

"Cost Plus" Health Insurance: A case in point

The case of *Spicy Sports Inc. et al v. The Queen*, 2004 TCC 463, an informal procedure case before the Tax Court of Canada, involved a "cost-plus" health insurance policy purchased for the major shareholder and principal employee of the corporation, which operated a sports supply shop. The case, described in the following article, serves to reinforce the need for appropriate planning in establishing private health services plans.

Plan Arrangement

Under the cost-plus arrangement, the insurer agreed to reimburse the shareholder, Steve Cousins, for his eligible out-of-pocket medical expenses. Before reimbursement, Spicy Sports Inc. would pay the insurer an amount equal to the expense plus an administration fee. The plan was not available to other employees.

Four or five months after the insurance policy came into effect, Mr. Cousins had an operation on his knee, which was performed in San Francisco. There was no evidence that the knee injury was incurred during the course of carrying out his duties of employment. The cost of the operation was about \$35,000, which Mr. Cousins paid. The corporation in turn paid about \$36,000 to the insurer, which then duly reimbursed Mr. Cousins and retained its administration fee of approximately \$1,000.

Enter the CRA

The CRA reassessed Mr. Cousins to include the payment he received from the insurer in his income as a shareholder benefit pursuant to subsection 15(1) of the Income Tax Act. The corporation was reassessed to deny the

deduction of the amount it paid to the insurer, on the basis that the expenditure was not incurred for the purpose of earning income from the business. The position of the taxpayer was that Mr. Cousins was provided with the benefit in his capacity as an employee, and the benefit was non-taxable since the insurance contract constituted a private health services plan.

The Tax Court stated that, "It all boils down to a question of fact. Was the benefit conferred on Mr. Cousins in his capacity as shareholder or employee and was it a business transaction made by the Corporation for the purposes of earning income?" The court found that Mr. Cousins received the benefit in his capacity as a shareholder. In making its finding, the Court noted that the benefit was not made available to other employees and observed that it was highly unlikely that such a cost-plus plan, with a potential liability of tens of thousands of dollars, would be made available to anyone other than Mr. Cousins or his family. In holding that the expenditure was not deductible to the corporation, the Court stated that the purpose of paying for the operation was for Mr. Cousins' personal physical comfort and not for the purposes of the corporation to earn income.

The value of advice

This case highlights the risks associated with establishing private health services plans only for shareholders and their families. Where there are other employees, the failure to include them in the plan will be an indication that the benefit is being provided by virtue of the shareholdings. The case also illustrates the additional difficulty in establishing that a cost-plus plan is not a shareholder benefit.

Unless there is a modest cap on the benefits to be paid each year, such a plan is unlikely to be provided for non-shareholder employees of small businesses. Consequently, small business owners should be advised of the tax risk when setting up a plan, particularly a cost-plus plan that excludes non-shareholder employees.

About the article

This article was originally published as part of CALU's INFO exchange 2004, Volume 3, and written by Ted Ballantyne, CMA, TEP, CALU's Director, Advanced Tax Policy. For more information concerning the opinions expressed on the issue by the Canada Revenue Agency, visitors to www.calu.ca are invited to review the publications available in the Advanced Tax Policy section of the site, particularly the 2002 edition of the CALU Tax Policy Roundtable Report (Question 3).

Drug Costs Increasing

While the increase in the cost of prescriptions slowed for the first time in a decade last year, Steve Semelman, vice-president of health management operations for ESI Canada, says it is too early to say this is a trend. Speaking at ESI Canada's 4th Annual Pharmacy & Dental Outcomes Conference, he said the cost of prescriptions per claimant increased 9.6 per cent to \$524 per person. This was down from the 11.2 per cent increase in 2003 over 2002. However, since 2000, the annual cost per person has risen 59.3 per cent. Reasons for the increase include the rising cost of ingredients, the increased use of prescription drugs, and increased professional fees.

LTD Settlements and Capital Gains

The Canada Revenue Agency (CRA) has accepted that lump sum settlements under an employee group disability insurance policy to which an employer has contributed are not taxable as employment income. However, it will assess such payments as capital gains, says a Mercer Communique. The ruling follows the Supreme Court of Canada's decision in *Tsiapraillis v. The Queen* which involved the taxation of lump sum settlements. In the case, the court ruled that where the insurer settles with an employee, a lump sum amount paid to discharge any future obligations under a group long-term disability policy is not taxable as employment income, even though the employer paid all or part of the premiums. The CRA views lump sum settlements of future LTD payments as proceeds of disposition of a capital property, namely the employee's rights under the LTD insurance contract.