bulletin that such reserves are acceptable in determining surplus.

¹ Paragraph 13 of the Draft IT actually states that a *contribution* in respect of such reserves is not considered to be a surplus. However, surplus is a balance sheet concept, whereas contributions are an income statement concept (although contributions are not income for tax purposes). We have assumed that it is intended to refer to the reserves themselves.

It seems to be expected in subparagraph 8(c) that action will be taken fairly promptly to eliminate a surplus. However, this is not realistic for many multi-employer health and welfare trusts. Often, the contributions to these trusts are negotiated as part of collective bargaining, and cannot be easily changed between rounds of bargaining. Nor is it appropriate to adjust benefits from year to year. Once new or enhanced benefits are introduced, from a practical perspective they cannot be withdrawn. Even with non-bargained trusts, it will often not be easy to take steps in the short term to eliminate a surplus. If the CRA accepts our proposal to allow claims fluctuation reserves, this would alleviate our concern to some extent. However, it would not eliminate it entirely. One solution would be to exempt multi-employer health and welfare trusts (or a suitable class of such trusts) from any surplus condition. In general, there is a constraint on contributions to such trusts, since employers do not want to contribute any more than is required, and so the CRA should not have any concern with surplus in such trusts.

A final concern we have with the condition regarding surpluses imposed by subparagraph 8(c) is that the subparagraph mixes observations of what happens in practice with statements regarding what must happen in order for a trust to be regarded by the CRA as a health and welfare trust. For example, the comment regarding contributions possibly having to increase if a deficit exists appears to have nothing to do with qualification as a health and welfare trust. The statement that “temporary surpluses” are usually eliminated within one year also seems to be an observation on what happens in practice (and, as such, is probably incorrect). It would be much clearer what conditions are being imposed by the CRA if subparagraph 8(c) were limited to those conditions, and did not also include observations on how the CRA thinks that health and welfare trusts actually operate.

Recommendation:

We recommend that the condition regarding surplus be eliminated, preferably for all health and welfare trusts but at the very least for multi-employer trusts or a suitable class of such trusts. If the condition is retained for any health and welfare trusts, it should be revised to address the concerns identified above with respect to the determination of whether there is a surplus. We are not making any recommendation at this time as to the exact form the condition should take, since we would first need to find out from the CRA why there is a need for the condition.

D. Loss of Status as Health and Welfare Trust

Subparagraph 8(c) of the Draft IT states that where a health and welfare trust loses its status as such, all contributions to the former health and welfare trust will be treated as non-deductible capital contributions to the trust. We submit that this would generally not be the result under the law. Contributions which an employer is required to make to a trust to fund benefits in respect of services rendered by its employees are current business expenses, not capital outlays. They are analogous to premiums paid to an insurer to provide health and welfare benefits to its employees under a group insurance policy. Thus, such contributions would be deductible as business expenses whether or not the trust is regarded by the CRA as a health and welfare trust.

Recommendation:

We recommend that the statement regarding the deductibility of contributions if a trust ceases to be a “health and welfare trust” be deleted. Alternatively, the statement could be revised to accurately reflect the law, in which case we suggest that it be moved to a more logical position in the bulletin. It does not seem appropriate to discuss, in the context of a condition on surplus, the tax treatment of contributions made to a trust that is not regarded as a health and welfare trust.

E. Miscellaneous Comments

The following are further comments arising from our review of the Draft IT:

1. The last bullet of the Summary states that the bulletin discusses “[t]he procedures to be followed in setting up a health and welfare trust”. This is not something discussed in the bulletin, nor in our view would it be an appropriate topic for the bulletin. Thus, we suggest that this bullet be deleted.
2. Paragraph 2 of the Draft IT states that a reference to a “group sickness or accident insurance plan” includes the three types of insurance plans described in paragraph 6(1)(f) of the Income Tax Act. It then goes on to state that “a ‘group sickness or accident insurance plan’ may also be referred to as a group disability insurance plan or a group income maintenance insurance plan that is not a ‘supplementary unemployment benefit plan’”. It is unclear what is meant by this latter statement. We suggest that it be deleted or clarified. Also, the term “group sickness or accident insurance plan” has a broader meaning than just those plans listed in paragraph 6(1)(f) of the Act. We suggest that a statement to this effect be made in paragraph 2. Paragraph 15 of the Draft IT may also need to be revised, since it assumes that the only type of group sickness or accident insurance plan is one that provides wage loss replacement benefits.

