Canadian Health Insurance
TAX GUIDE
June 2014

Corporate ownership of
critical illness insurance
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Bob owns all the shares in XYZ, Ltd. and is its key employee. Recently he’s begun to worry about what would happen if he suffered a critical illness. He’s not only concerned about making sure XYZ can survive a critical illness, but that he too could financially recover.

XYZ, has been incorporated long enough for Bob to know there are many advantages, namely, directing the corporation to pay for expenses using money earned at its lower tax rate. He wonders whether he or XYZ should own a critical illness insurance (CII) policy that would serve both XYZ’s needs and his own.

Needs analysis

Bob needs CII for his personal protection. Years ago, people recovered from a serious illness in the hospital. Today, they may leave the hospital before they’re fully recovered, and convalesce at home or in an institution. The costs associated with recovery aren’t necessarily covered by provincial health insurance. Many expenses, such as prescription drugs, physiotherapy, and medical devices (wheelchairs, canes, crutches and so forth), are not covered. In addition to the expenses, cash flow may be further diminished during situations where people need to take time off work to complete their recovery, but don’t qualify for disability insurance benefits. Bob is concerned that if he suffers a critical illness, he may need to spend money to convalesce, but won’t qualify for benefits under his existing insurance policies.

Bob also knows that XYZ will need money if he has to miss work while recovering from a critical illness. Even without Bob, XYZ’s business must continue. Employees will require their paycheques and the rent, electricity and telephone bills must be paid. Someone will also need to take over at least some of Bob’s duties on a temporary basis. Most importantly, XYZ’s customers will still need its goods and services. For businesses like Bob’s, continuity is imperative regardless of a particular owner’s health.

After considering these issues, Bob decides he and XYZ will each need to have $500,000 in CII on Bob. The unresolved question for Bob is who should own the policy.
Paying the premiums

CII premiums aren’t deductible for XYZ or Bob for the simple reason that the Income Tax Act (ITA) says insurance premiums are not deductible.¹ Neither Bob nor XYZ can claim the medical expense tax credit (METC) for the premiums they pay.²

XYZ can’t claim the METC because only individuals, not corporations, may claim the credit.³ For Bob, health insurance premiums count toward a claim for the METC only if the policy qualifies as a private health services plan (PHSP).⁴ Generally, premiums paid for CII policies don’t qualify because CII benefits are paid with no restriction on how the benefit may be spent. In contrast, a PHSP can only pay a benefit to reimburse the policy owner for a specific medical expense. Therefore, Bob can’t treat his CII premiums as medical expenses under the METC.

Consequently, whoever owns the policy will pay premiums using after-tax income. Bob is in the 46.41% marginal tax bracket;⁵ XYZ qualifies for the 15.50% small business tax rate on its income under $500,000. XYZ might consider owning the policy that’s intended to provide benefits to the company. Given the disparity in their tax rates, Bob thinks XYZ should own the policy that provides Bob’s personal coverage, and pay the premiums using its less heavily taxed income.

However, it’s not clear in all cases that corporate ownership is the most tax efficient way to own CII policies providing personal coverage, even when the corporation’s tax rates are about a third less than those of the owner.

If XYZ owns the policy, and if Bob suffers a covered critical illness, XYZ should receive the base benefit tax free. There is no provision in the ITA that taxes insurance benefits, and the CRA has said it doesn’t believe a CII benefit is taxable, as long as the premiums weren’t deductible.⁶

But XYZ won’t be able to pay any part of the insurance benefit to Bob without Bob having to pay tax on the payment. It would be different if XYZ owned a life insurance policy. Life insurance policy death benefits can be paid mostly tax-free through the capital dividend account (CDA) mechanism. The death benefit, minus an amount equal to the policy’s adjusted cost basis just before death, can be posted to the corporation’s CDA. Capital dividends can be paid tax-free to shareholders.

Unfortunately, CII benefits cannot be posted to a corporation’s CDA.⁷ If XYZ gets the CII benefit, it will have to pay it out to Bob as either a taxable dividend or shareholder benefit. If Bob received the CII benefit as a dividend, he’d have to include the dividend as income, but could use the dividend tax credit to reduce the amount of tax he pays on the dividend.

¹ Insurance premiums are defined under ITA paragraph 248(1)(b) as “personal or living expenses.” Under ITA paragraph 18(1)(h) personal or living expenses are not deductible.
² CRA Document 9711505, dated June 2, 1997. The CRA’s guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA’s interpretation of the law on a given subject and can help taxpayers plan their affairs to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the ITA and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.
³ Under ITA subsection 118.2(1) only an individual may claim the credit. Under ITA subsection 248(1), an individual is defined to mean a person that is not a corporation.
⁵ Ontario marginal tax rates as of November 2013. Tax rates will vary from province to province.
⁷ ITA subsection 89(1) restricts insurance policy benefits that can be posted to a company’s CDA to those coming only from a life insurance policy.
The alternative to paying the CII benefit to Bob as a dividend would be to pay it as a shareholder benefit. Unfortunately, shareholder benefits are taxed as income, just like salary, but with no tax credit.

