NO.: **IT-529** DATE: February 20, 1998

SUBJECT: INCOME TAX ACT
Flexible Employee Benefit Programs

REFERENCE: Paragraph 6(1)(*a*) (also subsections 6(3), 6(4), 15(1); the definitions of "salary deferral arrangement," "retirement compensation arrangement," "group term life insurance policy" and "private health services plan" in subsection 248(1); paragraphs 6(1)(*f*), 6(1)(*g*), 6(1)(*h*), 6(1)(*i*), subparagraphs 56(1)(*a*)(i) and (iii))

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Application

This bulletin discusses various tax consequences that may apply to flexible employee benefit programs.

Summary

This bulletin discusses the tax treatment of flexible employee benefit programs. These programs, which are sometimes referred to as "flexible benefit plans" or "cafeteria plans," are not defined in the *Income Tax Act* but can generally be described as a program of delivering company benefits where the employees are able to select the type and level of coverage from among a menu of available benefits. These programs are generally implemented to permit employees to build an individualized benefit program that most closely meets their coverage needs and budget requirements and to change their benefit elections over time as their life circumstances change.

Income tax considerations are an integral part of the design of flexible employee benefit programs and an important

aspect of the selection of benefits by the employee. The design of such programs would, for example, include the choices to be made by the employee between taxable and non-taxable benefits, the conditions attached to these choices and the method of purchasing the chosen benefits. Although the Act does not contain provisions that specifically apply to these programs as a whole, the design of the program must satisfy certain conditions in order to avoid adverse tax consequences for all benefits provided under the program. These conditions are discussed in the bulletin. Provided these conditions are satisfied, the various benefit components under the program are subject to specific provisions of the Act in the same manner as if they were offered on their own outside of the program. Therefore, depending on the particular benefit and how it is paid for, it may result in a taxable benefit to the employee or a non-taxable benefit.

The bulletin discusses these tax consequences in the context of a typical flexible employee benefit program, hereafter referred to in this bulletin as a **Flex Program**. However, since the purpose of such a program is to provide flexibility in the delivery of employee benefits, a particular flexible employee benefit program will not necessarily contain all the features described below, or it may be structured in a different format.

Discussion and Interpretation

Description of a Flex Program

¶ 1. Under one type of Flex Program, the employer allocates a notional amount (commonly called flex credits) to each eligible employee. Prior to the beginning of the plan year (see ¶ 4 below), the employees participating in the Flex Program allocate their flex credits to various benefits available under the Flex Program, some of which may result in a taxable benefit to the employee and some of which may not. The employer is then obligated under the terms of the Flex Program to provide the employee with the benefits so chosen. Typically, each employee will get a booklet from the employer explaining the details of the particular Flex Program and a worksheet to assist the employee in making choices. However, regardless of the manner in which the details of the Flex Program are communicated to the employees, the tax consequences described in this bulletin will not necessarily apply unless all eligible employees are informed of their rights under the Flex Program.

¶ 2. Another type of Flex Program permits employees to select a level of coverage for each benefit available under the Flex Program, ranging from no coverage to a premium level of coverage. A standard level of coverage is established by the employer for each benefit and a dollar value is assigned to each level of coverage above or below that standard. When an employee selects a level of coverage other than the standard established by the employer, the assigned dollar value for that level of coverage is either credited or debited to the employee's account. If an employee's selection of benefits results in a net deficiency, the additional amount required to pay for the benefits so chosen is withheld from the employee's salary. Since the tax treatment of each benefit is determined separately, a Flex Program will normally permit an employee to choose which benefit is considered to have been purchased by that employee through the use of payroll deductions. The terms and conditions of the Flex Program will determine whether any surplus can be paid to the employee as additional remuneration.

¶ 3. The allocation of flex credits annually by an employer to its employees represents the employer's contribution to benefits. In the second type of Flex Program, all benefits which are not attributable to a payment by the employee are considered to be funded by means of a contribution by the employer. A Flex Program may also allow an employee to increase the level of benefits provided under the Flex Program or acquire additional benefits by means of payroll deductions or by forfeiting some other right, such as vacation leave. In the same manner as for other payroll deductions, an employee who uses payroll deductions to purchase benefit coverage is taxed on the gross amount of salary received and not the net amount of the employee's pay cheque.