3. Paragraph 6 of the Draft IT contemplates the situation where part of a particular plan is a plan referred to in paragraph 1 of the Draft IT, and another part is an employee benefit plan or employee trust. It states that, as long as there is separate accounting for the two parts, the part that is a plan referred to in paragraph 1 will not be treated as an employee benefit plan or trust. In practice, it is more likely that the issue will arise where two or more distinct plans are funded through the same trust, rather than one plan with multiple parts. We suggest that it be clarified that the position taken in paragraph 6 also applies in the case of multiple plans.
4. Paragraph 7 of the Draft IT makes statements that do not appear to be requirements that must be met for a trust to qualify as a health and welfare trust, but rather are observations on the characteristics of some health and welfare trusts (composition of trustees; benefits agreed to by the employer and the employees). We have a similar concern with this paragraph as expressed above with respect to subparagraph 8(c). We find it confusing to include such observations in the bulletin. We recommend that these observations be deleted from paragraph 7.
5. Subparagraph 8(e) of the Draft IT refers to “situations where the beneficiaries of the trust have no claims against the trustees or the fund, except by or through the employer”. We do not think that the courts would give effect to any provision that sought to prevent the beneficiaries of a trust from enforcing their rights against the trustee. Thus, the situation contemplated by this reference should never arise. For this reason, we are wondering whether the CRA actually has something else in mind.
6. In paragraph 15 of the Draft IT under the heading “Group Term Life Insurance Policies”, the first sentence of subparagraph (b) makes a statement that appears to be irrelevant to the determination of the tax consequences to an employee. It notes that the disposition of an interest in a life insurance policy can result in an income inclusion to the policyholder. Since employees are not policyholders of policies held by health and welfare trusts, it is not apparent why this statement is made. It does not seem to have any relevance to the statement that follows, that a lump sum payment made to an employee’s estate or named beneficiary is not included in income. The same comment applies to subparagraph 15(c), which comments on the life insurance accrual rules in subsection 12.2(1) of the Act. These rules apply to policyholders, and so also seem irrelevant in determining the tax consequences to employees.
7. Subparagraph (e) under the heading “Group Term Life Insurance Policies” in paragraph 15 provides only half the picture regarding the tax treatment of settlement option annuities. It refers to the inclusion of payments in income pursuant to paragraph 56(1)(d) of the Act, but not to the deduction of the capital amount under paragraph 60(a). A further problem is that the interrelationship between subsection 12.2(1) and paragraph 56(1)(d) is misdescribed. The way double taxation is avoided is by excluding from the application of paragraph 56(1)(d) any annuity contract to which subsection 12.2(1)(d) applies. As an

alternative to revising this subparagraph, we suggest that the CRA consider deleting any discussion of settlement annuities, since they are not something that is unique to health and welfare trusts. They can also arise in connection with employer-owned group term life insurance policies.

8. Paragraph 16 of the Draft IT (Shared Contributions) makes a general statement that if a taxable benefit is being paid, in part, out of employee contributions, a pro-rated portion of the benefit will be non-taxable. This statement is confusing. As is made clear in the next paragraph, it does not apply to paragraph 6(1)(f) benefits. Thus, the only taxable benefit to which it could apply is group term life insurance. It would be much clearer if the statement referred specifically to this benefit. We submit that it would also help clarify paragraph 16 if it referred to the benefit as consisting of the provision of the life insurance coverage. Lastly, the position in this paragraph conflicts with the rules in Part XXVII of the Income Tax Regulations for determining taxable benefits in respect of group term life insurance. We recommend that paragraph 16 state that any employee contributions towards group term life insurance will be taken into account in determining the amount of the taxable benefit as provided by the rules in Part XXVII of the Regulations.
9. Another issue with paragraph 16 of the Draft IT is that it incorrectly describes the application of paragraph 6(1)(f) of the Act in a shared-cost situation. Paragraph 16 states that “the entire amount received by an employee must be included in income in the year received”, whereas paragraph 6(1)(f) reduces the benefit by the amount of employee contributions.

Income Tax Interpretation Bulletin

Wage Loss Replacement Plans

NO: **IT-428**

DATE: April 30, 1979

SUBJECT: INCOME TAX ACT
Wage Loss Replacement Plans

REFERENCE: Paragraph 6(1)(f) (also paragraph 6(1)(a) and section 19 of the Income Tax Application Rules, 1971)

1. Paragraph 6(1)(f) provides that, for 1972 and subsequent taxation years, amounts received on a periodic basis by an employee or an ex-employee as compensation for loss of income from an office or employment, that were payable under a sickness, accident, disability or income maintenance insurance plan (in this bulletin referred to as a "wage loss replacement plan") to which the employer made a contribution, are to be included in income, but subject to a reduction as specified in that paragraph for contributions made by the employee to the plan after 1967. Before 1972, such amounts received by a taxpayer were not included in income.

