Private Health Services Plan (PHSP)

Introduction

Generally, PHSPs have very favourable tax consequences – employer deductibility of contributions; no income inclusion for the contributions or expenses reimbursed to employees. Self-employed individuals may deduct premiums in respect of PHSPs insuring themselves and their family members within certain limitations. Outside of the employment context, PHSP premiums qualify as medical expenses for purposes of the medical expense tax credit.

This Tax Topic will consider the following questions: What is a PHSP? What types of plans will qualify as PHSPs? What is the tax regime relating to PHSPs in the employment context? What are the special rules regarding the deduction of PHSP contributions for sole proprietors and partners?

What is a PHSP?

A PHSP is defined in section 248 of the Income Tax Act (the "Act") as:

(a) a contract of insurance in respect of hospital expenses, medical expenses or any combination of such expenses, or
(b) a medical care insurance plan or hospital care insurance plan or any combination of such plans.

There are no other provisions of the Act that expand on any of the words of this section. For example, "medical expenses" or "medical care insurance plan" are not defined for purposes of a PHSP. The CRA has published administrative guidelines and technical interpretations containing its view of the meaning of these terms in the context of PHSPs.

In the nature of insurance

Archived Interpretation Bulletin IT-339R2 "Meaning of 'Private Health Services Plan'" dated August 8, 1989 sets out the CRA's position regarding PHSP characterization. Paragraph 3 sets out the requirement that a PHSP be a plan in the nature of insurance and provides that the following basic elements must exist:

(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.

This insurance requirement would be satisfied if an insurance carrier were contracted with to provide the relevant benefits. Traditional health and dental benefit plans offered by life insurers are specifically mentioned at paragraph 8 of IT-339R2 as qualifying as PHSPs.

However, such plans may also be "self-insured" provided the requisite elements exist. Paragraph 7 of IT-339R2 provides:

> 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.

Several technical interpretations have explored the requisite level of risk required to be assumed by an employer to constitute being in the nature of insurance. Interpretation letter #2010-0373091E5 dated September 15, 2010 provides:

> In order for an arrangement to qualify as a PHSP it must be a plan of insurance and thus involve a reasonable element of risk that is assumed by the employer. If the plan or arrangement is such that it can be terminated at any time by the employer, without notice, at his sole discretion, there may be some doubt as to the level of risk undertaken and whether this would be in fact a plan of insurance.

Even though a cap on benefits would reduce the risk to an employer, CRA Technical Interpretation #2010-0373091E5 reiterated the opinion that "it is our view that an otherwise qualifying plan would not automatically be disqualified as a PHSP solely by reason of the inclusion of such a feature. Where the employer is uncertain as to the amount of claims an employee will submit, the employer is at risk for the amount up to the cap." These comments are mirrored in a more recent CRA technical interpretation #2010-0380551E5 dated January 11, 2011.

In the context of a plan with both a cap and employer discretion to terminate the plan, CRA technical interpretation #2012-044701E5 dated June 26, 2012 confirmed that while the cap would not necessarily be a problem, sole discretion regarding termination of the plan would be.

IT-339R2 also recognizes that "cost plus" plans can also qualify as PHSPs provided the benefits under them are those described in paragraphs (a) and (b) of the definition of PHSP above. Paragraph 6 provides:

> In a 'cost plus' plan an employer contracts with a trusteed 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 trusteed 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.

In #2014-0521301E5, a cost-plus plan to reimburse the sole employee-shareholder (and family members) for medical and hospital expenses incurred, did not contain the necessary elements of insurance. The CRA stated: "Effectively, the sole employee-shareholder is paying for personal hospital and medical expenses for himself or herself and his or her household members through his or her solely-owned corporation without any risks being assumed by the Plan administrator." In the context of a cost plus plan #2016-0633741C6 CALU Q6, the CRA stated that "a plan for one plan member (which could include coverage for his or her spouse and members of his or her household), who is the company's sole employee who deals at arm's length with the company may qualify as a PHSP."

Expenses covered

Paragraph 2 of IT-339R2 specifically recognizes "contracts or plans that are either in whole or in part in respect of dental care and expenses" as qualifying as PHSPs.

Paragraph 4 of IT-339R2 specifically requires that "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) (of the Act) in the determination of the medical expense tax credit." Virtually every technical interpretation relating to questions involving PHSPs reiterates this statement.

