



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 have 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 person 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. Third, whether a payment from a life insurance policy qualifies as a disability benefit (paragraph (h) of the definition of "disposition" under subsection 148(9) of the Income Tax Act¹) or an entitlement to the policy proceeds after becoming totally and permanently disabled (paragraph (k) under the same subsection),

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

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is not always clear.² 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 person has 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 duties. 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 survival

² CRA Documents 2007-0257591E5 and 2009-0308411E5, December 15, 2008 and February 13, 2009. 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 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.

period of one and a half to two years before the obligations to buy and sell are triggered. The survival period in the agreement will often correspond to the survival 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 & CRITICAL ILLNESS INSURANCE ARE DIFFERENT FROM ONE ANOTHER

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.
- **Survival periods.** Buy-sell DI policies have long survival periods between the onset of disability and payout (between one and a half to two years) versus a 30-day survival 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 person could be partially paralyzed following a serious stroke and unable to return to work. Under many DI policies the insured person 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 person cannot work, resulting in a disability claim.

- **Heart attack.** Covered as a critical illness under most CII policies, but the insured person 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.

BUY-SELL DISABILITY INSURANCE IS DIFFERENT FROM DISABILITY OVERHEAD INSURANCE

Disability buy-sell insurance provides money needed to fund a buy-sell agreement triggered by a business owner's disability. Disability overhead insurance provides money needed to keep the business going while the business owner recovers from a disability. Typically, disability overhead insurance is used where the business is owned by one person, and the success of the business depends on that person. Without that person, the business could collapse. There are important differences between the two types of coverage:

- **Premium deductibility.** Premiums paid for disability buy-sell insurance are not deductible, but premiums paid for disability overhead insurance are.
- **Benefit tax treatment.** A disability buy-sell insurance benefit is paid as a tax-free lump sum. Conversely, disability overhead insurance benefits are taxable, and are paid to the business to reimburse it for covered business expenses as the business continues during the insured person's disability.
- **Business expenses.** Reasonable business expenses are tax deductible, whether paid using benefits from a disability overhead insurance policy or not. Effectively, the deductibility of business expenses offsets the taxation of the insurance benefit. Money paid to satisfy an obligation under a disability buy-sell agreement is not a deductible expense.

STRATEGIES COMBINING CII & DISABILITY BUY-SELL INSURANCE

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.

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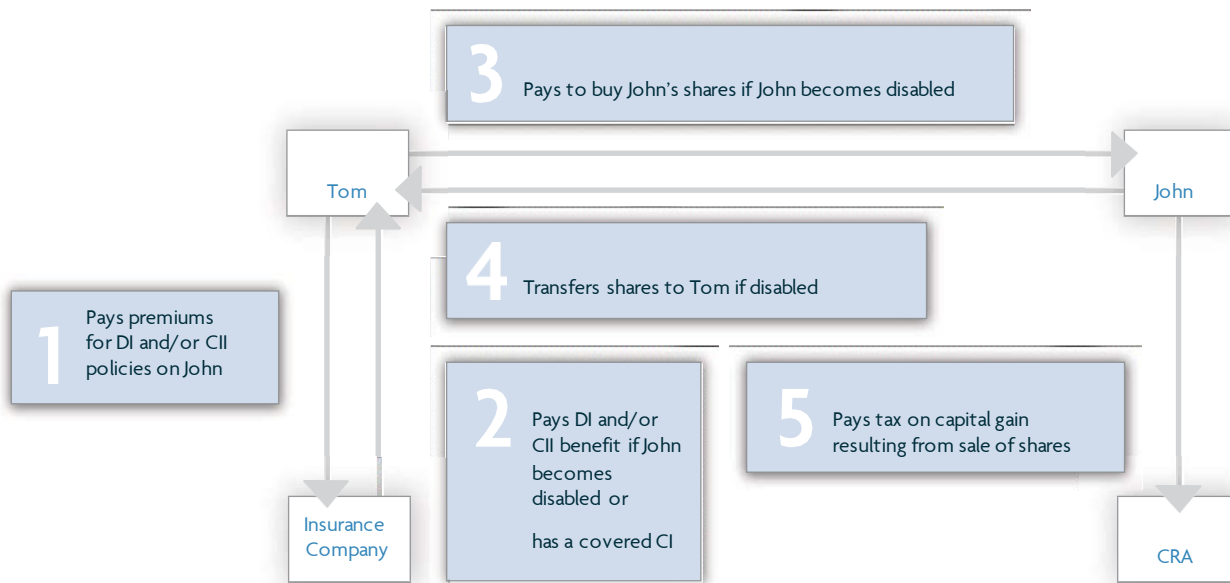
- **Complete coverage.** Tom and John could agree that if either of them had to withdraw from the business because of a disability or critical illness, the withdrawing shareholder would sell his share of the business to the other. Tom and John would determine the amount of coverage needed to cover either 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. However, 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 on cancellation or expiry riders** Tom and John could also add Return of premium on cancellation or expiry (ROPC/E) riders to their policies, if such riders were available. If either became disabled but did not have a critical illness, and if enough time had passed, the CII policy could be cancelled for a return of premium on cancellation or expiry. The same reasoning would apply to the DI policy if one of them had a critical illness but was not disabled. By cancelling coverage for a return of premium on cancellation or expiry, money needed to fund the buy-sell agreement that could not be obtained through an insurance benefit could be partially obtained through the ROPC/E rider.
- **Policy transfer.** If Tom or John had 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 on cancellation or expiry). This could be an option if the policy did not have an ROPC/E 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 had 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