Regardless of whether XYZ paid Bob a dividend or a shareholder benefit, XYZ would not be able to deduct the payment.

In spite of this unfavourable tax treatment, Bob still wonders if it could be beneficial from a tax perspective for XYZ to own a proportionately larger CII policy. Bob thinks he could have the same benefit if he owned the policy personally, but XYZ would pay less after tax in premiums than if Bob owned the policy personally. Let’s test Bob’s idea with an example.

A term to age 75 CII policy with a $250,000 base benefit costs $5,017.50 per year in premiums, assuming no optional coverage is added to the policy. Since he’s in the 46.41% tax bracket, Bob would have to earn $9,362.75 in salary to pay the premiums ($5,017.50 / (1 – 0.4641)). But dividends are taxed to Bob at a lower tax rate – 29.54%. If XYZ owned the policy, and wanted to put the same $250,000 into Bob’s hands as an after-tax dividend, it would have to own a CII policy with a base benefit of $354,811.24 ($250,000 / (1 – 0.2954)). XYZ’s premium payments would rise to $7,102.19.11 At a 15.50% tax bracket, XYZ would have to earn $8,404.96 ($7,102.19 / (1 – 0.1550)) to pay the premiums for its policy, about 10% less than Bob would have to earn.

Bob suspects that his accountant will resist the idea of Bob potentially paying $104,811.24 in taxes on the CII base benefit ($354,811.24 * 29.54%) just to have XYZ pay less, after tax, in premiums. But when considering this concept as an exercise in putting $250,000 in after-tax money into Bob’s hands if he suffers a covered critical illness, it may make sense because the annual after-tax cost for the premiums is less for XYZ than Bob.

However, there’s a final piece to this analysis: XYZ can treat the salary it pays to Bob as a reasonable business expense, and deduct it. It can’t deduct the premiums it pays for an insurance policy that it owns. After considering the deduction for the salary XYZ pays Bob, the after-tax cost to XYZ for Bob to own his own policy declines to $7,911.52 ($9,362.75 * (1 – 0.1550)), less than the $8,404.96 that XYZ has to earn to pay the premiums for the policy it owns. As a result, it turns out to be more expensive for XYZ to own the policy that provides Bob’s personal coverage than for Bob to own the policy himself, even though Bob pays taxes at a rate that’s almost three times that of XYZ.

What if Bob were paid in dividends instead of salary? In that case, XYZ would have to earn only $7,121.06 for Bob to pay the premiums on his policy ($5,017.50 / (1 – 0.2954)). That’s less than the $7,911.52 it has to earn to pay Bob the salary he needs to pay the premiums. Though it may be tempting to say that Bob should take his income from XYZ as dividends instead of salary, this conclusion needs to be tempered by the fact that there are many reasons for choosing to receive dividends or salary, not all of them having to do with the dividend tax credit. For example, dividend income doesn’t build registered retirement savings plan (RRSP) contributing room. If Bob contributes to an RRSP, he can lower his overall tax rate on the salary he gets.

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8 Shareholder benefits are taxed under ITA subsection 15(1) as income, without the benefit of the dividend tax credit.
9 ITA subsection 18(1) allows XYZ to deduct reasonable business expenses. Neither shareholder benefits nor dividends are business expenses.
10 Based on rates in effect as of November 15, 2013 for a 50 year-old male, non-smoker, $250,000 base benefit.
11 Based on rates in effect as of November 15, 2013 for a 50 year-old male, non-smoker, $354,811 base benefit.
Comparison of Bob versus XYZ owning a CII policy with base benefit to Bob (Bob paid salary)\textsuperscript{12}

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There are other, non-tax reasons for Bob to own his policy:

- **Creditor protection.** If XYZ is sued, any insurance proceeds in the corporation are subject to the claims of XYZ’s creditors. Establishing a holding company to own the shares of XYZ and the CII policy could help. If the operating company were sued, only the assets in the operating company would be exposed to the creditors’ claims, not those assets that had been transferred to the holding company before it got into trouble.

- **Retirement, withdrawal from the company or sale of the business.** If Bob leaves XYZ, the CII policy stays with XYZ, unless it transfers the policy to Bob. The CII policy would be an asset like any other, and would have to be valued by an actuary, which involves an added expense. To the extent that Bob did not pay fair market value (FMV) for the policy he would have to include its value in income as a shareholder benefit. Again, establishing a holding company and having the holding company own the policy and operating company shares could help here. If Bob retired or sold the business, he’d have the holding company sell the operating company shares, but would still keep the holding company.

\textsuperscript{12} Using rates in effect as of November 15, 2013, for a 50 year old male non-smoker purchasing a T75 CII policy with no optional benefits. Assuming marginal individual and corporate tax rates in effect for the 2013 tax year in Ontario (http://www.ey.com/CA/en/Services/Tax/Tax-Calculators), specifically, 46.41% personal tax rate, 15.50% corporate income tax rate, and 29.54% dividend tax rate.

