Does Your Child Care Benefits Program Meet Tax Rules?

Working parents are a staple of the 21st century workforce. So offering child care benefits has become one of the best ways to attract and retain quality employees. There are plenty of options—ranging from providing daycare services to reimbursing employees' for daycare and babysitting expenses. But regardless of how you choose to do it, you'll need to deal with some complicated tax and payroll rules if you offer child care benefits. Here's an overview of those rules and how to comply with them.

TAX IMPLICATIONS OF CHILD CARE BENEFITS

Providing child care benefits has significant income tax implications that you need to understand.

Federal Tax Rules

Child care benefits provided by an employer are generally taxable to the employee under Section 6(1)(a) of the *Income Tax Act*, which states that taxable employment income includes "the value . . . of benefits of any kind whatever received or enjoyed by the taxpayer" as a result of his employment. This definition would include child care support that employees receive from their employers, including:

- Cash benefits such as payments to employees to cover out-of-pocket child care expenses (subject to certain exceptions, as we'll explain below); and
- Non-cash benefits such as arranging to let employees enroll their children for free or at reduced rates in a daycare facility operated by a third party or at the workplace at a facility the company owns and operates itself.

Québec Tax Rules

In Québec, the rules are the same. When an employer furnishes daycare at its own facilities or reimburses employees for daycare expenses they incur, the benefits are taxable to the employee.

As a practical matter, though, in Québec the percentage of employers that provide child care benefits is relatively small because a government-subsidized daycare system operates most of the child care centres in the province. Parents can place their children in these government run facilities for less than $10 a day and thus are less apt to rely on their employers for child care benefits.

2 Federal Exceptions to Employee Taxability of Child Care Benefits that Don't Apply in Québec

Although most child care benefits are taxable to employees under both sets of tax laws, federal tax rules provide for 2 exceptions that don't apply in Québec:

Exception 1: On-Site Child Care Benefits: The first exception isn't mentioned in the *Income Tax Act* or regulations. It's an exception that the CRA has seen fit to carve out on its own. The exception is a narrow one that applies to employers that provide on-site child care services. According to CRA Employer's Guide T4130 ("Taxable Benefits"), child care benefits are not taxable under 4 conditions:

1. **Provided at Place of Business.** The benefit must be child care services that are provided at the employer's place of business in the form of on-site daycare.
2. **Directly Managed.** The employer must directly manage the services, a requirement the CRA has interpreted strictly to preclude employers from outsourcing the administration of an on-site centre to a professional child care service provider.
3. **Free or Cheap to Employees.** The employer must provide the services to all of its employees "at minimal or no costs." The benefit is taxable if it's limited to a few chosen employees.
4. **Exclusive to Employees.** The on-site services must be available only to employees only and not to members of the general public.

All 4 conditions must be met and the CRA doesn't give you any wiggle room.

<u>Example:</u> An employer provides free child care services to every one of its employees. All services are provided at the site of the workplace. The program's purpose is to provide employees not full-time but backup child care in case their normal daycare or babysitting arrangements are interrupted. Accordingly, employees can only use the service a certain number of times per year. The company limits employee participation to assure itself room to accept children from non-employees in the facility at full charge.

In an External Technical Interpretation, the CRA ruled that the benefits provided to employees under the program were taxable. In addition to accepting members of the general public, the employer hired a professional child care services provider to run the facility. The program thus failed to meet 2 of the 4 requirements of the T4130 exception (the second and fourth).

In addition, CRA Guide T4130 states that employees are also taxed when an employer makes the daycare facility available to non-employees for a higher rate than it charges employees. However, the employee is only taxed on the difference between what the general public pays and what the employee pays, not on the full value of the benefit.

Exception 2: Expenses to Allow for Required Travel: Because only a handful of employers can afford to furnish on-site child care services for their employees, child care benefits often take the form of cash payments. If the cash payment covers expenses for routine daycare and other child care arrangements provided by third parties during the workday, the benefit is taxable. But one kind of cash payment may *not* be taxable if your company seeks its own informal ruling from CRA: reimbursements of child care arrangements incurred by employees at the request of their employers so they can travel on business or attend a course.