There are numerous cases and technical interpretations that determine whether any particular expense does or does not qualify under the specific requirements of the medical expense tax credit. The CRA has also set out its administrative practice relating to medical expenses in Income Tax Folio S1-F1-C1, Medical Expense Tax Credit. This Tax Topic will not discuss this information in depth except in respect of specific comments made relating to critical illness insurance and long term care insurance plans, which will be set out in the pages that follow under the section entitled "What types of plans will qualify as PHSPs?" below.

Until 2015, when its practice changed, the CRA consistently stated that if there is even one benefit covered which would not qualify as a medical expense under subsection 118.2(2), the plan would not be considered a PHSP. In interpretation letter # 9433745 dated May 5, 1995, the CRA provides the following advice: "While it is a question of fact as to whether any particular expense qualifies as a medical expense as defined in subsection 118.2(2) of the Act, a list of eligible expenses should be described with sufficient precision of terms to ensure that coverage is not inadvertently extended to non-qualifying expenditures."

At the 2015 Canadian Tax Foundation conference (Q5 #2015-061075 C6), the CRA provided the following update:

After a detailed internal review and consultation with Finance Canada and external stakeholders, the CRA has revised its position on what qualifies as a PHSP. Our previous position was that all medical expenses covered under a plan had to be eligible for the medical expense tax credit (METC) for the plan to qualify as a PHSP. That is, it was an all or nothing test. Effective January 1, 2015, a plan is considered a PHSP as long as the premiums paid under the plan relate "all or substantially all" to medical expenses that would otherwise qualify for METC (assuming all other conditions to be a PHSP are met).
The CRA's website (http://www.cra-arc.gc.ca/whtsnw/tms/phsp-rpam-eng.html) further explained the CRA's position as follows:

> All or substantially all generally means 90% or more. Therefore, in most cases, 90% or more of the premiums paid under a plan have to be for coverage of medical expenses that are eligible for the METC.

The explanation uses an example that breaks the premium down for expenses that qualify for the METC and those that do not. While this example shows a clear position, in practice, premiums may not be broken down in this manner. While this position appears to be intended to be of a relieving nature, it is difficult to apply. It is also just a CRA administrative practice and is not the law. This position is also difficult to reconcile with the definition of PHSP which requires the plan to be for hospital care/expenses or medical care/expenses.

A counter argument to the position of the CRA that "all" prior to 2015 and "all or substantially all" after 2014, of the premiums relate to expenses eligible for the METC should be considered. The definition of the term PHSP uses the term "medical expense". The term "medical expense" is not defined broadly in the Act nor does the definition of PHSP reference 118.2(2). Subsection 118.2(2) is specifically limited to the medical expense tax credit. It states: "For the purposes of subsection (1), a medical expense of an individual is…" This discussion has relevance whether it is 100% or 90%. So long as an expense is a medical expense, it need not necessarily qualify for the METC to preserve PHSP status.

Also, it may be possible to preserve PHSP status in respect of a portion of a plan and have non-PHSP status apply to the remainder of it. In technical interpretation 2009-0351581E5 dated February 17, 2010, the CRA was asked about a plan which covered medical expenses as described in subsection 118.2(2) as well as expenses which would not (i.e. "gym memberships, ski club memberships, yoga classes"). The CRA stated that:

> when an employer wishes to provide non-qualifying benefits, in addition to those that do qualify, we will allow the employer to establish a separate plan, thereby preserving the more favourable income tax treatment for reimbursements of qualifying medical expenses. Where it is not feasible to set up two separate plans, we are prepared to treat the plan as two separate plans, provided that the plan administrator accounts separately for the non-taxable and the taxable portion.

In technical interpretation #2010-0366161E5 dated July 7, 2010, the CRA confirmed that a rider paid for by the employer or the employee which would provide supplemental coverage allowing an employee, in the event of termination of employment, to directly enter into an individual health contract with the insurance company, similar to the employee's existing PHSP, at standard premium rates and that most closely matches the employee's medical/dental needs without evidence of the employee's health status "would not, in and of itself, cause the plan to be disqualified as a PHSP."