2. Paragraph 6(1)(f) does not apply to a self-employed person inasmuch as any amount received by such person in the way of an income maintenance payment would not be compensation for loss of income from an office or employment. With regard to "overhead expense insurance" and "income insurance" of a self-employed person, see Interpretation Bulletin IT-223.

Exemption for Plans Established before June 19, 1971

3. Transitional provisions in section 19 of the Income Tax Application Rules, 1971 stipulate that amounts that would otherwise be included in income under paragraph 6(1)(f) are to be excluded if they were received pursuant to a plan that existed on June 18, 1971 and were in consequence of an event that occurred prior to 1974. Comments on these transitional provisions, particularly with regard to admissible and non-admissible changes in pre-June 19, 1971 plans, appear in IT-54. It is to be noted that, for 1974 and subsequent taxation years, the exemption in section 19 of the ITAR is applicable only if amounts received by a taxpayer are attributable to an event occurring before 1974. In this context, the word "event" has reference to the thing that caused the disability. In the case of an accident, for example, although the effect on the taxpayer's health may not have become noticeable or serious until 1974 or a later year, the "event" would have occurred before 1974 if the accident took place before 1974 and the later disability was directly attributable to the accident. Similarly, in the case of a degenerative disease such as muscular dystrophy, the "event" is the onset of the disease however much later the incapacity occurs. On the other hand, a recurring disease, such as a seasonal allergy or chronic tonsillitis, would qualify as an "event" only for the particular period of one attack.

4. For an illustration of the calculations involved where both paragraph 6(1)(f) of the Act and section 19 of the ITAR apply to a particular taxpayer, in different taxation years, see 25 below.

Meaning of a "Wage Loss Replacement Plan"

5. In the Department's view, a plan to which paragraph 6(1)(f) applies is any arrangement, however it is styled, between an employer and employees, or between an employer and a group or association of employees, under which provision is made for indemnification of an employee, by means of benefits payable on a periodic basis, if an employee suffers a loss of employment income as a consequence of sickness, maternity or accident. This arrangement may be formal in nature, as evidenced by a contract negotiated between an employer and employees, or it may be informal, arising from an understanding on the part of the employees, that wage loss replacement benefits would be made available to them by the employer. Where the arrangement involves a contract of insurance with an insurance company, the insurance contract becomes part of the plan but does not constitute the plan itself.

6. Where it is apparent that a plan was instituted with the intention or for the purpose of providing wage loss replacement benefits, the assumption will be that it is a plan to which paragraph 6(1)(f) applies unless the contrary can be established. Such a plan will be considered to exist where, for example, payments under the plan are to commence only when sick leave credits are exhausted or where benefits are subject to reduction by the amount of any wages or wage loss replacement benefits payable under other plans. A supplementary unemployment benefit plan, as defined in subsection 145(1), is not considered to be a plan to which paragraph 6(1)(f) applies.

7. A plan for purposes of paragraph 6(1)(f) of the Act and section 19 of the ITAR must be an "insurance" plan. Those provisions are not applicable, therefore, to uninsured employee benefits such as continuing wage or salary payments based on sick leave debits, which payments are included in income under paragraph 6(1)(a). It is to be noted that, while a plan must involve insurance, it is not necessary that there be a contract of insurance with an insurance company. If, however, insurance is not provided by an insurance company, the plan must be one that is based on insurance principles, i.e., funds must be accumulated, normally in the hands of trustees or in a trust account, that are calculated to be sufficient to meet anticipated claims. If the arrangement merely consists of an unfunded contingency reserve on the part of the employer, it would not be an insurance plan.

8. An employer may contribute to separate plans for different classes or groups of employees. For example, there may be one plan for clerical staff and another plan for administrative staff. Each plan will be recognized as a separate plan. In other circumstances, an employer may have one plan that provides for short-term sickness benefits and another plan that provides for long-term disability benefits. Each such plan normally would be considered a separate plan for all purposes but, if desired, they may be treated as one plan provided they comply with the following conditions:

(a) the same classes of employees are entitled to participate in both plans, and

(b) the premiums or other cost of each plan is shared in the same ratio by the employer and the employees.

