Canadian Health Insurance Tax Guide
Transferring Ownership
September 2021

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TRANSFERRING OWNERSHIP OF HEALTH INSURANCE POLICIES

Lois, Clark and Jim are equal shareholders in SmallCo, Ltd., a specialty publishing company. Clark has been thinking about retirement, and wonders what would happen if he had a critical illness or needed long-term care in retirement. An obvious solution is to buy critical illness insurance (CII) and long-term care insurance (LTCI). But Clark worries about how he'll qualify for coverage or afford the premiums in retirement. One answer is to buy coverage when he's young and premiums are lower.[1] This approach also protects Clark against the risk of becoming uninsurable later in life, and locks in the premium payments for CII (though not entirely for LTCI).

Having said that, Clark worries about whether he can even pay the premiums today for coverage he expects he'll need later. His current expenses – mortgage payments on his home and vacation property, retirement savings and children's education plans – will likely be gone by retirement, but they limit his cash flow today.

Clark could ask SmallCo to pay the premiums for policies that Clark would own.[2] Clark would have to include the premium payments as income and pay tax on them. But even in the top tax bracket, Clark's out-of-pocket expense would be approximately half what it would be if he had to pay the premiums himself. At the same time, SmallCo could deduct the premium payments, assuming they were a reasonable business expense.

Lois and Jim agree with some of what Clark wants, but suggest a different strategy. Instead of Clark owning one policy on himself, Clark and SmallCo would each own CII and LTCI policies. If Clark had a covered critical illness or needed long-term care, his policies would protect him personally, while SmallCo's policies would protect it against potential business losses arising from Clark's condition.[3]

SmallCo could pay the premiums for all the policies but would deduct only the premiums it paid for the policies owned by Clark. The premium payments the company makes for these policies could be treated as a salary or bonus, and could be deductible if they were reasonable business expenses incurred to produce income from a business or property.[4] Clark would have to receive this benefit in

[1] LTCI premiums are not fully guaranteed. It's possible that future claims experience could require premium increases.
[2] For more information on how this strategy would work, see our case study "Executive bonus plan with critical illness insurance" at www.sunlife.ca/files/advisor/english/PDF/HealthTaxGuide_CaseStudy_executive_bonus.pdf.
[3] For more information on this strategy, see our article, "Individually Owned Health Insurance Policies.".
[4] ITA section 67 and paragraph 18(1)(a).

his capacity as an employee of SmallCo.[5] SmallCo couldn't deduct the premiums it paid for the policies it owned. The Income Tax Act[6] (ITA) defines insurance premiums as "personal or living expenses,"[7] and denies a deduction for those expenses.

Similarly, Clark could not treat any part of the premium payments he paid (or had to include in income) as medical expenses in order to claim the medical expense tax credit (METC). Health insurance premiums count towards a claim for the METC only if the policy qualifies as a private health services plan (PHSP).[8] Generally, premiums paid for CII policies do not qualify because CII insurance benefits are paid with no restriction on how the benefit may be spent. The same applies to income style LTCI policies. In contrast, a PHSP can only pay a benefit to reimburse the policy owner for a specified medical expense. Only the premiums paid for reimbursement LTCI polices qualify for METC tax treatment, and only if the Canada Revenue Agency (CRA) has approved the policy as a PHSP.

In both cases, if Clark had a critical illness or needed long-term care, his and SmallCo's policies would pay tax-free benefits to their respective policy owners. Although neither CII nor LTCI benefits are discussed in the ITA, the CRA has confirmed that they would be paid tax-free.[9] Clark could use his

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[5] See the discussion of shareholder and employee benefits in our article, "Private Health Services Plans," under the heading, "Shareholder/employees".

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

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

[8] For more information on the METC, see our article, "The Medical Expense Tax Credit". In this case study we assume that Clark and SmallCo both purchase an income style LTCI policy.