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Taking on additional shareholders. As Bob’s business grows, he may have to allow others to own shares in XYZ. This would not affect XYZ’s right to own a CII policy on Bob, but it would mean that paying the benefit to Bob as a dividend would result in Bob’s co-shareholders receiving a dividend in proportion to their ownership interests in XYZ. In effect, they would get part of the benefit meant for Bob. Of course, Bob’s co-shareholders would point out that the corporation they partly owned also paid the premiums for that coverage, so they should take some of the benefit. Again, Bob could avoid this problem by setting up a holding company to own his shares and the CII policy.

While the above discussion may suggest that Bob could avoid the tax drawbacks of personal ownership by having a holding company own his policy, setting up and maintaining a holding company/operating company structure is more complicated and expensive than a single company structure.

In spite of the holding company advantages, Bob might want to resist the temptation to create a holding company only to make it more tax efficient to own an insurance policy meant for personal protection. If and when he needs a holding company for more general business or estate planning purposes, Bob can create one. At that time, if he could benefit from having the holding company own the policy, he could transfer the policy to the holding company. The same rule that applies to the transfer of an asset from a corporation to its shareholder also applies to the transfer of an asset from a shareholder to a corporation. Bob’s holding company may have to pay him an amount equal to FMV for his policy.

Tax and legal issues

The Income Tax Act doesn’t specifically discuss CII policies, and the Canada Revenue Agency (CRA) has offered little guidance on their taxation. What follows is a general discussion. Further details on the tax treatment of CII policies are available in the Canadian Health Insurance Tax Guide:14

- **CII premiums paid by individuals or corporations for their own protection are not deductible.** The ITA defines insurance premiums as “personal or living expenses.”15 Personal or living expenses are not deductible.16 For businesses specifically, a business may deduct expenses paid to earn income from a business or property.17 But insurance benefits are intended only to compensate the policy owner for the loss insured against, not to produce a gain for the policy owner. As a result, insurance premium payments are not deductible business expenses.

- **You may not claim the medical expense tax credit (METC) for paying CII premiums.** You may claim the METC for health insurance premiums only if the policy reimburses you for medical expenses, and only if all the items reimbursed under the policy would be medical expenses if you paid them separately.18 The CRA would need to make a determination regarding the policy. But since CII policies pay insurance benefits with no restriction on how the policy owner may use the funds, the premiums won’t qualify as medical expenses.

14 Available at www.sunlife.ca/advisor/HealthTaxGuide.
15 ITA paragraph 248(1)(b) under the definition of “personal or living expenses.”
16 ITA paragraph 18(1)(h).
17 ITA paragraph 18(1)(a).
CII base benefits are paid tax free. If a CII policy meets the definition of health insurance under provincial and territorial law, the CRA will treat the policy as health insurance under the ITA. Most CII policies sold in Canada meet the provincial and territorial definitions of health insurance. According to CRA guidance, health insurance policy benefits are paid tax free.\(^9\)

Medical expenses still may be claimed. If the policy owner suffers a covered critical illness, and uses the CII benefit to pay medical and/or nursing home expenses, they may still be able to apply those medical expenses toward a claim for the METC. It will not matter that the source of the money used to pay those expenses was a tax-free insurance benefit.

Key person insurance premiums are not included in the key person's income. Provided there is no agreement between the employer and the key person where an intention to pay out the benefit is established, and as long as the key person (or relative) is not named as a beneficiary to the policy, the key person will have no rights under the policy or to the insurance benefit, and will not have to include either the premiums or the insurance benefit as income. This rule covers employees and shareholders alike. If the employer names the employee, shareholder or a close relative as the beneficiary, or if the parties agree that all or part of the benefit will be paid to the key person or to someone he or she designates, the premiums will be taxable to the key person, but the insurance benefit will still be tax free.\(^\text{10}\)

Payment of the insurance benefit from the employer (or at the employer’s direction) to the employee or shareholder will be taxable. If the key person suffers a covered critical illness, the employer will receive the insurance benefit tax free, and could pay it to the key person. Alternatively, the employer could direct the insurance company to pay the insurance benefit directly to the key person. Either way, the payment will be treated as taxable income to the employee or as a dividend or shareholder benefit to the shareholder. If the parties want the shareholder to be able to treat the insurance benefit as a dividend, the employer must receive the insurance proceeds, declare a dividend, and then pay the money to the shareholder. If there's more than one shareholder, each shareholder will receive a dividend in proportion to their ownership interest. Neither shareholder benefits nor dividends are deductible to the employer. Income paid to an employee may be deductible if the employer can show that the payment was a reasonable business expense.


\(^\text{10}\) CRA Documents 2000-0002575 and 2004-0081901I7, dated March 29, 2000 and June 29, 2004 respectively.
Conclusion

After reviewing his particular circumstances with a tax advisor, Bob concludes that both he and XYZ should own and pay premiums separately for their own CII policies. At present, the arrangement is a tax-efficient one for Bob and XYZ. Later, as Bob’s business grows, that may change. In any event, Bob will review his insurance needs regularly, along with his tax situation. If it makes sense one day to transfer ownership of his CII policy to XYZ, or to a yet-to-be created holding company, Bob will consider the decision at that time.

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