9. An association of employers, or a health and welfare trust that is organized and managed by or on behalf of both employers and employees in a certain industry, may establish a plan with an insurer that is available to all employer-members. In these circumstances, if there is one insurance contract between the insurer and the association of employers or the health and welfare trust and the contract was entered into after June 19, 1971, there is considered to be one plan. Where employees contribute to the cost of benefits provided by a health and welfare trust, see paragraph 6 of IT-85R regarding the amount that may qualify as an employee's contribution for purposes of subparagraph 6(1)(f)(v). For plans that existed prior to June 19, 1971 see paragraph 7 of IT-54.

10. Where the nature of employment in a particular industry is such that it is usual for employees to change employers frequently (e.g. the construction industry) and the continuity of wage loss replacement benefits can be assured only if such benefits are provided under a plan administered

by a union or a similar association of employees rather than directly by the various employers, the arrangement between the participating employers and the organization representing the employees is viewed as a single wage loss replacement plan.

Lump-sum Payments

11. If a lump-sum payment is made in lieu of periodic payments, that amount will be considered to be income under paragraph 6(1)(f).

12. Some contracts of employment may provide for payment of periodic benefits to employees in respect of loss of income due to disability and may also provide that employees will receive a lump-sum payment on retirement, resignation or death based on the value of unused sick leave credits accumulated under that plan. Even though these separate arrangements may be jointly funded by employer-employee contributions, it is the position of the Department that such lump-sum payments are not a periodic payment under a wage loss replacement plan to which paragraph 6(1)(f) applies but are taxable in the employee's hands by subsections 5(1) and 6(3) as remuneration received by them pursuant to their contract of employment. To the extent that a part of the lump sum payment has been funded by employee contributions not deducted by the employee under subparagraph 6(1)(f)(v) in computing the portion of amounts taxable under paragraph 6(1)(f), the accumulated employee contributions in respect thereof (but not any interest credited thereon) would represent a return of capital to employees and need not be included as part of the taxable lump sum payment.

Employee's Contribution

13. Employee contributions that are deductible under subparagraph 6(1)(f)(v), are restricted to those that were made to the particular plan from which the benefits were received. Thus, if an employee changes employment and becomes a beneficiary under the plans of the new employer, the employee may not deduct the contributions made during the previous employment from benefits received from the new employer's plan. For this purpose, a change in employment is not considered to take place where an unincorporated business is incorporated or where there has been a merger or amalgamation. Also, the continuity of an existing plan is generally not affected by internal alterations in the plan, such as a change in the insurer or an improvement in benefits. However, for purposes of section 19 of ITAR, an increase in benefits after June 18, 1971, in a pre-June 19, 1971 plan may be viewed as the creation of a new plan as indicated in paragraph 4 of IT-54. On the other hand, where an employee, because of a promotion or job reclassification, is moved from one of his employer's plans to another, such as a move from the "general" plan to the "executive" plan, contributions to the former plan would not be deductible in respect of benefits received from the latter plan.

Employer's Contributions

14. For benefits received by an employee under a wage loss replacement plan to be subject to tax in his hands under paragraph 6(1)(f), the plan must be one to which the employer has made a contribution out of his own funds. An employer does not make such a contribution to a plan if he merely deducts an amount from an employee's gross salary or wages and remits the amount on the employee's behalf to an insurer. In these circumstances, the employee's remuneration for tax purposes is not reduced by the amount withheld and remitted by the employer to the insurer. Where the employer has made an actual contribution to a plan, paragraph 6(1)(a) provides that it is not to be included in the income of the employees if the plan is a "group sickness or accident insurance plan". It is considered that this exemption in paragraph 6(1)(a) applies to any of the three types of plans mentioned in paragraph 6(1)(f), provided that they are group plans.

15. If an employer should have a plan that is in part a wage loss replacement plan and in part a plan that provides for other types of benefits, the employer must be prepared to identify that part

of any premiums paid by him, or other contribution by him to the plan, that relates to the other types of benefits included in the plan and, similarly, the part of the employees' contributions, if any, that relate to the wage loss replacement part of the plan. This information is required to determine whether the wage loss replacement plan is one to which the employer has contributed and the relevant amount of an employee's contribution for purposes of subparagraph 6(1)(f)(v).

Employee Pay-All Plans

16. An employee-pay-all plan is a plan the entire premium cost of which is paid by one or more employees. Except as indicated under 21 below, benefits out of such a plan are not taxable even if they are paid in consequence of an event occurring after 1973, because an employee-pay-all plan is not a plan within the meaning of paragraph 6(1)(f).

