COMMENT

NUMBER 210 – NOVEMBER/DECEMBER 2001

DEDUCTING PHSP PREMIUMS

Premiums paid for coverage under a private health services plan ("PHSP") may be tax deductible. However, deductibility is not automatic. A number of Canada Customs and Revenue Agency ("CCRA") technical interpretations show that this can be a complex issue, especially for small business owners.

As a starting point, it's important to remember that the rules that apply to an incorporated owner-manager are different from those for sole proprietors and partners.

Incorporated owner-managers

Corporate payment of PHSP premiums benefits the individual covered by the plan. Deductibility of an owner-manager's PHSP premiums hinges on whether the benefit is related to that individual's employment or shareholdings. Premiums related to shareholdings are a taxable benefit to the owner-manager, and are not deductible by the corporation. In contrast, premiums related to employment are not taxable in the hands of the employee, and the corporation can claim them as an expense. Obviously, it's important to determine the status of the payments.

The CCRA looks at each specific case to determine whether payments are made "qua" shareholder or employee. There is a general presumption that benefits extended to a shareholder-employee relate to the shareholdings. However, if equivalent coverage is extended to all employees of the corporation, whether or not they are shareholders, the payment of the owner-manager's PHSP premiums will generally be treated as a non-taxable (and deductible) employee benefit.

Where all employees of a corporation are also shareholders, the premiums may be treated as an employee benefit if they are paid as part of a reasonable remuneration package. What is reasonable will be judged against benefits provided by employers of a similar size, to their employees who provide similar services and have similar responsibilities.

Sole proprietors and partners

Unincorporated business owners cannot be "employees" of their own businesses. A separate tax regime allows the deduction of PHSP premiums by sole proprietors and partners. The rules are complex, but essentially provide full deductibility for premiums where PHSP benefits are extended to all employees, and a limited deduction where there are no unrelated employees.

These rules are fairly new (they were introduced in 1998), and there have been a number of technical interpretations providing guidance. A recurring theme seems to be the issue of "cost-plus" plans.

Under a “cost-plus” plan, an administrator receives, verifies, and pays claims. The administrator then bills the person sponsoring the plan for the amount of the claim plus an administrative fee.

The CCRA agrees that such a plan *may* qualify as a PHSP, but only where there is indemnification of one person’s qualifying expenses by another person. The CCRA has consistently ruled that a cost-plus plan set up solely for the unincorporated business owner (including coverage for household members) will not qualify as a PHSP. However, a cost-plus plan that covers the business owner and at least one bona fide employee may be a PHSP (in which case premium deductibility will be determined under the rules in the Act).

IR 2400.12

CAPITAL DIVIDEND ACCOUNT

Recent changes to the capital gains inclusion rate have heightened awareness of the capital dividend account (“CDA”). While life insurance can create significant credits to the CDA, the disposition of capital property also produces credits in this account. The credit related to capital gains increases as the capital gains inclusion rate drops.

The capital dividend account of a private corporation has several different components:

a) the amount by which the non-taxable portion of capital gains exceeds the non-allowable portion of capital losses;
b) capital dividends received from another corporation;
c) the untaxed portion of gains realized on the disposition of eligible capital property;
d) the excess of life insurance proceeds received after March 31, 1977, over the corporation’s adjusted cost basis in the policy;
e) the balance in the corporation’s life insurance capital dividend account immediately before May 24, 1985;
f) the non-taxable portion of capital gains flowed through to the corporation from a trust (as calculated by formula); and
g) capital dividends flowed through to the corporation from a trust.

The calculation of the CDA balance is based on accumulating figures year over year. Note that each component has its own cumulative balance, after which the components are added together. None of the components can be negative – therefore what would otherwise be a negative balance in any one component cannot reduce the balance in the other components.

The total determined above will be reduced by any capital dividends that the corporation has previously declared.

The capital dividend account may be calculated at any point in time, and not just at an arbitrary date such as at year-end. Thus, a transaction undertaken on any particular day will affect the CDA balance immediately.

