Payments made on termination of health care plans to become taxable

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While all Canadians are eligible for heath care funded through our tax dollars and administered by the provincial governments, not all health care expenses are covered by such government plans. There are, in fact, a great number of expenses, most notably prescription drug and dental costs, which must be paid for by the individual.

For many Canadians, that gap in coverage has been filled by employer-sponsored private health services plans, the premiums for which are paid in full by the employer or shared between employer and employee. And, since the benefits under such plans were not taxable as employment income, it was a win-win situation for the employee.

While it's possible to provide such coverage on a group basis for much less than the cost would be for an individual seeking similar insurance, the costs are still significant. And, as with all health care related costs, the bill continues to go up as Canada's population ages. The result, in some cases, has been the termination or discontinuance by employers of such private health services plans.

Where a plan is cancelled, an employer will, in some instances, provide the affected employees (or retirees) with a lump sum payment intended to be used for future health care expenses. The Canada Revenue Agency (CRA) was of the opinion that, since the lump sum amounts paid could be considered to be advance reimbursements of medical expenses, they were not taxable to the employee and did not therefore need to be included in the employee's income for the year on a T4 or T4A. Unfortunately, the CRA has now reconsidered and changed that policy.

The announcement of that change came in the recent (June 6) federal budget. While the announcement did not indicate the reasons behind the change in policy, the effect is clear. Beginning with the 2012 taxation year, lump sum amounts paid upon the cancellation of a private health services plan will be fully taxable to the employee in the year the amount is received. Employers will be required to include any such amounts on a T4A and to withhold tax from the payment in the usual manner required for any taxable payments made to employees.

Where an employee must pay out-of-pocket for his or her own medical expenses, a medical expense tax credit may, in some circumstances, be claimed on the annual tax return. Such a claim can be made for medical expenses where the amount of those expenses are greater than either 3% of the taxpayer's net income for the year, or a specified amount, whichever is less. For 2011, that specified amount is $2,052.

Where an employee has received (after 2011) a taxable lump sum amount as the result of the termination of a private health services plan, the CRA acknowledges that the employee is entitled to claim a medical expense tax credit for medical expenses paid out of that taxable lump sum amount, as those expenses are incurred. Where, however, the employee has received such a lump sum amount on a non-taxable basis (before 2012), the CRA expects that the employee will not seek to claim the medical expense tax credit until such time as his or her cumulative medical expenses since the termination of the plan exceed the lump sum amount received. The CRA did not indicate how it expects to track or monitor such claims and amounts.

Finally, in some circumstances, payments received after 2011 will remain non-taxable to the employee. In employer insolvency situations, employees may not receive amounts due to them for some period of time. Consequently, if a payment made as a result of the termination of a private health services plan is received by an employee in 2012 or later years, and that payment came about because of an employer insolvency which arose prior to 2012, the CRA will treat the receipt by the employee as non-taxable.

The CRA has, clearly, provided a window of opportunity for employers and employees before the new rules take effect on January 1, 2012. While no one wants to see a private health services plan terminated, where such a termination is already in the works, it will be to the benefit of both employer and employees to effect that termination (and make any related lump sum payments) before the end of this year.