

Canadian Health Insurance Tax Guide

Case study – Key person protection

September 2021



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KEY PERSON PROTECTION USING CRITICAL ILLNESS INSURANCE

CLIENT

Jayne Smith is XYZ Systems Ltd.'s top sales representative. XYZ relies on her extensive network of industry contacts and on her hard work to win new clients and keep existing ones.

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XYZ already owns a life insurance policy on Jayne to protect it from the financial consequences it could experience in the event of her premature death. But XYZ's management now wonders what would happen if she had a critical illness and couldn't work for an extended period of time.

SITUATION

If Jayne were to have a critical illness, the financial consequences for XYZ would be similar to those it would experience from her premature death. XYZ would have to hire and train a temporary replacement and make allowances for lost revenue, lost goodwill and potentially tightened credit.

Additionally, XYZ would have to plan for Jayne's eventual return, including the possibility of having to make renovations and alterations to the workplace to accommodate her if she also had a reduction in mobility from her critical illness.

STRATEGY

XYZ's first step is to quantify the potential loss. Although financial underwriting of a key person for critical illness insurance (CII) is similar to that for life insurance, the two are not the same. One approach is to use an informal guide, such as a multiple of five to 10 times Jayne's current income.¹ Jayne earns \$400,000 per year, and is over age 55. She qualifies for at least \$2 million in coverage under the informal guide. Depending on her value to the company, she could qualify for more.

Alternatively, XYZ could quantify the potential loss more formally by estimating the different types of losses it could have. Quantifying the losses helps justify the requested insurance amount if it exceeds the informal guide. Here's a list of potential losses XYZ could experience if Jayne had a covered critical illness.

¹ The discussion on financial underwriting is for illustration purposes only. Consult with your insurance company's underwriting department for their financial underwriting guidelines.

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Potential loss	Estimated cost
Recruiting a temporary replacement for Jayne. If XYZ retains a recruiting agency, the agency's fee would typically be 25% of income.	\$100,000 (25% of Jayne's current \$400,000 income)
Paying for a replacement during Jayne's time off work.	\$300,000 (\$150,000 per year over a potential two-year period)
Replacing profits lost during Jayne's absence. XYZ doesn't expect a temporary replacement to meet Jayne's level of productivity.	Employees like Jayne typically deliver value for their employers of at least four times income. Employees who generate less income for the company may barely cover their own costs. Jayne delivers \$1.6 million in value to XYZ, but XYZ anticipates that a replacement could deliver only half that, or \$800,000.
Compensating for potential restrictions in credit, including the potential that some creditors may call their loans, increase interest rates on other loans, and for some suppliers to move to cash on demand.	\$500,000
Offsetting a potential reduction in the value of XYZ's goodwill.	\$100,000
Paying for physical changes to XYZ's workplace to accommodate Jayne upon her return to work.	\$200,000

Using either the informal guide or the above analysis, XYZ can qualify for up to \$2,000,000 in CII coverage on Jayne. XYZ decides to purchase CII to cover the risk of losing Jayne to a covered critical illness.

IMPLEMENTING THE STRATEGY

XYZ will be the owner, beneficiary and premium payor; Jayne will be the insured person, and will need to be underwritten. It's important for Jayne to understand that while she must disclose information and submit to medical tests as part of the underwriting process, she won't own the policy or receive a benefit from it if she has a covered critical illness. Also, if Jayne had a covered critical illness, she

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would need to cooperate with XYZ during the claims process, by agreeing to provide medical information to support XYZ's claim.

XYZ is also concerned about the premium expense if Jayne never has a covered critical illness. While XYZ could accept the premiums as a (non-deductible) cost of doing business, it could also add a Return of Premium on cancellation or expiry (ROPC/E) rider to its policy for an additional premium. If Jayne never had a covered critical illness, and as long as the policy has been in force for a minimum number of years, XYZ may cancel coverage for a refund of all the premiums it paid to the date of cancellation. Under current Canada Revenue Agency (CRA) guidance, the ROPC/E benefit should be tax-free.² If XYZ cancelled coverage, its only cost would be the opportunity cost for having spent money on insurance premiums instead of investing that money in the business. On the other hand, if Jayne did have a covered critical illness, XYZ couldn't recover the extra premium paid for the ROPC/E rider – the policy pays the same CII benefit with or without the ROPC/E rider.

