The Accountant's Complete Guide to Health Spending Accounts

What is a Health Spending Account?

The Bright Benefits spending account is a Private Health Service Plan (PHSP). Plan of this nature are derived from Section 248(1) of the Income Tax Act (the Act) and Interpretation Bulletin IT-339R2. Assuming the definition of a PHSP is met, the Bright Benefits health spending account enables an employer to reimburse an employee (including shareholder/ employees) for eligible medical expenses on a tax-free basis while deducting these expenses. Medical benefits paid on behalf of an employee by an employer are not taxable as a benefit to the individual; nor are the claim benefits themselves taxable to the individual employee. The cost of these benefits is considered a business expense.

Eligible medical expenses are defined as those expenses for which an individual can apply for a Medical Expenses Tax Credit on their income tax. Eligibility is determined not only by the expense itself, but also that it is performed prescribed by a qualified medical practitioner.

A PHSP is not a health and welfare trust nor an employee life and health trust. There are significant difference between a PHSP/HAS and an HWT/ELHT. Although they both provide methods of health and dental benefits to employees, they are treated differently under the Income Tax Act. The government is set to convert all HWT to ELHTs. As stated above, this change will not affect the Bright Benefits PHSP/HAS.

The Act allows a PHSP to take a number of different forms; however, to properly meet the definition, the PHSP must be contract of insurance in respect of hospital or medical expenses or similar insurance plan. This implies that CRA would expect to see a formal contract of employment incorporating the requirement that employer provide this medical coverage.

What are the qualifications

To qualify, a PHSP must include a minimum set of conditions. The Bright Benefits Health Spending Account provides that:

- The bright benefits health spending account is insurance.
- The employer is under legal obligation to fund the spending account for each employee.
- All employees in a particular classification must be offered equivalent benefit level.
- Employees not forego any amount to which he/she would otherwise be entitled in order to obtain the increased benefits (E.g. a salary decrease to accommodate for enrollment in the Bright Benefit Health Spending Account).
- In order to provide for the necessity of an element of risk, all reimbursement credits must be claimed in the year in which they are incurred or within 12 months of the plan year.
- Eligibility is maintained with respect to medical expenses, employees, and dependents
- No allowances is made for cash payments in respect of unused reimbursement credits.

Bright Benefits' Claim Process

Here is step by step example of the process for an incorporated client with $1,000 expenses.

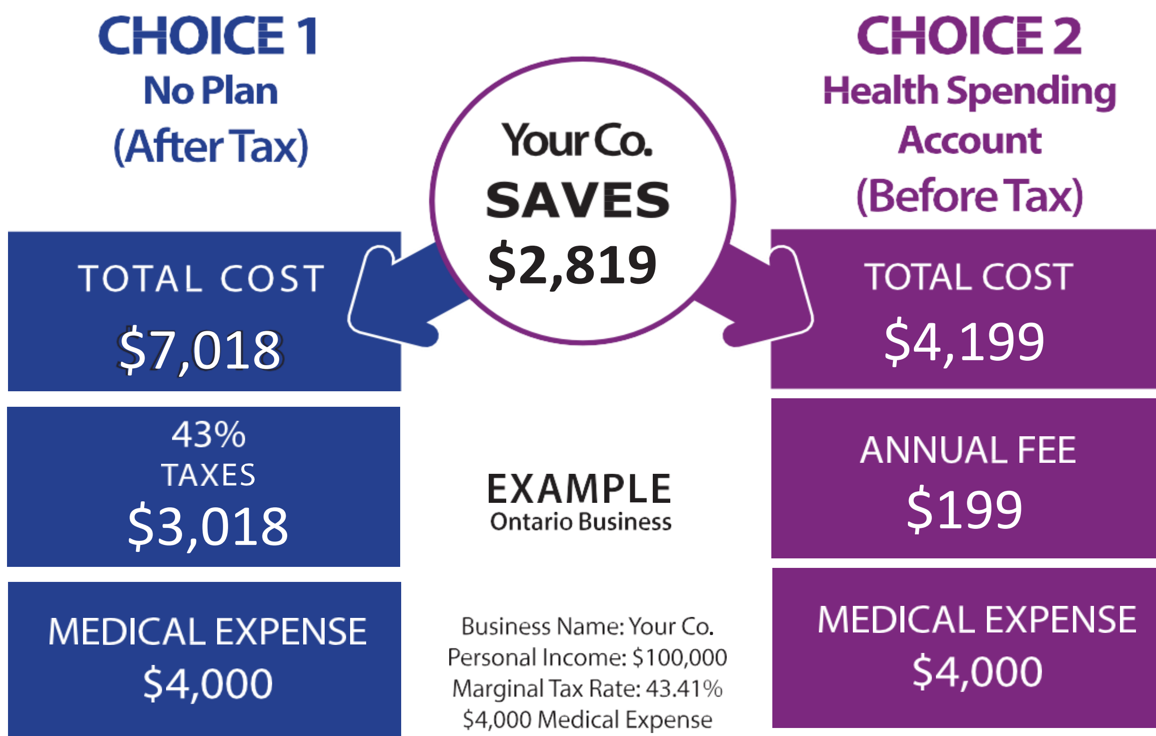
1. Client pays for the medical expenses personally. (E.g. with personal credit or debit card). ($1,000)
2. Client submit the claim online or by paper, make a payment from the corporation for the amount of expenses. (Pay Bright Benefits $1,000 from Corporation)
3. Bright Benefits reimburses personal banking account the original amount less processing fees and applicable taxes.

The $1,000 personal expense is tax free. The $1,000 payment from corporation is 100% tax deductible.

