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Scholarships for Adult Children – Not a Taxable Employee Benefit

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INTRODUCTION

In a trio of cases dated March 7, 2008, the Tax Court of Canada allowed three taxpayers' appeals regarding the taxation of employer-paid amounts awarded to the taxpayers' adult children in respect of post-secondary tuition. In *Dimaria v. The Queen, Bartley v. The Queen, and Okonski v. The Queen*, the Court rejected Canada Revenue Agency's ("CRA") unpopular characterization of such awards as taxable employee benefits, finding instead that the amounts were scholarship income to the intended recipients – the adult children. The Court's conclusion is significant in view of the preferential tax treatment of scholarship income. [1]

This Client Update reviews the Tax Court of Canada decisions in *Dimaria*, *Bartley* and *Okonski* , and considers the tax implications for employees and their children.

DIMARIA AND *BARTLEY* CASES

The *Dimaria* and *Bartley* cases both involved appeals by two Dow Chemical Canada Inc. ("Dow") employees. At issue were payments received by the appellants pursuant to a Dow administered program under which eligible children were entitled to awards of up to $3,000 as reimbursements for post-secondary tuition. The Dow program imposed a number of eligibility criteria, which included the requirement that children attend an approved institution, and have an average of at least 70% in the graduating year of high school. A maximum of 100 awards were available per year.

When the Dow program was established, tuition awards were treated as income to the recipient children. However, CRA included as a taxable benefit to the appellants the amounts awarded to the appellants' children in 2004. At around the same time, and as a result of a CRA audit, Dow changed its practice and commenced treating tuition awards as a taxable employee benefit.

In the *Dimaria* and *Bartley* appeals, CRA maintained its position that the tuition awards were income to the appellants pursuant to paragraph 6(1)(a) of the Income Tax Act (Canada) ("ITA") as benefits received or enjoyed in respect of, in the course of, or by virtue of the appellants' employment with Dow. With respect to this argument, Justice Rossiter stated that while there was no doubt that the appellants' children were awarded a benefit, the issue was whether it was a benefit received or enjoyed by the appellants.

In both cases Justice Rossiter concluded that the tuition awards were not benefits received or enjoyed by the appellants. His reasons in *Dimaria* (and adopted in *Bartley*) are as follows:

1. The employee was not enriched by $3,000, since the payment of the tuition award was made directly to his son.
2. The employee was not enriched by $3,000, since the employee had no legal obligation to support his adult son or to pay for his post-secondary education.
3. The employee was not enriched by $3,000 since he had no legal right to receive any money from the tuition award or to compel Dow to pay the amount to him instead of paying it to his son.
4. The employee was not enriched by $3,000 since he had no right to recover the amount of the tuition award from his son.
5. The employee did not negotiate with his employer to have the tuition award included as an employment benefit. He

did not assume extra responsibilities or forego other benefits in order for his son to receive the award.
6. The only person who is economically enriched is his son. It is his application for the scholarship and it is his education and his qualifications which make him eligible for the tuition award.
7. Expenses incurred by the son in pursuing his post-secondary education are not expenses of the employee or the employee's family. Tax is imposed on the individual person, not the family.

The Court also concluded that the amount of the award was properly characterized as a "scholarship" and included in the income of the appellants' children pursuant to paragraph 56(1)(n) of the ITA, rejecting the position that CRA had taken that the amounts were not scholarships since, generally, they were awarded to every child who applied provided they met minimal criteria.

OKONSKI CASE

Okonski also involved a tuition award program, but the employer in this case was the University of Western Ontario ("UWO"). As in *Dimaria* and *Bartley* , the Court concluded that the tuition award was scholarship income of the appellant's child pursuant to paragraph 56(1)(n) of the ITA, but adopted additional reasons in response to facts which distinguished this case from the other two.

Unlike the Dow tuition award program in *Dimaria* and *Bartley* , UWO's program had been collectively bargained as part of the employees' overall compensation package. The case was also distinguishable on the basis that the award was paid directly to the appellant as opposed to her child.

Neither of these facts were viewed as requiring a different result in this case. With respect to the negotiated benefit issue, the Court concluded that the appellant did not receive or enjoy anything in relation to the award. As for the fact that the award was paid directly to the appellant, the Court concluded that the award was subject to a resulting trust since it was the intention of all parties that the amount of the award be enjoyed by the appellant's daughter.

IMPLICATIONS

As of the date of this Client Update, no appeal has been filed in respect of the above cases. However, CRA has stated verbally that it disagrees with the Court's decisions and that it will soon be issuing a policy statement to this effect. This leaves some uncertainty, but unless *Dimaria*, *Bartley* or *Okonski* is successfully appealed, the cases may persuade CRA to modify its general approach to the taxation of tuition related amounts awarded to the adult children of employees. In the interim, if CRA chooses to maintain its position that such awards are taxable employee benefits, the decisions in *Dimaria*, *Bartley* and *Okonski* are likely to lead to further challenges.

As a result, employers that sponsor tuition benefit programs will wish to examine whether amounts that are awarded under such arrangements are properly treated for tax purposes as scholarship income, and whether any changes should be made to the way that such programs/awards are currently administered and/or reported for tax purposes. In this regard, it is noted that the Court's decisions in *Dimaria*, *Bartley* and *Okonski* do not suggest that a tuition benefit will be excluded from taxation as an employee benefit in all cases. For example, it is not clear whether an employer-paid tuition benefit that is awarded in respect of younger children (i.e., under the age of 16) – for whom attendance at school is an obligation of a parent/guardian – might be properly included in the income of the employee who is the parent or guardian. These and other situations may arise in which the linkage between an award and a benefit to an employee is more demonstrable, or where characterization of the award as a scholarship is not supportable.

QUESTIONS?

If you have any questions arising out this Client Update, please contact one of the members of our Pensions & Benefits Group.

[1] For tax years ending 2006 and beyond, the full amount of the scholarship is exempt from tax. A partial exemption is provided for prior years.

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