Other requirements
IT-339R2 paragraph 1 also states that coverage must be restricted to "the employee, the employee's spouse (or common-law partner) and any member of the employee's household with whom the employee is connected by blood relationship, marriage (common-law partnership) or adoption." The CRA has stated in technical interpretation #2008-0303211E5 dated February 25, 2009 that "a plan would not be a PHSP where benefits may be paid to a person who is not one of the above persons." (Recognition of common-law partnerships came after IT-339R2 was last revised but technical interpretations after the Act changed to recognize these relationships, do extend the above description to common-law partnerships.) Again, these requirements appear to align more with the medical expense tax credit and

do not appear to be requirements of the definition of PHSP in subsection 248(1) of the Act. However, given that the CRA takes the view that to be a PHSP, premiums under the plan relate, all or substantially all, to medical expenses which would qualify for the medical expense tax credit, it is not surprising that a similar requirement regarding who may benefit is also seen as a requirement.

Quebec
It is interesting to note that for Quebec tax purposes, the wording of the definition of PHSP is more broad than the federal equivalent and CRA interpretations prior to 2015 suggest. The Quebec Tax Act was amended in 2005 to allow a plan to meet the definition of PHSP for Quebec purposes if all or substantially all (i.e. 90% or more) of the premium is related to medical or hospital expenses. Prior to this change, the Quebec definition was essentially the same as the federal one. This allows plans with ancillary benefits to qualify as PHSPs in Quebec. When asked about issues relating to PHSP qualification in Quebec, the CRA defers to Minister of Revenue for Quebec (#2010-0372161M4 dated July 28, 2010).

What types of plans will qualify as PHSPs?

Critical illness insurance?
A stand-alone critical illness insurance policy (for general information about critical illness insurance and its taxation see Tax Topic entitled "Taxation of 'Stand-alone' Critical Illness Insurance that is Individually Owned") would not qualify as a PHSP since the lump sum critical illness benefit is not required to be used to cover hospital or medical expenses. This position was stated in technical interpretation #9711505, dated June 2, 1997 as follows:

> Based on your description of critical illness insurance, the payment of a lump sum benefit upon the first occurrence of a medical event does not appear to us to depend on, require or otherwise relate to the incurrence of any hospital or medical expense, or any combination of such expenses, by the individual (i.e. we understand that the insurance proceeds can be used without restriction to reduce debts, pay for vacations, cars or other personal items) such that the conditions outlined in paragraphs (a) and (b) of the definition of PHSP in subsection 248(1) of the Act do not appear to be met.

Long Term Care Insurance?
Long term care insurance products may qualify as PHSPs depending upon the terms of the policy. (For more information about long term care insurance and its taxation see Tax Topic entitled "Taxation of Long Term Care Insurance".) The CRA has clearly stated its view that the policy must be a reimbursement style plan (i.e. claimant submits receipts and is reimbursed) for medical expenses that would otherwise be eligible for the medical expense tax credit.

A non-reimbursement style long term care insurance policy could not qualify as a PHSP (#2003-0048461E5 dated March 5, 2004, #2003-0007605 dated April 8, 2003). In #2006-0197131C6 dated October 10, 2006 Q 9 APFF Conference, the CRA stated: "In our opinion, a plan that provides for a fixed benefit payment regardless of medical expenses incurred, is not a private health services plan."

A reimbursement style plan will not automatically qualify as a PHSP as the reimbursed amounts would, in CRA's view, have to qualify as medical expenses under the Act (#2000-0018375 dated May 29, 2000 and #2012-0451901M4 dated October 30, 2012).
The actual words of the policy that are used to describe the benefits do not have to mirror the language of subsection 118.2(2) descriptions of medical expenses so long as it can be discerned that the expenses covered are similar to those described in 118.2(2) of the Act (#2001-0082757 dated July 21, 2001).

Technical interpretation #2008-0303211E5 considered if a long term care insurance plan that required an individual to have received attendant care or care in a nursing home before a benefit is paid out of the plan. In addition to the usual provisos that medical expenses must be those qualifying under subsection 118.2(2) and they can only be for certain persons, the CRA stated: "In our view, a provision in the plan requiring certain conditions to exist before benefits are paid out would not be sufficient to conclude the ,plan qualifies as a PHSP."

Prior CRA comments stated that containing a return of premium on death rider or feature would disqualify a long term care insurance policy from qualifying as a PHSP. (#2001-0072855 dated May 31, 2001, Q 9 CALU AGM and #2003-0048461E5). In the former technical interpretation, the CRA's rationale for this position was that the plan would not meet both of the basic requirements of being a PHSP – all coverage under the plan must qualify as a medical expense and that plan benefits could not be paid to a person who is not one of the permitted recipients of benefits under a PHSP. Due to not meeting this latter requirement, it would appear that such a feature would still disqualify the plan even with the change in CRA practice.