Plan Year

¶ 4. A plan year is normally defined as a twelve-month period. However, in the case of the first year of a Flex Program, the plan year may be greater or less than twelve months so that the plan year will coincide with the year end designated in the Flex Program documentation. The plan year does not have to be the calendar year and does not have to be the same for all employees. For example, in order to ease the administration of a Flex Program, employers may require employees to make their annual selections prior to the month of their birth, in which case the selection would be valid for the plan year commencing with the month of their birth. In any event, the plan year should be explained in the Flex Program documentation available to all employees.

Tax Considerations in the Design of the Overall Flex Program

¶ 5. The concept of the plan year is important to a Flex Program if the program offers employees the choice of both taxable and non-taxable benefits. As a general rule, where one part of a Flex Program could be regarded as a health and welfare trust or similar arrangement and another part could be regarded as a salary deferral arrangement, a retirement compensation arrangement, an employee benefit plan or an employee trust, the statutory rules applicable to salary deferral arrangements, retirement compensation arrangements, employee benefit plans or employee trusts, as the case may be, will apply to the entire Flex Program. However, if the employees covered by the Flex Program are required to choose which benefits will be provided under the Flex Program and how the benefit will be funded prior to the beginning of the plan year (and, subject to ¶ 6 below, the selection is irrevocable), the Flex Program can be segregated into multiple parts and the taxation of the benefits offered under the Flex Program is not altered by the fact that it is provided under the umbrella of a Flex Program. While the discussion in this bulletin concerning the tax consequences of benefits provided through a Flex Program centres on whether or not a Flex Program is an employee benefit plan, the comments are applicable with the appropriate modifications, if the Flex Program is a salary deferral arrangement, a retirement compensation arrangement or an employee trust.

¶ 6. Two exceptions to the requirement (described in ¶ 5 above) that the employee's selection of benefits be irrevocable for the duration of the plan year is the occurrence of a "life event" or a change in employment status. The term "life event" should be defined in the plan documentation if the Flex Program permits changes in the selection of benefits when such a life event occurs. A life event is typically defined to include events such as the birth or death of a dependant, a change in marital status or the loss of insurance coverage under a spouse's employer's plan. A change in an employee's place of residence which does not result in a change to the amount of flex credits allocated to the employee would not be an acceptable life event which would warrant a change to the employee's allocation of flex credits during the plan year. In certain circumstances, a Flex Program may permit an employee to make certain changes to accommodate a life event (i.e. decrease coverage in one area to provide additional coverage in another) without adversely affecting the tax treatment of benefits under the plan. This is only possible if the changes do not require a withdrawal of funds credited to that benefit option contrary to the terms of that policy or plan and the Flex Program's definition of life event is confined to events such as those described in this paragraph. Also, if the amount of flex credits allocated to an employee is altered by reason of a change in employment status (for example, a part-time employee may be entitled to less credits than a full-time employee), an employee may be required to make changes to the original selection of benefits to accommodate the increase or decrease in the amount of flex credits available. However, any such change cannot be made on a retroactive basis. For example, if an employee had selected a certain type of insurance coverage, any change to that coverage would only be effective from the date of that life event or change in employment status.

¶ 7. Assuming that flex credits have no redemptive value and that nothing of value is forfeited by the employee to acquire such credits, flex credits are considered to be notional amounts in that a flex credit has no intrinsic value by itself. A Flex Program will not be considered to be an employee benefit plan if, under the terms of such a Flex Program, flex credits are notional and the employee is required to make an irrevocable selection of benefits to be provided with the flex credits before the beginning of the plan year (subject to the exceptions described in ¶ 6 above). The allocation of flex credits by an employer does not, in and by itself, normally give rise to a taxable benefit in the hands of the employee.

¶ 8. If, after the beginning of the plan year, a Flex Program permits:

- an exchange of unallocated or newly allocated flex credits for cash (although the actual payment of cash, according to the employee's allocation of flex credits prior to the beginning of the year, may occur after the beginning of the plan year);
- a transfer of credits between benefit options; or
- a selection of benefits (other than a reselection of benefits described in ¶ 6 above or an initial selection by an employee who enters the Flex Program at any time during the plan year);

the employee will be considered to have constructively received employment income equal to the value of the allocated credits (unless the entire Flex Program is considered to be an employee benefit plan). This would result in the inclusion in the employee's income of the value of all benefits received out of the Flex Program even though some of the benefits would not have been so included if offered separately from the Flex Program. This is because a flex credit which can be saved and negotiated for cash at any time has a redemption value and is thus not considered to be a notional credit as described in the previous paragraph.

