FTR Now

Taxation Rules for Lump Sum Amounts Received in Lieu of Benefits Coverage

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In June, 2011, the Canada Revenue Agency ("CRA") announced new rules governing lump sum payments made to employees or retirees in lieu of their healthcare coverage. These new rules, which come into effect on January 1, 2012, followed the announcement in the 2011 federal Budget that CRA was re-examining its position on these payments (see our *FTR Now* "Federal Budget Reintroduced June 6, 2011").

In this *FTR Now*, we discuss the impact these changes will have on employers considering a retiree benefits "buy out" and those already in the process of offering retiree benefits "buy outs" to existing employees and retirees.

CRA'S EXISTING POSITION

As employers that have been involved in settlements involving the elimination of retiree healthcare benefits in recent years will know, until recently, CRA's position, as set out in non-binding Technical Interpretations, has been that lump sum amounts received by employees or retirees on the cancellation of their benefits coverage could be treated, for tax purposes, as non-taxable advance reimbursements of medical expenses. Cash payments made in those circumstances were not taxable when received by the employee or retiree, and employers were not required to withhold income tax at source or report these cash payments as employment income.

CRA's position was based on an *Income Tax Act* ("ITA") exception which excludes employer contributions to a private health services plan ("PHSP") from inclusion in an employee's employment income. CRA's interpretation of the ITA extended this provision to treat lump sum payments to former employees and retirees in lieu of benefits coverage under a PHSP as being non-taxable on the cancellation of coverage under a PHSP. PHSPs are arrangements that are recognized under the ITA, and enjoy special tax status. Employee and retiree group health care benefits are typically delivered through a PHSP.

CRA'S NEW POSITION, EFFECTIVE JANUARY 1, 2012

CRA's revised interpretation is that cash payments received by an employee or retiree on or after January 1, 2012 upon cancellation of a PHSP will be taxable employment income. Employers making these lump sum payments will be required to withhold applicable taxes and will be required to report the payments on a T4A Information Return.

As set out above, these lump sum amounts were previously considered advance reimbursements of medical expenses and were, accordingly, non-taxable. However, CRA has identified that where an employee or retiree does not subsequently incur medical expenses following receipt of the payment, the payment cannot be in the nature of an advance reimbursement. It is on this basis that CRA has determined that the lump sum amount should be taxed upon receipt. However, when the employee or retiree does subsequently incur a medical expense, that employee or retiree can claim a medical expense tax credit.

RETIREE BENEFITS "BUY OUTS" IN 2011

As a result of CRA clarifying its new position that cash payments in lieu of benefits coverage under a PHSP will soon become taxable, employers in the process of offering retiree benefits "buy outs" to existing employees and retirees will no doubt be motivated to complete the process, including the cash payments, before the end of 2011.

Many retiree benefits “buy outs” to date have taken place in the context of a court supervised process and/or a class action lawsuit brought against a former employer alleging that the termination of the coverage was a breach of contract. In those situations, employers enjoy protections in the form of a court order in respect of the payments. In a non-court supervised “buy out”, employers will want to ensure that any cash payment made in consideration for the cancellation of benefits coverage is binding upon the employees and retirees, and legally enforceable . In addition, where the “buy out” is voluntary, employers will need to ensure that employees and retirees are given sufficient information about the arrangement so that they are in a position to give consent on a fully informed basis. Other issues to be considered carefully include the capacity of retirees and/or their surviving spouses to make an election to forego coverage, and the involvement of any union that negotiated the retiree benefits coverage.

EXCEPTION FOR EMPLOYER INSOLVENCIES ARISING PRIOR TO 2012

CRA’s new position does not affect employers who became insolvent before 2012. In those cases, provided the insolvency occurred prior to 2012, the payment of amounts to former employees and retirees in lieu of benefits coverage under a PHSP will not be taxable even if they are paid in 2012 or later. This is to account for the (sometimes significant) delay between the insolvency and the eventual payment of the amounts to retirees and former employees.

If you have any questions about the tax treatment of these lump sum amounts, please contact your regular Hicks Morley lawyer, or any member of our Pension & Benefits Practice Group.

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