INSIGHTS

JUNE 2005

Accomodating the Aging Face of Employees

I've taken some good-natured kidding about last month's article about benefits for retirees. Some thought it was just my way of positioning myself with my boss to ensure that there were benefits available when I make my exit. Not true. Some asked if I'd lost my mind; had I given the proper attention to the financial impact of such a notion? No and yes.

So, what do changes in accounting rules, a Supreme Court of Canada decision, government cutbacks and expensive new drugs have in common? All of these factors combined create real problems for employers and employees when it comes to non-pension retirement benefits programs.

Changes to accounting rules, which came into effect in January 2000, require employers to include the full projected cost of post-retirement benefits - not just annual premiums - for current active employees, as well as retirees, on their financial statements. This change has put public companies in a position where the full cost of these benefits and their impact on a company's bottom line have attracted the attention of board members, senior managers and analysts. As a result, cost containment or elimination of these expenses has become the central focus of discussions surrounding retiree benefits.

Some might think that the easy solution to this problem is to simply eliminate or reduce retiree benefits. However, one of the problems with this approach is that the decision of the Supreme Court of Canada's ruling in CAW vs. Dayco in 1993 stands in the way of taking away retiree benefits.

In this case, the Supreme Court ruled that retiree benefits were vested benefits that could not be taken away from retirees. As a result, the benefits of the current retiree population cannot be eliminated or cut back unless the employer has reserved the right to amend its plan and has communicated this power to employees. The legal reality is that only in exceptional circumstances can benefits be taken away from retirees without their consent.

Employers have chosen to try and contain costs by reducing or eliminating post-retirement benefits. Let's take for granted that government support will be less than it is today and that private plans can't meet everyone's needs. How then will their needs be addressed? Well, if we take the change in the accounting rules to their logical conclusion - pre-funding of post-retirement benefits provides us with a solution. How about this for a platform for the feds?… run their next election on a benefits plan that accumulates assets on both a tax-deductible and a tax-deferred basis. Treat it like a registered pension plan or RRSP and allow people to save for all of their benefit needs.

The issues that will arise as baby boomers age and the resulting crisis in post-retirement plans are problems that won't disappear on their own. Pre-funding is perhaps one way to save retiree benefits. Employers and baby boomers alike are hoping that the feds are giving it some thought.

Until next time…

The Benefits of Working in Later Life

The prestigious MacArthur Foundation Study of Aging in America has identified three key ingredients to successful aging, low probability of disease and disability, high mental and physical function, and active engagement with life. Work, whether paid or unpaid, can help fulfil two out of three of these requirements. A job that challenges your intellect, requires you to take initiative and make choices, and gives you the confidence in your ability to handle a variety of situations can keep your mind sharp -- much as physical work-outs keep your body in shape. By "active engagement with life," the MacArthur researchers mean close personal relationships and the pursuit of activities that produce something of value, be it a product or a service, such as providing nursing care or babysitting for a neighbour. Work can provide both of these.

"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 Tsiaprailis 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.