Canadian Health Insurance
TAX GUIDE

Critical illness insurance in a disability buy-sell agreement

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Sun Life Assurance Company of Canada is a member of the Sun Life Financial group of companies.
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Clients

Tom and John are the two equal shareholders in Harry, Ltd. They have a buy-sell agreement that requires one to buy the other’s shares if either wants to leave or retire, or if one dies. But recently they’ve begun to wonder what would happen if one of them became disabled and could no longer work. They have an appointment to discuss changes to their agreement with their lawyer. They also need to consider buying insurance to provide the money that would fund the agreement if one became disabled.

Situation

Disability buy-sell agreements are more complicated than buy-sell agreements covering occurrences such as death or retirement. Although retirement can be a gradual transition, it can also be abrupt, and death is final. It’s sometimes difficult to determine whether someone is disabled to the point where they have to leave the business – or when that might happen. It would be unfortunate if a business owner were forced to sell their business interest when they could’ve recovered from their disability and returned to work had they been able to wait. On the other hand, beyond a certain point it makes little sense to wait for a disabled business owner’s recovery that becomes less likely with every passing day.

It can be difficult finding enough disability insurance (DI) to fund a buy-sell agreement but there are alternatives. One is to access the cash value in a life insurance policy intended to fund a buy-sell agreement at death. There are several ways to do this:

- Assuming the policy offers this feature, the policy fund value can be paid as a tax-free disability benefit if the insured becomes disabled.
- Withdraw money from the life insurance policy cash value.
- Borrow from the policy.
- Borrow from a third party using the life insurance policy as collateral security.

But there are several problems associated with these approaches. First, it’s not possible to plan so that the cash value in a life insurance policy (or the policy’s value as collateral security) will be enough to fund a disability buy-sell agreement. Second, regarding policy withdrawals and loans, policy withdrawals are taxed in the same proportion that the cash value bears to the policy’s taxable gain, and policy loans are taxed to the extent they exceed the policy’s adjusted cost basis. Finally, while it may be possible to borrow from a third-party lender and use the life insurance policy as security for the loan, it could be difficult to find a lender willing to lend to a business that’s going through the difficulties imposed on it by an owner’s disability. Even if such a loan were available, the parties couldn’t be sure in advance that they could borrow enough to fund their buy-sell agreement. Because of these difficulties, the parties to a buy-sell agreement shouldn’t rely on life insurance policy values as their only source of funding.

Another alternative is critical illness insurance (CII). A CII policy pays a benefit if the insured suffers a covered critical illness and survives for the contractually provided time, usually 30 days. This case study will consider whether and to what extent it’s possible or advisable to substitute CII for DI in a disability buy-sell agreement.
Key aspects of disability buy-sell planning

Planning for a disability differs in several ways from other types of buy-sell planning. Here are some of the differences:

- **Disability can be ambiguous.** Some disabilities, like degenerative diseases, develop gradually, and include periods where the individual partially recovers before relapsing. It isn’t always clear when an individual can’t work, or has to cut back on their hours. Different policies define disability in different ways, to provide different types and levels of coverage.

- **Disability can be temporary.** A disability buy-sell agreement must have enough flexibility to not force someone to sell their business interest and withdraw from their company when, given enough time, that person could return to normal duties. Often, the agreement will have a waiting period of one and a half to two years before the obligations to buy and sell are triggered. The waiting period in the agreement will often correspond to the waiting period in the DI policy used to fund the buy-sell agreement.

- **Business and personal expenses continue.** Regardless of whether the terms of a buy-sell agreement are ultimately triggered, the business's and owner's expenses continue. The business will need some form of key person insurance and the business owner will need disability income insurance. A discussion of the business's and owner's needs during the period leading to a return to work or a disability buy-sell is beyond the scope of this case study, but those needs should be kept in mind when considering a buy-sell agreement triggered by disability.

Disability insurance and critical illness insurance are not the same thing

When businesses plan for disability, they should not treat critical illness insurance as another form of disability insurance. There are some key differences:

- **Different mechanisms to control risk.** Insurance companies that sell DI policies protect themselves from taking on too much risk through contractual provisions that limit the amount of coverage available and exclude coverage for certain conditions. Life insurance companies that sell CII policies protect themselves through underwriting and higher premiums.

- **Waiting periods.** Buy-sell DI policies have long waiting periods between the onset of disability and payout (between one and a half and two years) versus a 30-day waiting period in many CII policies after a critical illness is diagnosed.

- **Different risks covered.** Conditions that trigger payment of a DI policy benefit may not trigger payment of a CII policy benefit, and vice versa. Consider the following examples:
  - **Serious stroke.** Covered as a critical illness under most CII policies. The insured could be partially paralyzed following a serious stroke and unable to return to work. Under many DI policies the insured would also be treated as disabled.
  - **Severe arthritis.** Not covered as a critical illness under some CII policies. But arthritis may progress to the point where the insured cannot work, resulting in a disability claim.
  - **Heart attack.** Covered as a critical illness under most CII policies, but the insured may recover and return to work. While proceeds from the CII policy may be payable, a claim under a DI buyout policy may not be possible.
Strategies that combine disability buy-sell insurance with CII

There are several ways to combine disability insurance with critical illness insurance in a disability buy-sell strategy. The strategies depend on insurance needs and on how much coverage Tom, John and/or Harry, Ltd. can obtain and afford.

