Canadian Health Insurance Tax Guide
Case Study
September 2021

Sun Life
Life's brighter under the sun

CORPORATE OWNERSHIP OF CRITICAL ILLNESS INSURANCE

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 had 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 to incorporation, 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 has 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 an owner's health.

After considering these issues, Bob decides he and XYZ will each need to have $250,000 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.[1] Nor can Bob or XYZ claim the medical expense tax credit (METC) for the premiums they pay.[2]

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[1] Insurance premiums are included under paragraph (b) of the definition, "personal or living expenses", in ITA subsection 248(1). Under ITA paragraph 18(1)(h) personal or living expenses are not deductible.

[2] CRA Document 9711505, 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

XYZ can't claim the METC because only individuals, not corporations, may claim the credit.[3] For Bob, health insurance premiums count towards a claim for the METC only if the policy qualifies as a private health services plan (PHSP).[4] A policy qualifies as a PHSP if all or substantially all (at least 90%) of the premiums are spent to provide coverage for expenses that would qualify as medical expenses under Income Tax Act (ITA)[5] subsection 118.2(2) if the policy owner paid for them personally.[6] 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 53.53% marginal tax bracket; XYZ qualifies for the 12.16% small business tax rate on its income under $500,000.[7] 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 less than a third of the owner's.

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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 Income Tax Act 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] ITA subsection 118.2(1) says that only an individual may claim the credit. ITA subsection 248(1) says that an individual is a person that is not a corporation.

[4] For more information on the METC, see our article, "The Medical Expense Tax Credit".

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

[6] CRA Document 2015-0610751C6, November 24, 2015. See additional CRA commentary at www.cra-arc.gc.ca/whtsnw/tms/phsp-rpam-eng.html.

[7] Ontario corporate small business tax rates and personal marginal tax rates as of November 2021. Tax rates will vary from province to province.

If XYZ owns the policy, and if Bob has 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.[8]

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 to shareholders mostly or completely 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.[9] 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.

The alternative to paying the CII benefit to Bob as a dividend would be to pay it as a shareholder benefit.[10] 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.[11]

In spite of this unfavourable tax treatment, Bob still wonders if it could be beneficial from a tax

[8] CRA Document 2003-0004265, June 18, 2003.

[9] 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.

[10] Shareholder benefits are taxed under ITA subsection 15(1) as income, without the benefit of the dividend tax credit.

[11] ITA subsection 18(1) allows XYZ to deduct reasonable business expenses. Neither shareholder benefits nor dividends are business expenses.

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 $5,585.00 per year in premiums, assuming no optional coverage is added to the policy.[12] Since he's in the 53.53% tax bracket, Bob would have to earn $12,018.51 in salary to pay the premiums ($5,585.00 /(1 – 0.5353).

Corporate ownership, with the CII benefit paid to Bob as a taxable dividend, looks different. After the dividend tax credit, non-eligible dividends are taxed to Bob at a lower effective tax rate – 47.74%.[13] 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 $478,377.34 ($250,000 / (1 – 0.4774). XYZ's premium payments would rise to $10,645.83.[14] At a 12.16% tax rate, XYZ would have to earn $12,119.57 ($10,645.83 / (1 – 0.1216) to pay the premiums for its policy, about the same that Bob would have to earn to pay the premiums for his personally owned policy. Unlike salary, dividend payments are not deductible to XYZ.

Bob suspects that his accountant may resist corporate ownership if only because Bob would have to pay $228,377 in taxes on the CII base benefit ($478,377 * 47.74%) if he had a covered critical illness, and XYZ paid the benefit to him as a dividend. Even though Bob and XYZ have to earn, after tax, about the same amount of money to pay their respective premiums, and even though either arrangement puts the same amount of money in Bob's hands after-tax if Bob has a covered critical illness, Bob's accountant still resists any arrangement that comes with a large tax bill.