XYZ also wonders about providing a CII benefit for Jayne. XYZ's leaders expect that if Jayne had a covered critical illness, she and her family would also suffer financially. Though XYZ needs the CII coverage, it doesn't want to be seen as benefitting from Jayne's misfortune while she and her family suffer. There are at least two ways to approach this: one is for XYZ to pay premiums for a separate policy that Jayne would own on herself. We discuss this option in our case study, "Executive bonus plan with critical illness insurance."³ A second approach would involve XYZ paying a portion of any CII benefit it receives to Jayne. It could do this in one of the following ways:

² CRA Document 2003-0004265, June 18, 2003. See also CRA Document 2003-0034505, 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, December 24, 2004. 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 in order 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 Available at www.sunlife.ca/advisor/HealthTaxGuide.

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- XYZ could name Jayne as a beneficiary to receive part of the CII benefit if Jayne had a covered critical illness and survived the required survival period.
- XYZ could remain as the sole beneficiary, but could agree with Jayne that if she had a covered critical illness, XYZ would pay an agreed part of the insurance benefit to Jayne.
- XYZ could decide at the time of a claim that it would pay part of the insurance benefit to Jayne, but it would have no agreement with Jayne requiring it to do so, and would be under no legal obligation to do so.

However, there are some drawbacks to these approaches. We discuss the disadvantages to XYZ paying premiums for a policy Jayne owns in our case study, "Executive bonus plan with critical illness insurance."⁴ Here are some of the drawbacks to sharing the CII benefit with Jayne from a policy that XYZ owns:

- XYZ would have to increase its insurance amount and premiums to cover both its needs and Jayne's.
- If XYZ and Jayne agreed to share the insurance benefit, the premiums attributable to Jayne's share of the insurance benefit would be treated as a taxable employee benefit to her. The insurance benefit would be tax-free to both parties if Jayne had a covered critical illness. XYZ could deduct the premiums attributable to Jayne's CII coverage if it was a reasonable business expense.⁵
- If XYZ and Jayne had no agreement obligating XYZ to pay part of the insurance benefit to her, Jayne would not have to treat any of the premiums as income, but any insurance benefit paid to her would be treated as a taxable employee benefit. XYZ wouldn't be able to deduct any part of the premiums. It's uncertain whether XYZ would be able to deduct any payment it made to Jayne. As noted above, a deduction is available only for reasonable business expenses. XYZ would need to consult with its tax advisors to determine the amount, if any, that it could deduct.

As a final note, when Jayne retires, XYZ could transfer the policy to her. XYZ would need to retain an actuary to determine the policy's fair market value (FMV). To the extent that Jayne paid less than

⁴ Available at www.sunlife.ca/advisor/HealthTaxGuide.

⁵ ITA paragraph 18(1)(a).

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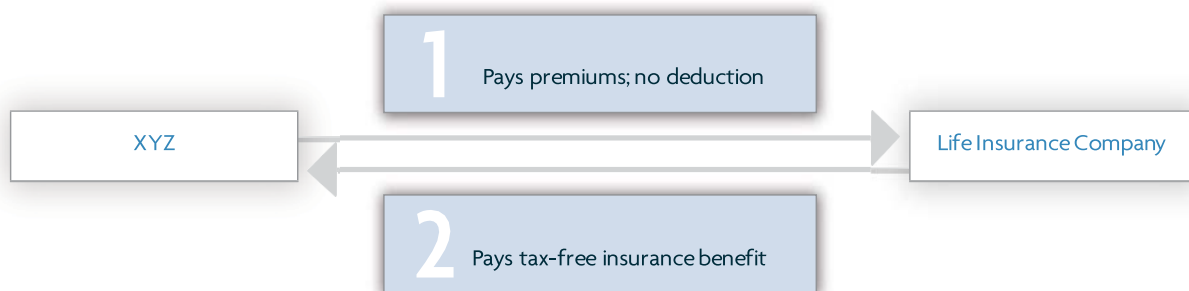


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FMV for the policy, she would be treated as having received a taxable benefit from XYZ. It's uncertain whether XYZ could deduct the taxable part of any transfer it made to Jayne.

