Wage loss replacement plans

An employer can own and pay for a group of individual disability insurance contracts to form a Wage loss replacement plan (WLRP) which has special tax benefits under the *Income Tax Act* (Canada). This article discusses these tax benefits and looks at the rules surrounding WLRPs in practice.

Why use a WLRP?

Employers have three options for providing disability coverage to an employee using an individual disability insurance (DI) contract. First, an employer may purchase a DI policy for the benefit of an employee (who would receive the disability benefits), the premium amount would be a tax-deductible expense and a taxable employment benefit to the employee. Disability benefits paid by an insurer to an employee under this arrangement would be tax-free to the employee. Second, if instead the disability contract was grouped with other individual DI contracts to form a WLRP, the amount of the premiums would be tax deductible to the employer; however, they would *not* be a taxable benefit to the employee. Another major difference of using a WLRP is that the disability benefits would be taxable to the employee. Third, the employee could own the DI policy and the employer could increase their salary so that they have enough after-tax dollars to pay the premium. Disability benefits paid to the employee under this arrangement would be tax-free to the employee.

Type of DI coverage for employee	Taxation of premium payment / increased salary		Taxation of DI benefit to employee
	To the employer	To the employee	
1 .Non-grouped DI owned – employer-	Tax deductible	Taxable benefit	Non-taxable
2. WLRP	Tax deductible	Not taxable	Taxable
3. Non-grouped DI owned – employee-	Tax deductible	Taxable benefit	Non-taxable

Even though DI benefits paid to an employee under a WLRP are taxable, these arrangements are an attractive benefit to employees because they provide DI coverage while not giving rise to added income for tax purposes. Other benefits for employees include:

- Potential transferability of the DI contract in the event the WLRP terminates or the employee leaves the employer
- DI benefits from a WLRP are earned income for the purposes of calculating the employee's RRSP deduction limit for the following year

Attractive to employers

WLRPs are typically offered to smaller classes of key employees within an organization to form part of a benefit package to help attract and retain talent. When comparing paying the employee with enough after-tax dollars to purchase a DI contract that provides an equal after-tax monthly disability benefit, a WLRP can be more cost-effective for an employer.

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Let's look at an example.

1. Example

EmployerCo is subject to tax at a general business rate of 27% and wants to provide individual disability coverage to its top performing managers, like Mr. Employee. He is 40, a non-smoker and within occupation class 4A. Mr. Employee's marginal tax rate is 50% and he has an annual income of $151,000. EmployerCo is considering the following two strategies: 1) fund DI coverage on Mr. Employee through a WLRP, or 2) Mr. Employee owns the DI contract and receives an additional bonus so he has enough after-tax dollars to pay the premium.

The goal with each option is to provide a net after-tax monthly benefit of $7,000. In this regard the premium for the WLRP option is $2,977 and $2,049 for the employee-owned option. Using Canada Life's WLRP tool to analyze this scenario we can show that the WLRP option is the least costly for Mr. Employer – as shown in the table below.

	Employee owned with additional bonus	WLRP
Mr. Employee		
Taxable benefit / additional bonus	$4,098	$0
Tax liability	$2,049	$0
Total cost to employee	$0	$0
EmployerCo		
Premium / additional bonus	$4,098	$2,977
Savings from deduction	$1,106	$804
Net cost to employer	**2,992**	**2,173**

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

The table shows that on a net after-tax basis, using a WLRP saves EmployerCo $818 annually, or 27%.

What type of arrangement of DI policies qualifies as a WLRP?

A WLRP is an arrangement between an employer and a group of employees. It may provide short-term disability or long-term disability benefits. The benefits may be paid by either the employer, trustee or insurance company.

There's no definition of a WLRP in the *Income Tax Act* (Canada) ("ITA"). It's an industry term for a group of individually underwritten DI contracts that are offered under an arrangement that qualifies as a "group sickness and accident insurance plan" (GSAIP) under paragraph 6(1)(a) of the ITA. The CRA also provides guidance surrounding what qualifies as a WLRP[i]. Based on this framework of rules, all the following conditions must be met for the arrangement to qualify as a WRLP:

- it's an arrangement of grouped individual DI policies
- the plan is funded, in whole, or in part, by the employer

- the purpose of the plan is to indemnify employees against a loss of employment income as a result of sickness, accident or maternity
- benefits are paid on a periodic basis, not as a lump-sum

WLRPs in practice

The above guidelines are the source for many of the issues that arise with WLRPs in practice. We'll briefly look at some the more common issues:

Meaning of grouped individual policies is flexible – There must be at least two employees participating in the WLRP. One employer may have several different classes of employees within a WLRP. Employees within each class should have a logical defining common denominator, like executive, manager, clerical or administrative. A class of employees defined by either their share ownership or relationship to a shareholder isn't an acceptable classification. Each employee within a defined class should be invited to participate in the WLRP.

WLRPs are for employees, including shareholders who are employees – Only employees may participate in a WLRP. A shareholder who's an employee may participate in a WLRP if they are doing so in their capacity as an employee, not in their capacity as a shareholder. Evidence of an employment relationship and that the WLRP benefit is conferred by virtue of an employment relationship may include:

- receipt of salary remuneration from the employer
- an employment contract which provides for participation in the WLRP
- the participation within the shareholder's group includes other employees who aren't shareholders
- benefit levels given to employees who are shareholders are reasonable compared to benefit levels given to other groups which don't have shareholders, and
- the invitation and acceptance/rejection of other employees to participate in the WLRP.

Implementation – Canada Life requires DI policies used within a WLRP to be held within an arrangement that satisfies the CRA requirements noted above. It's recommended that clients consult with their tax and legal advisors to implement a WLRP. Typically, WLRPs are evidenced with a directors' resolution and a written plan setting out the WLRP terms. The plan's terms may describe the group or class of employees covered by the WLRP, that benefits are payable to the insured person, benefit amounts, waiting and benefit periods, and transferability of the DI contract.

Partnerships and sole proprietors – Individuals who are partners in a partnership or sole proprietors may not participate in a WLRP; however, they may purchase non-grouped disability insurance.

Withholding tax and reporting payments of DI benefits – Canada Life is required to deduct income tax from DI benefits paid pursuant to a WLRP using payroll deduction tables published by CRA. We also issue a T4A slip for every taxation year in which DI benefits are paid from a WLRP.

Return of premium (ROP) isn't available – A DI policy that's part of WLRP may not have an ROP rider. The CRA stated that a GSAIP cannot provide benefits other than a sickness or accident insurance benefit and an ROP benefit is not a sickness or accident insurance benefit[ii].

Transferring an individual DI policy – WLRP plans may permit a terminated or retiring employee to obtain ownership of their individual DI contract. Transferring ownership of a DI contract to an employee may give rise to a taxable employment benefit equal to the fair market value of the contract and provide a corresponding tax deduction to the employer[iii]. There wouldn't be an income inclusion to the employer as a result of the transfer[iv]. An employer and employee should consult with their tax advisor to see if a transfer of the DI contract would give rise to any tax consequences.

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[i] See archived IT-428, Wage Loss Replacement Plans, and the CRA's publications about WRLPs posted on the Canada.ca website.
[ii] CRA TI 2009-0314871E5, March 3, 2011.
[iii] The taxable employment benefit would be reduced by any consideration paid by the employee for the policy. A consulting actuary could provide an estimate of the fair market value of a DI contract, Canada Life doesn't provide policy valuation services.
[iv] Subparagraph 39(1)(a)(iii) of the ITA.

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