What if Bob paid the premiums for a personally owned policy using dividends instead of salary? In that case, XYZ would have to pay Bob only $10,686.95 for Bob to pay the premiums on his policy

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[12] Based on rates in effect as of November 14, 2021 for a 50 year-old male, non-smoker, $250,000 base benefit.

[13] 2022 rates for Ontario. Ineligible dividends are taxed more heavily than eligible dividends because ineligible dividends are paid from after-tax corporate profits that were taxed at the low 12.16% small business tax rate.

[14] Based on rates in effect as of Novembr 14, 2021 for a 50 year-old male, non-smoker, $478,377.00 base benefit.

($5,585.00 / (1 – 0.4774). That's less than the $12,018.51 it would have to pay Bob in salary 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. Nor does dividend income build any entitlement to Canada Pension Plan payments upon retirement.

Comparison of Bob versus XYZ owning a CII policy with base benefit to Bob[15]		
	Bob owns policy	**XYZ owns policy**
CII base benefit	$250,000	$478,377
Annual premium	$5,585	$10,646
After-tax premium cost (Bob paid salary)	$12,019	
After-tax premium cost (Bob paid dividend)	$10,687	
After-tax premium cost (for XYZ)		$12,120

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 the operating company got into trouble.

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[15] Using rates in effect as of November 14, 2021, 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 2021 tax year in Ontario (www.ey.com/CA/en/Services/Tax/Tax-Calculators), specifically, 53.53% personal tax rate, 12.16% corporate income tax rate, and 47.74% dividend tax rate.

- **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.

- **Taking on additional shareholders**. As Bob's business grows, he may have to let others 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. He will likely not have any tax consequences from the transfer because the deemed disposition rules under ITA section 148 apply

only to life insurance policies. Further, by transferring a policy *to* rather than *from* his holding company, he is not receiving a shareholder benefit from that company.

If XYZ Ltd. owns the policy, it could transfer policy ownership to a holding company as an intercorporate dividend in kind. Generally, these types of dividends are tax-free. However, Bob's tax advisor will need to consider the rules under ITA subsection 55(2), to make sure that the dividend payment can indeed be made tax-free. In particular, XYZ Ltd. will need to have enough safe income (generally after-tax income) on hand to cover the value of the policy.

TAX AND LEGAL ISSUES

The ITA doesn't specifically discuss health insurance 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 health insurance policies are available in the Canadian Health Insurance Tax Guide.[16]

- **Premiums paid by individuals or entities for their own or for their family's 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.[17] Personal or living expenses are not deductible.[18]

- **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.[19]

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[16] Available at www.sunlife.ca/advisor/HealthTaxGuide.

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

[18] ITA paragraph 18(1)(h).

[19] 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.

- **The ROPC/E benefit is paid tax-free**. The CRA has said that a return of premium at cancellation or expiry (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.[20] The CRA's guidance considered 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.

- **Deductible expenses may be claimed even if paid from tax-free insurance benefits**. If the insured person has a covered critical illness, and the corporate policy owner uses the CII benefit to pay reasonable business expenses, the policy owner may be able to deduct those expenses. It will not matter that the source of the money used to pay those expenses was a tax-free insurance benefit.

- **Corporations may not claim the METC, only individuals**. The ITA allows individuals to claim the METC. The definition of an individual excludes corporations.[21]

- **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.[22]

[20] 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.
[21] ITA subsections 118.2(1) and subsection 248(1), c.f. "individual".
[22] CRA Documents 2000-0002575 and 2004-008190117, March 29, 2000 and June 29, 2004.

- **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 ROP benefit to the employee.[23]

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

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

This case study is intended to provide general information only. Sun Life Assurance Company of Canada does not provide legal, accounting or taxation advice to advisors or clients. Before a client acts on any of the information contained in this case study, or before you recommend any course of action, make sure that the client seeks advice from a qualified professional, including a thorough examination of their specific legal, accounting and tax situation. Any examples or illustrations used in this case study have been included only to help clarify the information presented in this case study, and should not be relied on by you or the client in any transaction.

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