¶ 9. While a portion of the flex credits allocated to an employee may be computed as a percentage of the employee's salary, the conversion of any portion of the employee's salary to flex credits will result in an income inclusion of the amount of salary so converted. Thus, if an employee forgoes an amount to which the employee is or will become entitled, such as a negotiated salary increase, vacation or bonus, the amount of remuneration forgone is included in income in the year in which the amount is converted to flex credits as explained in ¶ 22 below. On the other hand, when a contract of employment is renegotiated upon the <u>expiry</u> of a former employment contract to incorporate a decrease in the level of salary or wages to be paid to an employee over the term of the new contract and the new contract also provides for additional flex credits, the additional credits will not be required to be included in the employee's income as part of salary and wages. However, if an employment contract is renegotiated during the term of an employment contract to decrease salary and increase the allocation of flex credits, the additional credits so allocated will be included in the employee's income as salary. Also, the benefits acquired by means of the additional credits will be considered to have been provided through employee contributions.

Setting up a Flex Program

¶ 10. All employees covered by the Flex Program must have legal access to the rights granted under the Flex Program. Generally, this means that the employees must have access to some document which outlines their entitlement under the Flex Program. As with health and welfare trusts, there is no formal registration procedure for a Flex Program and no requirement that the plan documents be submitted to Revenue Canada for approval prior to the implementation of the Flex Program. However, the advice of the local tax services office may be requested where there is any doubt as to whether the Flex Program could be considered to be an employee benefit plan, an employee trust, a retirement compensation arrangement or a salary deferral arrangement. Alternatively, an advance income tax ruling as described in the current version of Information Circular 70-6 may be requested. Full particulars of the Flex Program including a copy of all pertinent documents should accompany such a request.

Statutory Considerations

¶ 11. In determining the tax consequences arising from a Flex Program, consideration must be given to whether the Flex Program falls within the definition in subsection 248(1) of a salary deferral arrangement, a retirement compensation arrangement, an employee benefit plan or an employee trust. Flex Programs are usually designed so that both taxable and non-taxable benefits can be provided through the same plan. However, failure to be excluded from the statutory rules governing an employee benefit plan, an employee trust, a retirement compensation arrangement or a salary deferral arrangement can result in adverse tax consequences where the intention is to provide non-taxable benefits to employees. The following is a brief explanation of these terms.

¶ 12. Employee trust – This term is described in the current version of IT-502, *Employee Benefit Plans and Employee Trusts*.

Employee benefit plan – This term is described in the current version of IT-502. Virtually, all funded plans other than salary deferral arrangements and retirement compensation arrangements which provide employees with benefits (including payments by an employer under an insurance policy) could meet the definition of an employee benefit plan unless the plan fits within one of the statutory exclusions. The statutory exclusions which are common to Flex Programs are:

– private health services plans, including health care spending accounts as described in ¶ 14 below;
– group term life insurance policies; and
– group sickness or accident insurance plans.

Retirement compensation arrangement – This term is described in the *Retirement Compensation Guide*. The rules relating to retirement compensation arrangements are intended to prevent tax deferral on unregistered retirement savings plans that escape the salary deferral arrangement rules. Note that a Flex Program which permits an employee to allocate flex credits to a benefit option which is not expected to be provided until after a substantial change in services rendered by that employee (such as retirement), or the portion of the plan which relates to that choice, may be considered to be a retirement compensation arrangement.

Salary deferral arrangement – Briefly stated, a salary deferral arrangement is:

– a plan or arrangement (whether it is funded or not);
– between an employer and an employee who has a right to receive an amount under the arrangement; and
– one of the main purposes for the creation or existence of the right is to postpone the tax payable under the Act by the employee in respect of salary or wages for services rendered in the year or a preceding year.

