Shared Ownership of Critical Illness Insurance

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Shared ownership of critical illness insurance – suggestions for making every sale a good one

Sales of critical illness insurance (CII) with shared ownership have been gaining momentum since the launch of the new product in January 2009. With the strong interest in CII, and in the shared ownership strategy, this paper will review some of the things you need to know to ensure the success of each CII shared ownership sale you make. While the shared ownership concept appears simple on the surface, there's a bit more to it than meets the eye.

Key Principles of CII Shared Ownership

Ensure a need for critical illness coverage exists

Like any business strategy, the corporation must need CII coverage on the employee or shareholder. Some individuals are vital to the success of an organization. Losing that person's ideas and business experience as the result of a critical illness can have devastating short- and long-term financial impacts on the business. Work directly with clients to help demonstrate the value of the key employees and shareholders, and help identify the need for CII before presenting this strategy.

Clients should obtain independent tax and legal advice

One of the advisor's responsibilities is to make sure that both the corporation and the insured understand the importance of getting their own tax and legal advice to make sure that this strategy meets their needs:

- The CII shared ownership strategy, while attractive to many, may not be suitable for all parties.
- This strategy provides only one benefit. Therefore, while two separate parties are paying premiums under the shared ownership agreement, only one of the parties will receive a benefit. In all cases, either the corporation will receive the CII benefit or the insured will receive the Return of Premium (ROP) benefit.

Highlight the importance of the "behind the scenes" responsibilities

In addition to providing advice, the parties' lawyers will also work "behind-the-scenes" to help the parties put the strategy into place. They will draft a corporate resolution for the board of directors to pass to allow the corporation to buy the insurance and agree to the strategy, and will draft a shared ownership agreement for the parties to sign (see below). They will also guide the parties when important decisions affecting the agreement need to be made.

Put a shared ownership agreement in place

The parties will need to have a written shared ownership agreement in place to record their rights and obligations, and to support the validity of this strategy. If desired, the agreement may be put in place after the insurance has been issued to avoid wasting the cost of producing the agreement if for any reason the policy cannot be issued. There are many issues that the agreement should cover. Here are some of the key issues, although this is not an exhaustive list:

- The allocation of premiums and benefits
- Terminating the agreement (including what to do at cancellation or expiry of the policy)
- What happens if the employee's employment ends or if the shareholder leaves the corporation (i.e., death, resignation, retirement)
- How a buy-sell agreement impacts the shared ownership agreement
- What happens if the corporation is wound up, goes bankrupt or becomes insolvent

Recording the policy on our system as a shared ownership arrangement is not enough

Clients should work directly with their legal and tax advisors to ensure that they have a written shared ownership agreement. Recording the policy on our system as a shared ownership arrangement does not mean that there's a legally valid shared ownership agreement in place. Clients' legal and tax advisors can refer to the outline of a sample shared ownership agreement on our website for reference.

Plan for tax consequences

As with all types of sales strategies, tax planning is a key component to the success of the strategy. A CII shared ownership strategy is no different. Here are two tax planning aspects that should be considered before implementing this strategy:

- There are product tax issues that may arise outside of the CII shared ownership strategy. Currently, there are no laws governing the tax treatment of CII. We rely on Canada Revenue Agency CRA guidance to determine the tax treatment of these policies. However, that guidance is not binding on the CRA – it could change at any time.
- There are also tax issues that arise from the relationship between an employee or shareholder and his or her corporation. Unlike the situation governing the tax treatment of CII products, the laws governing the tax treatment of employee and shareholder benefits are well established in the Income Tax Act (ITA), court decisions and CRA guidance. Even if you conclude that no tax consequences arise from the payment of a CII benefit to the policy owner(s) that does not end the discussion. Tax consequences may still arise based on the relationship between the employee or shareholder and the corporation.

Understand that the corporation is a separate legal entity

It is important to remember that a corporation is considered a separate legal person distinct from its shareholder or shareholders, and that the CRA may treat the corporation this way. Here are some of the tax matters that may arise from this distinction:

- If the insured is a controlling shareholder or someone else who doesn't deal at arm's length with the corporation, and unilaterally cancels the shared ownership CII policy to collect the ROP benefit, the CRA may say that the shareholder has received a benefit from the corporation even though the corporation has not done anything to actually confer that benefit. The CRA may assert that the corporation agreed to cancel coverage because the shareholder controls the corporation, not because cancelling coverage was a sound business decision for the corporation (see discussion under the section, "Make clients aware of potential tax and legal issues").
- If a shareholder deals at arm's length with a corporation, though, the CRA acknowledges that you need to have the corporation agree to transfer something of value to the shareholder in order to say that the corporation has conferred a benefit on the shareholder. If the shareholder transfers something of value to himself or herself without the corporation's agreement, then there could be inappropriate conduct like theft, embezzlement, fraud or misappropriation of funds.

Make clients aware of potential tax and legal issues

As an advisor, you need to make clients and their legal and tax advisors aware that there are tax and legal issues arising from a CII shared ownership arrangement. You do not have to resolve these issues for the client; after all, you cannot provide tax and legal advice. But a client's legal and tax advisors need to discuss these matters with the client, and need to provide advice about the decisions the client should make. Here are some of the issues they need to discuss (though not an exhaustive list). A taxable benefit to an employee or a shareholder may arise when:

- The corporation pays premiums for individual CII coverage on the employee, but the benefits are paid to the employee directly. There may be situations involving variations of the employer/employee relationship that may allow for different tax treatment.