The authority for the exception is informal correspondence between a taxpayer and the CRA in 1993. An employer asked an employee to travel to attend a course. The employee also took courses at night after work hours. In each case, she gave her employer receipts for her child care arrangements and received reimbursement. The CRA ruled that the first reimbursement was not taxable but the second one was. The difference: The employer required the employee to go to the course out of town but didn't require her to take courses at night [CRA, Head Office Memo 1993-009302256(e)].

PAYROLL IMPLICATIONS OF CHILD CARE BENEFITS

The fact that, subject to a couple of very limited exceptions, child care benefits are taxable to the employee has important implications for payroll.

1. Income Tax Withholdings

First, you must add the value of the child care benefits the employee receives to her taxable income when you calculate how much income tax to withhold and remit. How you calculate the value of the benefit depends on the kind of benefit that you provide:

Direct Reimbursement of Out-of-Pocket Expenses: Add the amount of the reimbursement to the employee's taxable employment income. Example: If an employee who has taxable income of $60,000 annually receives cash reimbursements of child care benefits worth $4,000 annually, report her taxable income on the T4 as $64,000.

Subsidized Rate on Third Party Child Care Services: If you arrange for employees to get a free or concessionary rate at a third party child care facility, you mustreport the amount of the subsidy as employment income. Example: Diaper Day Care agrees to cut its rate for ABC Manufacturing employees from $500 to $250 per month with ABC paying the remaining $250. So if your employee, Maxine, enrolls 2 of her kids in Diaper at the subsidized rate, you must report the additional $500 per month you're paying Diaper for Maxine's children in employment income on her T4.

In either case, once you calculate the value of the benefit, you must report it on the T4 slip:

- In Box 14 ("Employment Income") and
- In the "Other Information" area at the bottom of the slip under code 40.

2. GST/HST Requirements

Child care benefits, whether taxable or non-taxable, are generally not subject to GST if certain conditions are met. According to a GST Memoranda, G300-4-4 Child and Personal Care Services, child care services are exempt from GST if the primary purpose is to provide for the care and supervision of children 14 years of age or under, for periods of less than 24 hours per day.

Example: Assume Maxine in the above example keeps her 2 kids, ages 2 and 4, enrolled in Diaper Day Care for 10 months for less than 10 hours a day on average. She'd then have a taxable benefit of $5,000 for the year that is exempt from GST.

3. CPP/QPP Withholdings

Because child care benefits are taxable, they're also pensionable. So you must deduct premiums from employees' income on the amount of the child care benefit in the employee's taxable income.

Example: MNOP Corp. subsidizes day care at a local day care provided at a rate of $300 a month per child. Judy, an MNOP employee, utilizes the service for her new baby. Judy would thus have an additional $300 a month of taxable income, and that $300 must be included in the calculations for determining CPP contributions.

QPP treats child care benefits the same way.

4. EI Withholdings

Taxable child care benefits may also be subject to EI withholdings depending on how the benefit is paid. If the taxable benefit is paid in cash, such as in the form of a cash reimbursement to enroll the child in a daycare centre or to pay a babysitter, the amount is insurable and you must deduct the EI premiums. If, however, the benefit is not in the form of a cash reimbursement, the benefit amount isn’t insurable and you don’t deduct EI premiums.

Example: XYZ Corp. operates an on-site daycare centre which charges XYZ employees $200 a month per child. It also makes the centre available to children of non-employees for $400 a month. Shannon, an XYZ employee, has one child enrolled in the centre, so she incurs a monthly taxable benefit of $200 a month. That $200 is added toShannon’s taxable income and the $200 is also pensionable. However, because the benefit is not paid in cash, the $200 is not insurable so no EI premiums are due.