17. It is a question of fact whether or not an employee-pay-all plan exists and the onus is generally on the employer to prove the existence of such a plan. It should be emphasized that the Department will not accept a retroactive change to the tax status of a plan. For example, an employer cannot change the tax status of a plan by adding at year end to employees' income the employer contributions to a wage loss replacement plan that would normally be considered to be non-taxable benefits. On the other hand, where an employee-pay-all plan does, in fact, exist and it provides for the employer to pay the employee's premiums to the plan and to account for them in the manner of wages or salary, the result is as though the premiums had been withheld from the employee's wages or salary. That is, the plan maintains its status as an employee-pay-all plan if the plan provided for such an arrangement at the time the payment was made.

18. If, under a wage loss replacement plan, the employer makes contributions for some employees, but not all, the plan will not be considered to be an employee-pay-all plan even for those employees who must make all contributions themselves. It is the Department's view that all payments out of a wage loss replacement plan to which the employer has contributed are subject to the provisions of paragraph 6(1)(f) regardless of the fact that the employer's contributions may be on account of specific employees only.

19. Where the terms of a plan clearly establish that it is intended to be an employee-pay-all plan, the plan will be recognized as such even though the employer makes a contribution to it on behalf of an employee during an elimination period (i.e. the period after the disability but before the first payment from the plan becomes due). During this period normally there would be no salary or wages from which the contribution could be deducted. Any amount so contributed by an employer should be reported as remuneration of the employee on whose behalf it was contributed in order to maintain the employee-pay-all character of the plan.

20. Where an employer pays, on behalf of an employee, the premium under a non-group plan that is

- (a) a sickness or accident insurance plan,
- (b) a disability insurance plan, or
- (c) an income maintenance insurance plan,

the payment of the premium is regarded as a taxable benefit to the employee. The payment by the employer is not viewed as a "contribution" by the employer under the plan, and paragraph 6(1)(f) does not apply to subject to tax in the employee's hands any benefits received by him pursuant to the plan.

21. Whether or not the benefits an employee receives under a plan are required to be included in

his income is governed both by the type of plan in effect at the time of the event that gave rise to them and any changes in the plan subsequent to that time. When a pre-June 19, 1971 plan, or an employee-pay-all plan, is changed and becomes a new taxable plan, an employee who was receiving benefits at the time of the change may continue to receive them tax-free thereafter but only in the amount and for the period specified in the plan as it was before the change. Where the new taxable plan provides any increase in benefits, whether by increases in amounts or through extension of the benefit period, the additional benefits must be included in income since they flow from the new taxable plan. Where an employee is receiving benefits under a taxable plan at a time when it is converted to a new employee-pay-all plan, the benefits he continues to receive subsequent to the date of conversion, to the extent that they were provided for in the old plan, will remain of an income nature because they continue to flow from the old taxable plan.

Claimant's Survivors

22. If the payment of wage loss replacement benefits should continue after the death of an employee who was receiving such benefits, paragraph 6(1)(f) is not applicable to such benefits paid to the widow or other dependent for the reason that the amounts received do not relate to a loss of income from an office or employment of the recipient. Such payments, however, may be viewed as being received in recognition of the deceased employee's service in an office or employment and be included in income as a death benefit if they exceed the exemption provided in subsection 248(1).

Information Returns

23. Paragraph 200(2)(f) of the Income Tax Regulations stipulates that every person who makes payments pursuant to a wage loss replacement plan is required to file Form T4A information return. The law does not require that income tax be deducted from such payments.

U.I.C. Employee Premium Rebate

24. A wage loss replacement plan may qualify the employer for a reduction in unemployment insurance premiums under subsection 64(4) of the Unemployment Insurance Act, 1971. This subsection also provides that five-twelfths of any such reduction must be used by the employer for the benefit of his employees. The benefit may be conferred directly by the employer, indirectly through an employees health and welfare trust or in any other manner, but it will only be tax-free in an employee's hands if it is conferred in the form of a benefit specifically exempt from taxation by paragraph 6(1)(a).

Computation of Benefit

25. The following is an example of the computation of the amount of payments received under a wage loss replacement plan that is included in income pursuant to paragraph 6(1)(f):

Assume:

(a) Employee's contributions (in addition to employer's contributions)		
Year	Amounts	Cumulative Balance
1968-71	\$ 110 per annum	\$ 440
1972	120	560
1973	140	700
1974	140	840
1975	140	980
1976	140	1120

1977	160	1280
(b) Payments received		
1972	\$ 200	\$ 200
1973	300	500
1974	240	740
1975	1000	1740
1976	100	1840
1977	1000	2840

(c) The plan was in existence prior to June 19, 1971 and remains unchanged.