It is important to note that the “right” mentioned in the definition includes any right that is subject to one or more conditions, unless there is a substantial risk that any one of those conditions will not be satisfied. As a result, the salary deferral arrangement rules cannot be avoided by making the employee’s right to the funds subject to some condition which will likely be met anyway. For example, it is not relevant for the purpose of determining whether a Flex Program is a salary deferral arrangement whether or not the receipt of the deferred amount is contingent on:

– the employee remaining an employee for a minimum period of time;
– the employee not being dismissed for the cause or commission of a crime;
– the employee refraining from transferring or encumbering the employee’s interest in the deferred amount; or
– the employee abstaining from competition or being available for consultation after retirement or termination of employment.

When all or part of a Flex Program meets the general definition of a salary deferral arrangement, the list of statutory exceptions must be examined. Those which are the most relevant to a Flex Program include:

– disability or income maintenance insurance plans;
– group sickness or accident insurance plans; and
– certain employer education and training plans.

Amounts deferred under a salary deferral arrangement are included in the employee’s income in the year they are earned under paragraph 6(1)(*a*) by virtue of subsection 6(11). A deferred amount means an amount at the end of the year that the employee has a right to receive in the future.

Taxation of Individual Benefits

¶ 13. Except for certain statutory exclusions, employees are taxed on the value of any benefit received or enjoyed because of their employment under paragraph 6(1)(*a*). The tax consequences relating to some of the various benefits which may be provided under a Flex Program are described below.

Health Care

¶ 14. One option that may be found in a Flex Program is a secondary health care plan (sometimes called a “health care spending account” or a variation of that term). These plans are comprised of individual employee accounts that provide for the reimbursement of eligible medical and dental expenses as defined by the terms of the plan. A health care spending account may qualify as a private health services plan provided that it meets the criteria set out in the current version of IT-339, *Meaning of "Private Health Services Plan."* If it does not qualify as a private health services plan, the amount of any benefit received out of the plan will be taxable to the employee.

¶ 15. While some health care spending accounts are only funded to the extent of claims actually made against the account (on a pay-as-you-go basis), an employer is obligated to reimburse employees for eligible costs incurred by the employee to the extent of the balance of credits remaining in the account. A credit in a health care spending account should not be confused with a flex credit. Since a health care spending account is designed to be a plan of insurance, the amount of credits in a health care spending account (as determined by the amount of flex credits applied to this benefit option as a result of an employee allocation) sets a ceiling on the amount that can be claimed under the plan of insurance. For this purpose, there may be a distinction under the terms of the Flex Program between when the amount is allocated by the employee (prior to the beginning of the plan year) and when that allocation is applied to the health care spending account so that the employee is able to claim expenses to the extent of the limit of health care insurance in force at the time the expense is incurred. Under some Flex Programs, the full amount of the allocation is applied to the health care spending account at the beginning of the year and under others, a proportionate amount is applied each pay period. As with other plans of insurance, an employee has no inherent right to the balance of credits applied to a health care spending account.

¶ 16. One of the criteria for a private health services plan is that the plan must be a plan of insurance. In order for a health care spending account to qualify as a plan of insurance, there must be a reasonable element of risk. For example, if the plan or arrangement is such that there is little risk that the employee will not eventually be reimbursed for the full amount allocated to that employee annually, then the arrangement is not a plan of insurance and therefore, not a private health services plan. While a plan which includes a carry forward provision undoubtedly reduces the risk of loss to the employee, a plan which permits the carry forward of either the unused allocation or eligible medical expenses (but not both) up to a maximum of 12 months will not be disqualified as a private health services plan solely by reason of the carry forward provision in the plan.

¶ 17. If an employee is able to withdraw or transfer an amount from a health care spending account (other than as a premium payable in respect of another private health services plan), the health care spending account will not be a private health services plan and all amounts received out of the account, including reimbursements of eligible medical expenses, will be included in the employee's income under paragraph 6(1)(*a*). For example, if an employee is able to reallocate an amount which was previously applied to a health care spending account to another benefit option such as a group RRSP, the health care spending account will not qualify as a private health services plan because a contribution to an RRSP is not a qualified medical expense. However, the ability to reallocate credits to another private health services plan, such as a vision or dental plan will not affect the status of the health care spending account as a private health services plan.