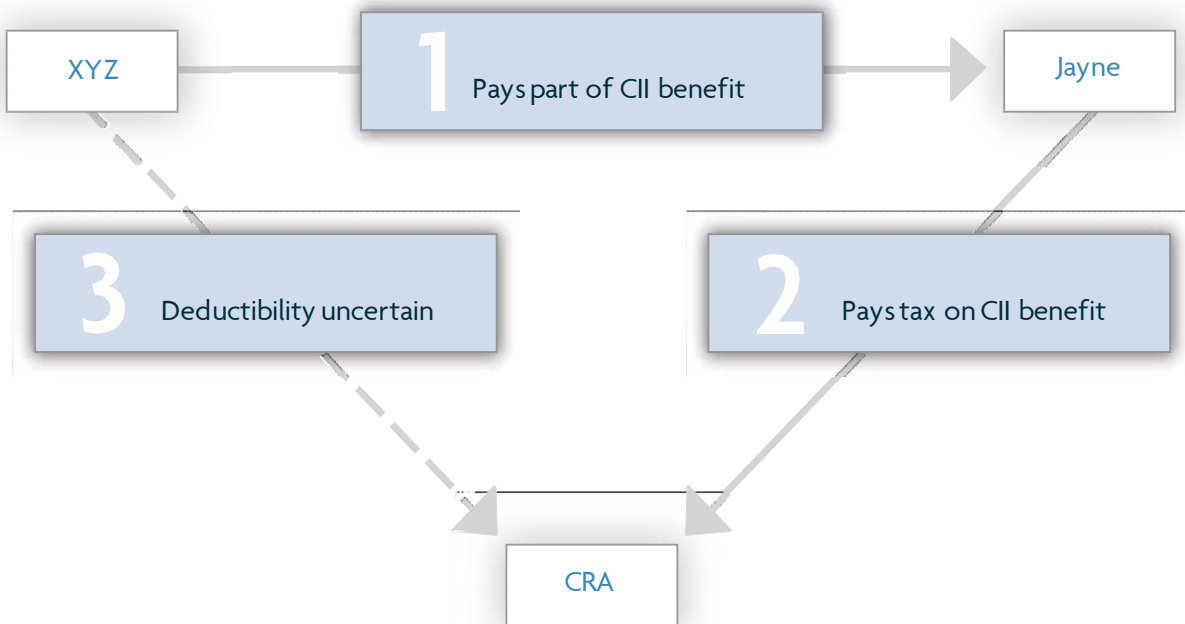
HOW IT WORKS

XYZ OWNS POLICY EXCLUSIVELY FOR ITS OWN BENEFIT



- Premiums not deductible.
- Insurance benefit paid tax-free.
- Reasonable business expenses can be paid and deducted using the CII policy benefit. The CRA doesn't care if XYZ uses tax-free money to pay deductible business expenses.

XYZ OWNS POLICY FOR ITS OWN BENEFIT BUT PAYS PART OF THE CII BENEFIT TO JAYNE



TAX AND LEGAL ISSUES

The Income Tax Act⁶ (ITA) doesn't specifically discuss health insurance policies, and the CRA has provided little guidance on their taxation. What follows is a general discussion. Further details on the tax treatment of health insurance policies are available in the Canadian Health Insurance Tax Guide.⁷

- **Premiums paid by entities for their own coverage are not deductible.** The ITA defines insurance premiums as "personal or living expenses" if the proceeds of the policy or contract are paid to or for the benefit of the taxpayer or to a person connected with the taxpayer by blood

⁶ Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.

⁷ Available at www.sunlife.ca/advisor/HealthTaxGuide.