(d) The payments received out of the plan in 1974, 1975, 1976 and 1977 are as a result of events occurring after 1973.

Amount Included in Income:

1972 and 1973 -

none of the payments received are income because of section 19 of the ITAR

1974 - lesser of:

a) payments received in 1974 \$ 240

b) aggregate of payments received after 1971 \$ 740

less:

aggregate of contributions made after 1967 840 NIL

amount to be included under paragraph 6(1)(f) NIL

1975 - lesser of:

a) payments received in 1975 \$1000

b) aggregate of payments received after 1971 \$1740

less:

aggregate of contributions made after 1967 980 760

amount to be included under paragraph 6(1)(f) \$ 760

1976 - lesser of:

a) payments received in 1976 \$ 100

b) payments received in 1976 \$ 100

less:

contributions made in 1976 140 NIL

amount to be included under paragraph 6(1)(f) NIL

1977 - lesser of:

a) payments received in 1977 \$1000

b) payments received since the most recent year during which a benefit was taxable under this provision (1975) \$1100

less:

contributions made since 1975 300 800

amount to be included under paragraph 6(1)(f) \$ 800

Date Modified: 2002-09-06

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IT339R2 Meaning of private health services plan [1988 and subsequent taxation years]

(VERIFIED AND PAGED)

INTERPRETATION BULLETIN

SUBJECT: INCOME TAX ACT
Meaning of "Private Health Services Plan"

NO.: IT-339R2

DATE: AUGUST 8, 1989

REFERENCE: Subsection 248(1) (also paragraphs 6(1)(a), 18(1)(a), 118.2(2)(q) and 118.2(3)(b))

APPLICATION

The provisions discussed below are effective for the 1988 and subsequent taxation years. For taxation years prior to 1988, refer to Interpretation Bulletin IT-339R dated June 1, 1983.

SUMMARY

This bulletin discusses the meaning of a "private health services plan" and describes some of the arrangements for covering the cost of medical and hospital care under such a plan. It also discusses the tax status of contributions made to such a plan by an employer on behalf of an employee and the circumstances under which the premium costs incurred by an employee qualify as medical expenses for purposes of the medical expense tax credit.

DISCUSSION AND INTERPRETATION

1. 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). On the other hand, an amount paid by an employee as a premium, contribution or other consideration to a private health services plan qualifies as a medical expense for purposes of the medical expense tax credit by virtue of paragraph 118.2(2)(q). The amounts so paid must be for one or more of

- (a) the employee
- (b) the employee's spouse and
- (c) any member of the employee's household with whom the employee is connected by blood relationship, marriage or adoption.

For further comments on the medical expense tax credit see the current version of IT-519.

For purposes of the Act, a "private health services plan" is defined in subsection 248(1).

2. The contracts of insurance and medical or hospital care insurance plans referred to in paragraphs (a) and (b) of the definition in subsection 248(1) of "private health services plan" include contracts or plans that are either in whole or in part in respect of dental care and expenses.

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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.

4. Coverage under a plan must be in respect of hospital care or expense or medical care or expense which normally would otherwise have qualified as a medical expense under the provisions of subsection 118.2(2) in the determination of the medical expense tax credit (see IT-519).

5. 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.

6. 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.

7. An arrangement where an employer reimburses its employees for the cost of medical or hospital care may come within the definition of 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.

8. Medical and hospital insurance plans offered by Blue Cross and various life insurers, for example, are considered private health

services plans within the meaning of subsection 248(1). In addition, the Group Surgical Medical Insurance Plan covering federal government

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employees qualifies as a private health services plan 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).

9. Private health services plan premiums, contributions or other consideration paid for by the employer are not included as medical expenses of the employee under paragraph 118.2(2)(q) by virtue of paragraph 118.2(3)(b) and are not employee benefits (see 1 above). They are however, business outlays or expenses of the employer for purposes of paragraph 18(1)(a). On the other hand, contributions or premiums qualify as medical expenses under paragraph 118.2(2)(q) where they are paid directly by the employee, or are paid by the employer out of deductions from the employee's pay. The amounts so paid must be for one or more of

(a) the employee,

(b) the employee's spouse and

(c) any member of the employee's household with whom the employee is connected by blood relationship, marriage or adoption.

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