¶ 18. There will generally be no advantage to an employee in using payroll deductions to contribute to a health care spending account. Since the flex credits allocated to a health care spending account will typically set a limit on the maximum reimbursement payable under the plan and the employee is taxed on the gross amount of salary paid, including the amount withheld through payroll deductions to pay for benefits under the plan, a contribution of salary may result in the taxation of more income than the employee actually receives. While any contributions that are made by the employee to a health care spending account that is a private health services plan would qualify as a medical expense for the purpose of the medical expense tax credit, the medical expense tax credit may not fully offset the income inclusion and there is no mechanism by which an amount forfeited at the end of the year can be refunded to the employee.

Survivor Benefits

¶ 19. Flex Programs may offer choices relating to benefits to be provided to an employee's spouse or dependants after the death of the employee. The taxation of the benefit depends, to a large part, on how the benefit is funded by the employer.

¶ 20. Life insurance coverage for employees or former employees is taxable under subsection 6(4) if it is provided through a group term life insurance policy as defined in subsection 248(1). Since the definition of group term life insurance policy excludes a policy which provides coverage for anyone other than an employee or former employee, an employee's taxable benefit derived from an employer's contribution to a policy which provides coverage for a dependant or spouse is included in income under paragraph 6(1)(*a*). Thus, the benefit from a policy which covers both employees and their dependants is determined under paragraph 6(1)(*a*) but the benefit from a policy which otherwise qualifies as a group term life insurance policy which only covers employees and former employees is determined under subsection 6(4). The value of the benefit derived from life insurance coverage under a policy which is not a group term life insurance policy would ordinarily be the amount of premium paid by the employer in respect of such coverage. The rules for calculating the benefit to be included in income under subsection 6(4) are found in section 2700 of the *Income Tax Regulations*. Further information can be found in the Departmental publication T4130, *Employers' Guide to Payroll Deductions – Taxable Benefits*.

A payment of an uninsured amount by the employer to the surviving spouse or named beneficiary of an employee upon his or her death will ordinarily qualify as a death benefit as defined in subsection 248(1) even though the employee has allocated flex credits to ensure the payment of such amount. However, if the employer creates a fund, including an administrative services contract with an insurer, to provide for death benefits, the fund will likely be an employee benefit plan with the effect that the employer would not be entitled to a deduction for contributions to the fund until such time as the death benefit was paid. Since an administrative services contract with an insurer is not a policy of insurance, it is not a group term life insurance policy as defined in subsection 248(1).

Short-Term and Long-Term Disability Insurance

¶ 21. Even though an employee may choose to use payroll deductions to acquire coverage under a disability insurance plan, any resulting benefit received out of the plan will be taxable under paragraph 6(1)(*f*) unless the entire plan is funded solely with payroll deductions. Since flex credits allocated to an employee represent the employer's obligation to provide benefits to the employee, a disability insurance plan will be considered a plan to which the employer has contributed when flex credits have been allocated by any employee to ensure coverage under that particular plan. If, however, an employer has two separate disability plans (one which is funded solely by the employees through payroll deductions and one that is funded by the employer) and the funds of the two plans are not cross-subsidized, benefits received out of the plan funded solely through payroll deductions will not be included in the employee's income and benefits derived from coverage acquired by means of an allocation of flex credits will be taxable to the extent provided by paragraph 6(1)(*f*). Employee-pay-all plans are discussed in the current version of IT-428, *Wage Loss Replacement Plans*.

Vacation Selling

¶ 22. Where an employee forgoes vacation or other amounts to which the employee is otherwise entitled in order to obtain or increase the amount of flex credits available under the plan, the value of the amount forgone is included in the employee's income at the time the additional flex credits are so credited. For example, assuming that an employee is entitled to a $52,000 annual salary for working 49 weeks with 3 weeks of vacation leave, the employee will be taxed on $53,000, if the employee works an extra week in exchange for additional flex credits (whether or not the flex credits are applied to benefits which would have been taxable if funded by the employer's contribution). In this situation, the employee is considered to have paid for the additional benefits by way of additional services rendered. It is the trading of vacation entitlement by the employee that triggers a taxable event and not the use of the flex credits obtained. Even when the conversion of taxable employee entitlements to flex credits is required under the terms of the Flex Program, an employee has a degree of control over the amount of salary or other entitlement forfeited by means of the choices available to the employee under the Flex Program.