Saving Comparison

Let's use an example of an incorporated business owner in Ontario. She pays herself a salary of $100,000 and has a marginal tax rate of 43%. In the upcoming year, she expects to spend $4,000 on her family's medical and dental costs. She has no plan of insurance in place. 100% of the cost is going to be paid out of pocket.

In the diagram below, we see a savings comparison between paying for the costs out of pocket versus using a Health Spending Account.



Choice 1 - Out of pocket (After Tax Expense)

With no plan of insurance (remember it's not so easy to find a dental plan for a one-person company), the cost is paid for out of pocket with after tax dollars. For her marginal tax rate, the company will have to pay out $7,018, with 43% of that amount being reserved to pay her income tax ($3,018).

In other words, each dollar she spends on her dental costs require the company to pay her $1.78. 78 cents (43%) of this pay goes to Canada Revenue Agency in the form of provincial and federal taxes. The true cost for a $1 of dental work is therefore $1.78 when you factor in the additional cost of taxes.

Choice 2 - Health Spending Account: Before Tax

By using a Health Spending Account, she can write off 100% of her dental costs through her corporation. The after-tax expense from choice 1 now becomes a before tax expense. Instead of paying an additional 43% on every dollar she spends on dental, a flat rate annual fee is paid to the provider of her Health Spending Account.

In our example, her company will save approximately 40% on every dollar she spends. The higher the tax bracket (the top tax bracket in Ontario for 2013 was $49.53%), the more she saves. For top earners in Ontario, this means you can cut your dental costs in half. In every tax bracket, you will save money by paying for your dental costs through your company, as a before tax expense, with a Health Spending Account.

FAQ

Are shareholders eligible?

Yes, but if the plan is made available only to shareholders, CCRA may argue that the plan is not a benefit received by virtue of employment, but rather an appropriation by a shareholder. If there is any doubt as to whether benefits are received as an employee or a shareholder, then steps can be taken to demonstrate that a person receives the benefit in his or her capacity as an employee. We can discuss these with your accountant.

Guidelines to determine employee status:

For an individual to receive tax-free health benefits from an employer, CRA (Canada Revenue Agency) must in fact define them as an employee. If one of the following factors are met, then the person in question is almost certainly an employee.

1. Does the individual collect a wage, salary, fees or bonus?
2. Does the corporation (employer) remit payroll taxes (income tax and CPP) on behalf of the individual?
3. Are payments made to the individual deductible from the corporation's (employer's) income? Such payments include management fees, wages, salaries and bonuses.
4. Dividend payments may qualify.

Do we qualify if all the employees are also shareholders and we have no other employees?

- Yes, if the plan is made available to all employees who are also shareholders and it is demonstrated that they are receiving the benefits as employees.
- Small business owners should be careful in setting up a Bright Benefits plan that excludes non-shareholder employees. A Bright Benefits plan for a majority shareholder and principal employee of a corporation that excludes non- shareholder employees should be carefully planned to meet tax

deductible eligibility status. We strongly urge anyone setting up a plan that excludes non-shareholder employees to discuss with a tax expert to obtain proper documentation.

APPENDIX

With respect to the shareholder-manager of a corporation, there is a general presumption that a benefit with respect to a private health services plan would be conferred on the individual in his or her capacity as a shareholder and included in income pursuant to subsection 15(1) (see Technical Interpretation No. 9505265). Revenue Canada appears to have reversed this position.

In a recent interpretation, Revenue Canada indicated that “when equivalent coverage under a private health services plan is extended to all employees, including the employees who are shareholders, the benefit provided to the employee-shareholders from such coverage is normally considered to be an employment benefit rather than a shareholder benefit”. Where all employees of the corporation are shareholders, Revenue Canada states:

“Similarly, when all employees of a corporation are shareholders and it is reasonable to conclude, based on the particular facts of the situation that the private health services plan coverage has been provided as part of a reasonable remuneration package, the benefit from such coverage is also considered to be an employment benefit rather than a shareholder benefit. In such a case, the benefit is not included in the employee-shareholders” income by reason of the exclusion in subparagraph 6(1)(a)(i) of the Act, and the corporate employer is entitled to a deduction in respect of the contributions made for such coverage, subject to any limitations imposed under the Act”.

Technical Interpretation, Business and Publications Division,
July 27, 1998

Document No. 9815645

APPENDIX

Private Health Services Plans Must Provide for a Degree of Risk

It is Revenue Canada's belief that a health insurance plan must involve a reasonable degree of risk in order to meet the definition of "private health services plan" in subsection 248(1). Plans that provide an indefinite carry forward of unclaimed medical expenses would not involve a reasonable degree of risk. However, a plan would have a reasonable degree of risk if it provided that any unused balances be forfeited.

Technical Interpretation, Business and General Division
June 2, 1992
Revenue Canada File Number 9210485

Rollover of Unused Credits in a PHSP

Is it permissible for unused credits in a health care plan established under a cafeteria plan to be rolled over to future years?

Department's Position

Yes. However, for the health care plan to qualify as a PHSP, the plan must involve a reasonable element of risk that is assumed by the employer. Plans that permit the choice of a rollover or a cash-out of unused credits will not qualify as PHSPs. A plan that permits the rollover of unused expenses as well as credits also is not likely to qualify. Plans that permit the rollover of unused credits to be applied to other plans under a cafeteria plan are not considered PHSPs.

On the assumption that your current plan qualifies as a Private Health Services Plan, expenses and co-insurance amounts eligible for reimbursement under the health spending account option will be limited to amounts which would otherwise qualify as medical expenses of the individual within the meaning of subsection 118.2 of the Act. Eligible amounts may be claimed in the plan year in which they are incurred or within 12 months of the end of the plan year. The individual subscriber forfeits any credit remaining at the end of a plan year.

Technical Interpretation, Business and General Division
Revenue Canada File Number 9428595