This creates a planning point. If the first component has a positive balance, it will be advantageous to declare dividends and elect them as capital dividends before realizing a capital loss. This is especially true now that the proportion of the loss that will offset any positive balance in the first component has increased to 50 per cent. (Note, however, that future capital gains would not produce a positive balance in the first component of the CDA until the non-taxable portion of such gains exceeds the non-allowable portion of that capital loss.)

If the corporation declares a capital dividend in excess of the balance in the CDA, the excess is subject to a tax of 75 per cent. This tax penalty can be avoided by electing to treat the excess as a regular, taxable dividend. This election is available up to 90 days after the mailing of an assessment for the 75 per cent penalty tax.

I/R 2101.02

THE VALUE OF A LIFE INSURANCE POLICY

There are a number of different circumstances where the fair market value of a life insurance policy must be determined. These situations include the following:

Transfer of a policy from a corporation to a shareholder or employee

A taxable benefit may arise upon the transfer of a policy from a corporation to a shareholder or employee. A shareholder benefit or employee benefit may arise if the amount of consideration paid by the shareholder or employee is less than the policy's fair market value. Therefore, at the time of transfer, the fair market value of the policy must be determined. The Canada Customs and Revenue Agency (CCRA) has provided guidelines that can be used to determine the fair market value of the policy. The guidelines discuss the different factors that should be considered. Some of the factors include: the cash surrender value; face value; state of health and life expectancy of the life insured, and other policy attributes such as conversion privileges and term riders.

Share valuation upon the death of a shareholder

Upon death, the deceased is deemed to have disposed of his/her property at fair market value. If, at the time of death, the deceased owns shares in a private company and the company owns a life insurance policy, the value of the policy must be considered in determining the fair market value of the shares. The Income Tax Act (the "Act") provides that, in certain circumstances, the value of a life insurance policy will be its cash surrender value at a defined point in time. If a corporation owns a policy on the life of a shareholder, his or her spouse, or some other related person (e.g., a son or daughter), the Act specifies that upon the death of the shareholder the value of the policy will be equal to its cash surrender value without regard to any policy loan. This rule applies to single life, multi-life and joint life policies. Conversely, if the corporation owns a policy on the life of a shareholder or key employee who is not related to the deceased (i.e., who deals at arm's length), the policy would be valued in accordance with normal valuation principles using the factors described above.

Gift of a life insurance policy to a charity

Where a life insurance policy is donated to a charity, the fair market value of the policy determines the size of the charitable gift (i.e., the amount of the charitable donation receipt). In this case it is the CCRA's view that the fair market value of the policy is equal to the cash surrender value of the policy minus any policy loan outstanding plus any accumulated dividends and interest. The CCRA does not believe that the face value or the state of health and life expectancy of the life insured are relevant for determining the value of the charitable gift.

The CCRA has different rules for determining the fair market value of a life insurance policy depending on the purpose of the valuation. It is important that all relevant factors to the particular situation are considered in determining the value of the policy.

I/R 5200.06

DONATION OF SECURITIES

Several Comment articles have examined the charitable donation of publicly traded securities since the 1997 reduction in the capital gains rate on such dispositions (see, for example, "Planned Giving" in our last issue). The reduced capital gains rate (25 per cent, compared to the 50 per cent regular rate) was set to expire on December 31, 2001.

On October 12, 2001, Finance Canada announced that this measure had proven successful in encouraging charitable donations. As a result, the reduced capital gains rate for securities donations will be made permanent.

The press release also indicated that the government would look at extending this measure "beyond its current application" – but no further details were provided.

I/R 1600.00

ONE HEAD, ONE HAT – UPDATE

Our July/August issue (number 208) lead with an article called "Can You Wear Two Hats?" The issue is whether an executor can hold corporate shares in a personal capacity, and as the estate's legal representative, and have those two shareholdings treated separately when assessing affiliation between the estate and the corporation.

The article referred to a recent Canada Customs and Revenue Agency (CCRA) ruling that the estate does not control a company simply because the executor has control in a personal capacity. We have since learned that the CCRA has revised its position in subsequent technical rulings, declaring that an individual cannot act in two separate capacities for this purpose.

As "Can You Wear Two Hats?" pointed out, the CCRA's position has changed a number of times. The article went on to suggest that naming a third-party executor is a prudent course of action.

I/R 2500.07

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