- **Complete coverage.** Tom and John could agree that if either of them had to withdraw from the business because of a disability or critical illness, the withdrawing shareholder would sell his share of the business to the other. Tom and John would determine the amount of coverage needed to cover either contingency – critical illness or disability. They would purchase insurance on the assumption that regardless of the health event that occurred, at least one policy would pay, and the insurance benefit from that policy would be enough to fully fund the buy-sell agreement.

- **Make-up coverage.** If Tom and John cannot obtain enough DI to fully fund their agreement, they can partly make up the difference using CII. This is an imperfect solution, because it could leave Tom and John with insufficient coverage if a disability strikes that is not also a covered critical illness under their CII policy. There could also be a timing mismatch. If both benefits were payable, the CII benefit would be payable 30 days after the critical illness was diagnosed, but the DI benefit may not be payable until one and a half to two years had passed. Still, for those cases where a disability is also a critical illness, the addition of CII could help Tom and John fully fund their buy-sell agreement.

- **Return of premium riders.** Tom and John could also add return of premium (ROP) riders to their policies, if such riders were available. If either became disabled but did not suffer a critical illness, and if enough time had passed, the CII policy could be cancelled for a return of premium. The same reasoning would apply to the DI policy if one of them suffered a critical illness but was not disabled. By cancelling coverage for a return of premium, money needed to fund the buy-sell agreement that could not be obtained through an insurance benefit could be partially obtained through the ROP rider.

- **Policy transfer.** If Tom or John suffered a disability but not a critical illness, or vice versa, and had to withdraw from the business, the policy that was not used to fund the buy-sell agreement could be transferred to the departing business owner (assuming it was not cancelled for a return of premium). This could be an option if the policy did not have an ROP rider, or if the policy paying the benefit provided enough money to fund the buy-sell agreement. The transfer could generate tax consequences though. If Harry Ltd. were the policy owner, the recipient would be treated as having received a shareholder benefit to the extent they did not pay fair market value (FMV) for the policy. The parties would need to retain an actuary to value the policy. If the policies were owned personally though, the remaining business owner could transfer his policy to the departing business owner without tax consequences.
Structuring the buy-sell agreement

There are many ways to structure a buy-sell agreement. Two of them – cross-purchase and entity-redemption – are illustrated below.

Cross-purchase agreement

Under a cross-purchase agreement, Tom and John own DI and CII policies on each other. While the chart above shows only Tom owning insurance on John, in fact they would own insurance on each other. If John suffered a covered disability and/or a covered critical illness, the insurance company(ies) would pay a tax-free benefit to Tom. Under the terms of their agreement, Tom would have to buy John’s shares in Harry, Ltd., using the proceeds of insurance. John would have to treat half of the gain on the sale of his shares as income. He may be able to take advantage of the lifetime capital gains exemption if Harry, Ltd. qualifies.1

If Tom later sold the business, the adjusted cost base (ACB) in the shares he bought from John would be the price he paid for them, and any gain in those shares would be measured from the date he bought them. This gives Tom a tax advantage in that his capital gain on the shares he bought from John would be less than the capital gain on the shares he owned before John’s withdrawal from the business. In practical terms, Tom would not be able to sell the shares he acquired from John separately. The ACB averaging rules would require that the ACB of any shares he sold would be an average of those he acquired from John and those he originally owned.

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1 The exemption can shelter up to $750,000 in capital gains of a qualified small business corporation’s shares in 2013, rising to $800,000 in 2014, and indexed to inflation in 2015 and following years.
An alternative to the above agreement is to have Harry, Ltd. own the policies on Tom and John. If John suffered a covered disability, Tom would buy John’s shares using a promissory note. The insurance company(ies) would pay a tax-free benefit to Harry, Ltd. Once Tom owned all the shares in Harry, Ltd. he would cause Harry, Ltd. to pay him a dividend, which he would use to repay the promissory note.

Two advantages to this approach are that it avoids the need for each shareholder to own policies on every other shareholder if there are multiple shareholders, and the corporation can usually pay the premiums using less heavily taxed dollars than the shareholders. But unlike a buy-sell agreement triggered by an owner’s death using life insurance, there is no capital dividend account tax treatment for the proceeds of DI or CII policies. The dividend will be taxable to Tom.

**Redemption buy-sell agreement**

Under a redemption buy-sell agreement, Harry, Ltd. owns DI and/or CII policies on Tom and John. If either Tom or John becomes disabled or suffers a critical illness, Harry, Ltd. claims the insurance proceeds and uses those proceeds to redeem the disabled shareholder’s shares.