Based on CRA's views, Manulife's Living Care long term care insurance product would not qualify as a PHSP.

Personal Health and Travel Insurance products?
Personal health and travel insurance products may qualify as a PHSP depending upon the benefits provided under the specific product. For example, some health and dental plans provide accidental death and dismemberment coverage as a standard benefit, which would not be an expense listed in subsection 118.2(2) nor would it more broadly be considered a medical or hospital expense and may also be paid to someone other than the persons listed and discussed above. Also, many travel insurance products include vehicle return or return of dependants, which are again, not listed in subsection 118.2(2) nor would they be considered medical or hospital expenses. Based on the CRA's views, these plans may not qualify as PHSPs. As mentioned earlier in this article, it may be possible to preserve PHSP status with respect to a portion of the plan by splitting the plan and accounting for the PHSP and non-PHSP portions separately.

Health Care Spending Accounts (HCSAs)
HCSAs are not defined in the Act. To be non-taxable to employees, HCSA's must be designed to be PHSPs under the Act. Generally, HCSAs are comprised of individual employee accounts that provide for the reimbursement of medical or dental expenses. Income Tax Folio S2-F3-C2, Benefits and Allowances Received from Employment dated July 7. 2016 which replaced IT-470R Employees' Fringe Benefits provides some very general guidance in paragraphs 2.42 and 2.43. Archived IT-339R2 - Meaning of "private health services plan" also provides some general guidance. Cancelled IT-529: "Flexible Benefit Programs," dated February 20, 1998, used to set out the main administrative positions regarding HCSAs at paragraphs 14-18. Most of these administrative rules centered on ensuring that there is the requisite elements of insurance. Paragraph 16 of IT-529 stated: "if the plan or arrangement is such that there is little risk that the employee will not eventually be reimbursed for the full amount allocated to that employee annually, then the arrangement is not a plan of insurance and therefore, not a private health services plan." IT-529 permited the carry forward of either the unused allocation or medical expenses (but not both) up to a maximum of 12 months without jeopardizing PHSP status.

IT- 529 paragraph 17 provided that if an employee is able to withdraw or transfer an amount from a HCSA other than as a premium payable in respect of another PSHP, the HCSA will not qualify as a PHSP.

With the introduction of the Income Tax Folio, it is unclear whether these prior stated positions are still the CRA's position.

Taxation of PHSPs in the employment context

Contributions made by an employer to a PHSP are excluded from the employee's income under subparagraph 6(1)(a)(i) of the Act. They are also not considered to be eligible medical expenses of the employee. Where the employee pays a PHSP premium by payroll deduction and the employer reimburses 50% of these premiums by a payroll adjustment, technical interpretation #2009-0322451E5 dated November 5, 2009 confirmed that "such reimbursement may be considered to be a non-taxable employment benefit under subparagraph 6(1)(a)(i) of the Act." Employee-paid premiums for a PHSP is a medical expense eligible for the medical expense tax credit (paragraph 118.2(2)(q) of the Act).

PHSP contributions are deductible by the employer as business outlays or expenses of the employer for purposes of paragraph 18(1)(a) of the Act. Amounts contributed to a PHSP are subject to the overall test of reasonableness (section 67).

Reimbursements of medical expenses under a PHSP are not included in the employee's income. Reimbursed amounts for medical expenses under a PHSP cannot be claimed by the employee as medical expenses under the medical expense tax credit (paragraph 118.2(3)(b) of the Act).

Where a plan does not qualify as a PHSP, any benefit received out of the plan is taxable to the employee under the general provisions of 6(1)(a) of the Act which includes " the value of…benefits of any kind whatever received or enjoyed…in respect of, in the course of, or by virtue of an office or employment…". If a "group" plan is not considered a PHSP, it may still qualify as a group sickness or accident insurance plan. Paragraph 6(1)(a) provides an exclusion from employment income for premiums paid by an employer under a group sickness or accident insurance plan. However, paragraph 6(1)(e.1) includes premiums paid by an employer under a group sickness or accident insurance plan if the benefits would not ultimately be included in employment income under paragraph 6(1)(f). Group sickness or accident insurance plan benefits may or may not be included in income of the employee under paragraph 6(1)(f). (See the Tax Topic entitled "Individual Insurance for Employee Group Plans" for more detailed discussion of this topic.) It is also possible that a plan that does not qualify as a PHSP may be considered an employee benefit plan

(#2004-0071731E5 dated September 15, 2004). Generally employees are taxable on amounts paid out of an employee benefit plan and an employer ordinarily may not deduct contributions for employees until the employee actually receives a corresponding benefit out of the plan.