Vacation Buying

¶ 23. A Flex Program may include an option under which an employee may obtain additional vacation leave. If the additional leave is funded by way of payroll deductions, the leave is effectively unpaid leave. If it is funded through an allocation of flex credits, the terms of the plan will typically require the employee to use the purchased vacation within the plan year in which it is acquired. When a Flex Program permits vacation leave so purchased to be carried forward to a subsequent plan year, the arrangement may be considered to be a salary deferral arrangement. While vacation pay trusts are excluded from the definition of a salary deferral arrangement, an arrangement to pay for the vacation leave so purchased out of a trust would not qualify as a vacation pay trust as defined in paragraph 149(1)(*y*). The criteria for establishing a vacation pay trust are explained in the current version of IT-389, *Vacation Pay Trusts Established under Collective Agreements*.

Cash Payments, Transfers, Diversions

¶ 24. When an employee chooses, prior to the beginning of the plan year, to receive a portion of his or her flex credits in cash or deposited into an RRSP, the amount so received or deposited is included in the employee's income as salary or wages when it is received or deposited. If the amount is placed into a registered plan such as an RRSP or an RESP, the terms of which require contributions to be made by the planholder or subscriber, the employee is considered to have received the amount of flex credits allocated to that benefit option and must include that amount in income. In the case of a contribution to an RRSP, the employee is entitled to a deduction to the extent permitted under the rules governing RRSPs. Other benefits available under a Flex Program will be included in an employee's income in the same way as they would if offered separately from the plan. For example, if one of the choices is a low interest loan from the employer, an interest benefit is calculated under section 80.4 and is included in income under subsection 6(9) of the Act.

Tax Implications to the Employer

¶ 25. For greater certainty, no deduction is available to the employer solely by reason of the allocation of flex credits to an employee. In the case of benefits which are provided through a plan of insurance, subsections 18(9) and (9.01) impose restrictions on the amount that can be deducted in the year by the employer on account of contributions to fund a plan of insurance or on account of premiums paid in respect of a policy.

Benefits to Shareholders

¶ 26. The comments in this bulletin apply only in respect of a Flex Program which is offered to a group of employees or former employees, as opposed to a group of shareholders and persons related to shareholders. When flex credits are allocated to an individual who is both an employee and a shareholder (or an employee who is related to a shareholder of the employer), the Flex Program benefits will be presumed to have been conferred upon the shareholder by reason of his or her shareholdings unless the participant is a member of a group of employees who participate in the Flex Program and the rules applicable to that Flex Program, including the allocation of flex credits and availability of benefit choices, are applied equally to all participants in the Flex Program. For comments concerning benefits provided to shareholders in their capacity as shareholders, see the current version of IT-432, *Benefits Conferred on Shareholders*. If a benefit is granted "qua shareholder," it will be taxed under subsection 15(1) without regard to any of the exceptions found in section 6. In addition, the corporation will not be entitled to a deduction for any amount paid on behalf of the shareholder.

Benefits to Former Employees

¶ 27. Where a former employee is required to include an amount in income on account of the benefits described in this bulletin, the authority for taxing the benefit is found in either subsection 6(3) or paragraph 56(1)(*a*) depending on whether the obligation to provide the benefit arose immediately prior to, during or immediately after the former period of employment or at some other time. However, the amount to be included in the former employee's income will not exceed the amount that would otherwise have been included in income had the former employee been an employee at the time the benefit was conferred. For example, no amount will be included in the former employee's income on account of coverage under a private health services plan.

Related Bulletins and Guides

¶ 28. The current versions of the following bulletins and guides contain information which may be applicable to a Flex Program.

Bulletins

IT-85	*Health and Welfare Trusts for Employees*
IT-227	*Group Term Life Insurance Premiums*
IT-247	*Employer's Contribution to Pensioners' Premiums Under Provincial Medical and Hospital Services Plans*
IT-339	*Meaning of "Private Health Services Plan"*
IT-389	*Vacation Pay Trusts Established under Collective Agreements*
IT-428	*Wage Loss Replacement Plans*
IT-432	*Benefits Conferred on Shareholders*
IT-470	*Employees' Fringe Benefits*
IT-502	*Employee Benefit Plans and Employee Trusts*
IT-508	*Death Benefits*
IT-519	*Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction*

Guides

T4130	*Employers' Guide to Payroll Deductions – Taxable Benefits*