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relationship, marriage or common-law partnership, or adoption.⁸ Personal or living expenses are not deductible.⁹

- **The CII base benefit is paid tax-free.** If a CII policy meets the definition of health insurance under provincial or territorial law, the CRA treats it as a sickness or accident insurance policy (SAIP). Most CII policies sold in Canada meet the provincial and territorial definitions of health insurance. According to CRA guidance, the base benefits from a CII policy are paid tax-free.¹⁰
- **The ROPC/E benefit is paid tax-free.** The CRA has said that the ROPC/E benefit from a CII policy is tax-free when none of the premiums paid (including the premiums paid for the ROPC/E benefit) have been deducted, and represent no more than the total premiums paid.¹¹ The CRA's guidance considered CII policies owned by one person or entity. The fact that an employer owns the policy doesn't affect this tax treatment.
- **Small business tax rate.** A corporation that qualifies for the small business tax rate under the ITA and provincial or territorial tax legislation will usually pay premiums using less heavily taxed dollars than its shareholders.
- **Corporations and entities may not claim the METC, only individuals.** The ITA allows individuals to claim the METC. The definition of an individual excludes corporations.¹²

⁸ ITA subsection 248(1). See paragraph (b) of the definition, "personal or living expenses".

⁹ ITA paragraph 18(1)(h).

¹⁰ 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 the base benefit) from a CII policy is not taxable: CRA Document 2003-0004265, June 18, 2003. See also CRA Document 2003-0054571E5, December 24, 2004.

¹¹ CRA Documents 2002-0117495 and 2003-0054571E5, March 4, 2002 and December 24, 2004. CRA Document 2002-00117495 discussed a disability income insurance plan, but the CRA's comments should also apply to CII policies.

¹² ITA subsections 118.2(1) and subsection 248(1), c.f. "individual".

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- **Key person insurance premiums aren't included in the key person's income.** If the key person or someone closely related to them is named as beneficiary or has any rights to the insurance benefit the key person will have to include the premiums in income, though the insurance benefit will still be tax-free. Otherwise, as long as the key person has no rights to the insurance policy or benefit, the premiums will not be a taxable employee or shareholder benefit.¹³
- **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 has 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 to the key person. Either way, the payment will be treated as a taxable benefit to the employee or as a dividend or shareholder benefit to the shareholder. If the parties want the shareholder to treat the insurance benefit as a dividend, the employer must receive the insurance proceeds, declare a dividend, and pay the money to the shareholder. If there is 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. Taxable benefits paid to an employee may be deductible if the employer can show that the payment was a reasonable business expense. Unlike life insurance, capital dividend account tax treatment is not available for corporate-owned health insurance policies. The same comments apply if the insured person does not have a critical illness, the employer cancels coverage and decides to pay the ROPC/E benefit to the employee.¹⁴

¹³ CRA Documents 2000-0002575 and 2004-008190117, March 29, 2000 and June 29, 2004.

¹⁴ ITA subsection 89(1), c.f. paragraph (d) of "capital dividend account".

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CONCLUSION

CII helps protect an employer from the financial losses that could result from a key person's covered critical illness. Although the key person would be the insured person, they would have no rights under the policy or to the insurance benefit, and the CRA would not treat them as if they were receiving a taxable benefit. If the key person had a covered critical illness, the employer would receive a tax-free CII benefit to help offset the losses it would incur as a result.

Any reasonable business expenses the employer paid with the CII benefit would be deductible; it doesn't matter that the insurance benefit used to pay those expenses was paid tax-free.

There are several ways for an employer to help the insured person protect themselves personally against the financial consequences of a critical illness. An employer could:

- pay some or all of the premiums for a key person's personally owned policy,
- name the key person or a relative as a beneficiary to receive some or all of the CII benefit,
- direct the insurance company to pay some or all of the benefit to the key person, or
- pay some or all of the benefit to the key person after receipt.

Each strategy carries tax consequences for the employer and key person to consider.

If the key person never has a covered critical illness, and if enough time has passed under the policy, the employer could cancel coverage and receive a tax-free refund of premiums if it had added the ROPC/E rider to its policy.

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