Deductibility of PHSP premiums by the self-employed

Prior to 1998, health, medical and dental insurance premiums paid by self-employed individuals for their own insurance coverage or for the coverage of their families were not deductible in computing business income. This was a disadvantage when compared to incorporated businesses because corporations could deduct such premiums payable for insurance coverage on the owner-manager as well as other employees.

Section 20.01 was added to the Act to allow self-employed individuals to get tax benefits similar to PHSPs enjoyed by employees. Self-employed individuals who are actively engaged in a business may be sole proprietors or members of a partnership reporting business income (not income from employment). In order to claim the deduction under section 20.01 of the Act, the individual's total business income for fiscal periods ending either in the current taxation year or in the preceding year must exceed 50% of the individual's total income for that year. Alternatively, the deduction is allowed if the individual's income from other sources (other than businesses) in the current year or in the preceding year does not exceed $10,000. (This deduction is not available in Quebec, therefore, any eligible premium would have to be claimed as part of the medical expense tax credit.)

If the individual had no employees the deduction is restricted to a maximum of $1,500 for the individual, $1,500 for each of the individual's spouse (or common-law partner) and household members 18 years and older, and $750 for each household member under age 18 and is pro-rated for the number of days the person was insured.

If the individual had employees, the deduction is only available if "equivalent coverage" is provided to arm's length employees. If the individual had at least one qualified employee (arm's length, full time with more than 3 months service) throughout all of the year, and at least 50% of the insurable persons in the business were qualified employees, the individual's claim for PHSP premiums is limited based on the lowest cost of "equivalent coverage" for each qualified employee. Specific examples and calculations are provided in the CRA Guide to Business and Professional Income (T4002).

Technical interpretation 2001-0101935 dated November 22, 2001, confirmed that where a "cost plus" plan is used, section 20.01 may still allow a deduction. However, technical interpretation 2001-0158495 dated December 20, 2002, stated that a sole proprietor's cost-plus plan will not qualify if there are no employees. The rationale for this was stated as follows:

> Since a plan of insurance must include an undertaking by one person to insure another person (i.e., an employee), it is our view that a cost-plus plan that provides coverage solely for a proprietor and family members who are not employees will not qualify as a PHSP. The Department of Finance is currently reviewing this requirement to determine if a legislative amendment is advisable.

A similar response was provided more recently by the CRA in technical interpretations #2008-0273771E5 dated July 8, 2008 and #2011-0400311E5 dated June 20, 2011.

In Technical Interpretation 2015-0581431E5 "Private health services plan deduction" dated August 18, 2015, the CRA answers the following question: Can a sole proprietor (Mr. A) deduct from his business income the maximum dollar limit under section 20.01 of the Act, for the premiums paid to a PHSP (Plan 1), that covers both Mr. A and his spouse (Mrs. A) even if said spouse, who also carries on business as a sole proprietor, deducted an amount in respect of the premiums she paid to another PHSP (Plan 2) that covers the couple?

The CRA replied that this was a question of fact but, on the basis of the facts submitted, it was quite likely that Mr. A could deduct from his business income the maximum dollar limit under the Act, even if Mrs. A claimed a deduction from her own business income for the premiums paid to the second plan.

To the extent that a premium under a PHSP is not deductible under section 20.01 it would still be considered a medical expense which may be claimed under the medical expense tax credit. As is the case in the employment context, reimbursements for medical expenses under a PHSP are not included in income and cannot be claimed by the individual as medical expenses under the medical expense tax credit (paragraph 118.2(3)(b) of the Act).

Conclusion

PHSPs have very favourable tax consequences – employer deductibility of contributions and no income inclusion for the contributions or expenses reimbursed under the plan to the employee. Self-employed individuals may deduct

premiums in respect of PHSPs insuring themselves and their family members within certain limitations. (In Quebec, there is no equivalent provision so PHSP premiums would have to be claimed as medical expenses under the medical expense tax credit.) Important in the determination of whether a plan qualifies as a PHSP for the CRA is whether the costs relating to all or substantially all of the medical expenses covered qualify as eligible for the medical expense tax credit and that the coverage be in respect of qualified dependents. Critical illness insurance does not qualify as a PHSP. Long term care insurance, personal health insurance products and health care spending accounts can qualify if the conditions for PHSP status are met.

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