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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.³

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

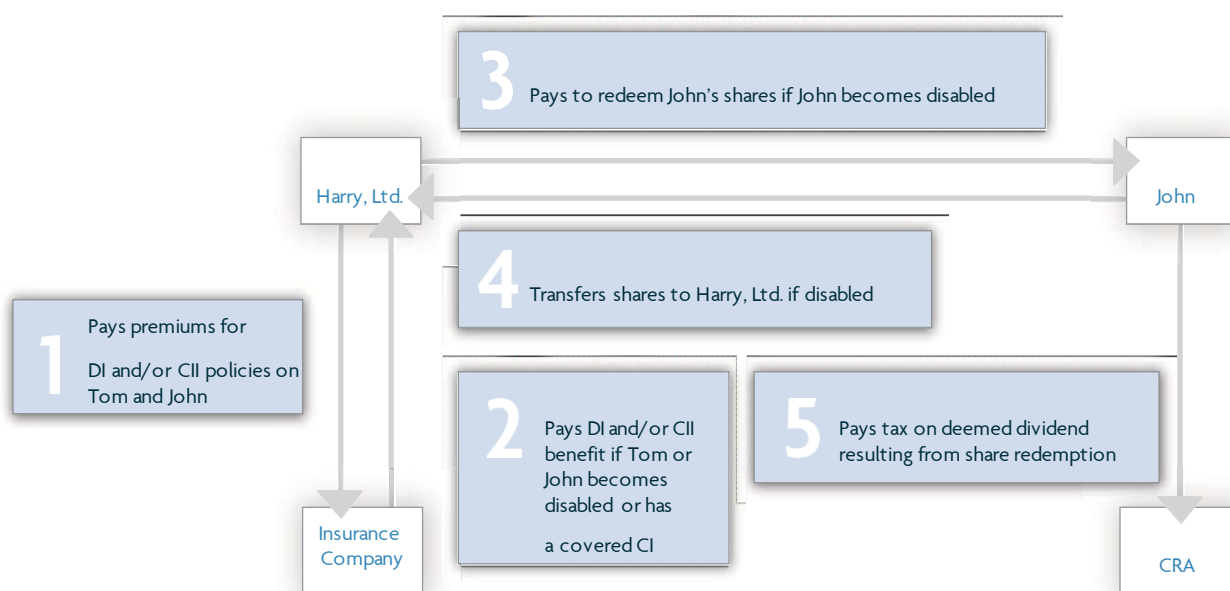
An alternative to the above agreement is to have Harry, Ltd. own the policies on Tom and John. If John had a covered disability, Tom would buy John's shares using a promissory note. The insurance company(ies) would pay a tax-free benefit to Harry, Ltd. Once Tom owned all the shares in Harry, Ltd. he 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.

³ For 2020 the lifetime capital gains exemption for small business corporation shares is \$883,384, and is adjusted each year for inflation.

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 has 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

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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.

This strategy contemplates two owners with an operating company. The strategy becomes more complicated when they each have personal holding companies. The clients and their advisors will need to consider the capital gains stripping rules under ITA subsection 55(2). Clients will need their own independent tax and legal advice

TAX AND LEGAL ISSUES

- **Premiums paid by individuals or 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 relationship, marriage or common-law partnership, or adoption.⁴ Personal or living expenses are not deductible.⁵
- **CII and lump sum DI base benefits are paid tax-free.** If a CII or DI 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 and DI policies sold in Canada meet the provincial and territorial definitions of health insurance. According to CRA guidance, the base benefits from a CII or lump sum DI policy are paid tax-free.⁶

⁴ ITA subsection 248(1). See paragraph (b) of the definition, "personal or living expenses".

⁵ ITA paragraph 18(1)(h).

⁶ 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 Documents 2003-0004265 and 2003-0054571E5, June 18, 2003 and December 24, 2004. Regarding DI policies, lump sum payments a corporation receives under a disability insurance policy it owns on a shareholder pursuant to a shareholder's agreement are not taxable: CRA Document 9208045, June 30, 1992.

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- **The ROPC/E benefit is paid tax-free.** The CRA has said that the ROPC/E benefit from a CII or DI 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.⁷ 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.
- **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 lifetime capital gains exemption to shelter some or all of his gains from tax⁸
- **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 has 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

⁷ 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

⁸ For 2020 the lifetime capital gains exemption is \$883,384, and is adjusted each year for inflation

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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.

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 ROPC/E and the cash values in life insurance policies to make up the difference.

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