- The corporation pays premiums for individual CII coverage on the shareholder, but the benefits are paid to the shareholder directly. The corporation cannot deduct the premium cost, resulting in double taxation on the dollars used to pay for this coverage.
- The corporation transfers ownership of a CII policy to an employee or shareholder, but the employee or shareholder does not pay for the policy, or pays less than fair market value.
- In a shared ownership arrangement between a corporation and a shareholder, the shareholder unilaterally cancels the CII policy. The shared ownership agreement should set out procedures for cancelling the CII policy that protect both parties' interests and which help to confirm the legitimacy of the agreement. For example, under Sun Life Financial's outline of a sample CII shared ownership agreement, if the shareholder wants to cancel coverage he or she must notify the corporation. The corporation then has the right to maintain the policy in force, if desired. If the shareholder ignores the corporation's rights, cancels coverage and receives the return of premium benefit, the CRA could regard the return of premium as a shareholder benefit because the shareholder denied the corporation an opportunity to protect its rights under the agreement. As discussed above, even if the shareholder controls the corporation, the CRA will treat the corporation as a separate legal person with rights that the shareholder cannot ignore.

Be aware of issues unique to sole shareholders

The tax situation for sole shareholders may be more involved than many people think. Here are some thoughts:

- The CRA taxes benefits to shareholders under the Income Tax Act (ITA s. 15(1)). The CRA treats a shareholder benefit as something paid by the corporation not to earn income, but because the shareholder owns shares in the corporation. Therefore the benefit will be taxed as income to the shareholder, but the corporation will not be able to deduct the value of the benefit as a business expense.
- Whether a corporation has conferred a benefit on a shareholder under ITA s. 15(1), what that benefit is, and the value of that benefit, are all questions of fact in each case. Generally, the CRA's position is that any transfer of property or payment of money from a corporation to a shareholder, or use of corporate property by a shareholder, is a shareholder benefit.
- Here are some of the issues that arise in such cases:
  - In order to be characterized as an employee benefit, there must be a reasonable business purpose for the benefit. It has to make good business sense for the corporation to spend the money. In our case, a CII shared ownership arrangement needs to be a reasonable business transaction that benefits both parties.
  - It could help persuade the CRA that a shareholder is receiving an employee benefit if non-owner employees are receiving the same or proportionate benefits. If the benefits are not equal, differences in size should reasonably express the value of the contributions that individuals are making to the corporation. If the shareholder's benefits are disproportionately large compared to those the non-owner employees receive, the CRA may conclude that the shareholder has received larger benefits because he or she owns shares in the corporation, not because the shareholder's services are so much more valuable to the corporation.
  - The benefit must be "conferred". However, as discussed above, in sole shareholder situations, the CRA does not care whether the corporation has done anything to formally confer the benefit. If a sole shareholder receives something of value from the corporation, or uses corporate assets for his or her own benefit, the CRA may assume that the corporation agreed to the transaction. In cases where the shareholder deals at arm's length with the corporation, the CRA may want to see the documentation surrounding the benefit to help it make a determination.
  - A shareholder benefit enriches the shareholder to the same extent that it financially diminishes the corporation. In contrast, an employee benefit does not financially diminish the corporation because the corporation receives services from the employee of equal value to the employee benefit.

Assessing the value of a shareholder or employee benefit

What is the value of the benefit? The only guidance we have from the CRA is that the measure of value is the benefit's "fair market value". In the context of a CII shared ownership arrangement, to the extent that property is transferred to the shareholder or employee through payment of the ROP benefit, the question is what is the worth of the ROP benefit? Unfortunately, there is no market for the ROP benefit. You cannot buy an ROP benefit except as part of a CII policy, nor can you combine one company's health benefit with another company's ROP benefit, and you cannot exchange one company's rider for another's. You could say that the fair market value is whatever the insurance company charges, but what the insurance company charges may not necessarily reflect the fair market value of the benefit.

Provide a thorough explanation of potential issues

Ensuring clients have a thorough understanding of the CII product and shared ownership strategy issues that potentially impact them and/or their business, will help you build a lasting customer relationship. Here are a few additional items that you will want to raise with clients and their legal and tax advisors.

- If the insured employee or shareholder suffers and survives a critical illness, there is no return of premium. The corporation receives the health benefit. If the insured is a shareholder, the corporation could pay the health benefit to the shareholder, treat the payment as a benefit – taxable to the shareholder, but not deductible to the corporation. If the insured was an employee, the corporation may have no obligation to pay the health benefit to the employee, absent a specific provision in the agreement covering that issue.
- There may be situations where, if the employee or shareholder suffers and survives a covered critical illness, the corporation could not pay the health benefit to the insured shareholder or employee even if both parties agreed to accept the tax consequences. Lenders may call the corporation's loans, suppliers may tighten payment schedules, and so forth. The bottom line is that the corporation may actually need the health benefit for key person purposes (hiring and training a replacement, lost profits, overhead, etc.) even if the parties may have thought that the health benefit could be flowed out of the corporation to the insured employee or shareholder.
- The corporation's financial health may suffer because of the insured employees' or shareholder's critical illness. But when the health benefit is paid to the corporation, the benefit becomes available to satisfy claims of the corporation's creditors. When there are competing claims for those assets, shareholders will collect nothing until all the secured and ordinary creditors' claims have been paid in full. While employees rank ahead of shareholders they are still considered ordinary creditors.

For more information

CII in a shared ownership arrangement can offer many benefits to both sides of the arrangement. If you are recommending a CII shared ownership arrangement, make sure that your clients and their advisors understand the many issues that these arrangements raise. To help you, we have several reference pieces and articles discussing CII and shared ownership arrangements available on our website at www.sunlife.ca/advisor:

- Shared ownership arrangements using critical illness insurance
- Critical illness insurance - Health and welfare trusts and other concepts
- Part 1 - CRA Technical Interpretations indicate increasing clarity with critical illness insurance
- Part II - Critical illness insurance - Health and welfare trusts
- Part III - Critical illness insurance - shared ownership

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