The proceeds paid from a share redemption are treated as a dividend to the extent the proceeds exceed the shareholder’s paid-up capital in the shares. After Harry, Ltd. redeems John’s shares, Tom will still have the same number of shares, but those shares will control the entire company. If Tom later sells his shares, he won’t benefit from the partial increase in ACB that he received under the cross-purchase agreement.

One issue that arises in disability or critical illness buy-sell agreements that doesn’t arise in a buy-sell agreement triggered by death is obtaining information needed to support the claim for the insurance proceeds. Since in these examples John will be alive after the event that triggers the claim, he will need to consent to the release of information that Tom or Harry, Ltd. will need to claim the insurance benefits. If John’s disability or critical illness renders him incapable of giving that consent there could be a problem unless he’d given someone a power of attorney to provide information on his behalf. The lawyer drafting their agreement will need to consider this issue and make appropriate provisions.
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Tax issues

- **Neither CII nor DI premiums paid by an individual or corporation for their own benefit are deductible.**
  
  The Income Tax Act (Canada) (ITA) defines insurance premiums as “personal or living expenses.”
  If personal or living expenses are not deductible.

- **Reasonable business expenses are deductible.**
  
  The ITA allows a business to deduct all reasonable expenses made to earn income from a business or property.
  However, insurance premiums paid to fund a buy-sell agreement are not a business expense.

- **The DI and CII basic benefits are paid tax-free.**
  
  If a DI or CII policy meets the definition of sickness insurance under provincial law, the Canada Revenue Agency (CRA) will treat the policy as insurance under the ITA. Most DI and CII policies sold in Canada meet the definition of sickness insurance under provincial law.
  There is nothing in the ITA that taxes health insurance policy benefits.
  The CRA has said that it believes that CII policy benefits are paid tax-free, as are lump sum DI policy benefits received to fund a redemption buy-sell agreement.

- **ROP benefits are paid tax-free.**
  
  As long as the ROP benefit does not exceed the cumulative premiums paid, and the premiums were not deductible, the ROP benefit should be paid tax-free.

- **Cross-purchase arrangement tax consequences.**
  
  Tom and John will not be able to deduct the insurance premiums they pay, but will receive the proceeds of insurance tax-free.
  They’ll get the other’s shares with an ACB equal to the shares’ FMV on the date of sale.
  That will reduce the remaining shareholder’s capital gains tax exposure when they eventually sell the business.
  The departing shareholder will recognize a capital gain on the sale of his shares to the extent the proceeds he receives exceed his ACB in the shares.
  Half of the capital gain will be included in income. The departing shareholder may be able to use the capital gains tax exemption to shelter some or all of his gains from tax.

- **Redemption buy-sell arrangement tax consequences.**
  
  Harry, Ltd. will not be able to deduct the insurance premiums it pays but, if it qualifies for the small business tax rate, will pay those premiums using less heavily taxed money than either Tom or John (assuming they’re in one of the higher marginal tax brackets).
  If Tom or John becomes disabled and/or suffers a covered critical illness, Harry, Ltd. will get the insurance benefit(s) tax free.
  Harry, Ltd’s payment to the departing shareholder to redeem that shareholder’s shares will be treated as a dividend to the extent the payment exceeds the departing shareholder’s paid-up capital in his Harry, Ltd. shares.
  The departing shareholder may be able to use the dividend tax credit mechanism to reduce tax on the dividend.
  The remaining shareholder won’t receive any shares in this transaction, but the value of his shares will increase by the value of the departing shareholder’s redeemed shares.
  The remaining shareholder’s ACB in his shares will remain the same, meaning that when he sells his shares the entire value of those shares, less his ACB, will be a capital gain.

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2 ITA paragraph 248(1)(b) under the definition of “personal or living expenses.” The CRA has said that premiums payable on a corporate-owned disability insurance policy used to fund a redemption buy-sell agreement are not deductible: CRA document 9208045, dated June 30, 1992.

3 ITA paragraph 18(1)(h).

4 ITA paragraph 18(1)(a).

5 There are no sections in the ITA that tax CII benefits. The CRA has said that a CII policy should be viewed as a “sickness” policy, and that the disposition (i.e., payment of a benefit) from a CII policy is not taxable: CRA Document 2003-0004265, dated June 18, 2003. See also CRA document 2003-0034505, dated December 9, 2003 (the CRA’s opinion was considering a CII policy that was part of a group benefits plan) and CRA document 2003-0054571E5, dated December 24, 2004.


7 CRA document 2002-0017495 dated March 4, 2002. In this case the CRA considered an ROP rider attached to a DI policy, but the reasoning should also apply to a CII policy.
Conclusion

DI and CII address overlapping and complementary insurance needs. They can be used to provide coverage to support a buy-sell agreement. But it’s important to recognize the differences in the products and what they cover. In the ideal case, the company or its shareholders have enough coverage from both policies to fully fund their buy-sell agreement, even if the event triggering the obligation to buy and sell is covered by one policy but not the other. More commonly, CII is used to make up the difference between the insurance need and the amount of DI coverage available. It’s important to realize the limitations to this approach, and to consider features like ROP and the cash values in life insurance policies to make up the difference.

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