[9] Regarding CII insurance policy benefits, see CRA Documents 2003-0004265 and 2003-0054571E5, June 18, 2003 and December 24, 2003. Regarding LTCI insurance policy benefits, see CRA Document 2003-0048461E5, March 5, 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 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.

insurance benefit(s) to pay for expenses associated with his long-term care or with his recovery from a critical illness. If the expenses qualified as medical expenses, and if Clark otherwise qualified, he could use those expenses as part of his claim for the METC. The CRA does not care that the money used to pay for a medical expense came from a tax-free insurance benefit, only that the cost qualifies as a medical expense.

If SmallCo used its benefit to pay reasonable business expenses while Clark recovered from a critical illness or was receiving long-term care, it could deduct those expenses. If SmallCo instead paid the insurance benefits to Clark, the benefits would be treated as taxable shareholder or employee benefits, both of which Clark would have to include in income. Although SmallCo could pay the benefit as a dividend, Lois and Jim would share in the dividend payment. Dividends benefit from the dividend tax credit, but Clark would have to give up two-thirds of the insurance benefit to Lois and Jim to get this beneficial tax treatment. Neither dividends nor shareholder benefits are deductible to a corporation. SmallCo could deduct the payment of an employee benefit if it was a reasonable business expense.

TRANSFERRING A HEALTH INSURANCE POLICY

Clark and SmallCo both buy CII and LTCI on Clark. They hope never to claim a benefit under their policies during Clark's working years (or at all). They hope instead that SmallCo will transfer its policies to Clark when he retires, and that Clark can own all four policies in retirement. After Clark retires, SmallCo will not need its policies because it will not have a loss if Clark has a critical illness or needs long-term care. While SmallCo could stop paying premiums at Clark's retirement and lapse its policies, it could also transfer ownership of both policies to Clark. The added coverage could provide a measure of inflation protection for Clark by increasing the insurance benefits available to him.

There's a tax cost associated with such transfers. To the CRA, an insurance policy is an asset like any other. To the extent that Clark does not pay fair market value (FMV) for his policies, he would have to treat their value as a shareholder or employee benefit, include that value in income, and pay tax on it.[10]

Before transferring any policies, Clark and SmallCo would have an actuary appraise the policies' values. That's because the CRA could challenge the policies' values after the fact, and assess Clark with additional taxes, plus interest and penalties. The CRA will be more likely to accept an independent professional valuation over one that's provided by Clark or SmallCo. Following the professional assessment, the CRA may also be more inclined to accept the amounts for those policies that Clark would report as income on his tax return.

There are no rules in the ITA or regulations that describe how to value a health insurance policy, nor is there any CRA guidance on the subject. But the CRA has listed several factors in Information Circular IC 89-3 that govern the valuation of a life insurance policy.[11]

- The policy's
    a. cash surrender value,
    b. loan value,
    c. replacement value,
    d. face amount, and
    e. conversion privileges, if any,
- the insured person's state of health and life expectancy, and
- other policy terms, such as term riders and double indemnity provisions.

These factors were created with life insurance policies in mind, but many of them apply also to transfers of health insurance policies. One rule that doesn't apply though, is the deemed disposition rule under ITA subsection 148(7). When someone transfers an interest in a life insurance policy, the

[10] CRA Documents 9411015, 2003-0182875 and 2016-0651771C6, July 12, 1994, June 30, 2003 and October 7, 2016.
[11] Paragraph 40 of Information Circular IC 89-3, August 25, 1989.

transfer is treated as a taxable disposition to the transferor. In a non-arm's length transfer, the policy owner has to include in income the difference between the life insurance policy's adjusted cost basis (ACB) and the greatest of the following three amounts: the policy's ACB, its cash surrender value (CSV) and the FMV of any consideration the policy owner receives for the policy. For arm's length transfers, the policy owner subtracts the policy's ACB from the FMV of any consideration the policy owner receives for the policy. ITA subsection 148(7) applies only to life insurance, not health insurance policies.

To determine the value of Clark's health insurance policies when SmallCo transfers them to him, an actuary could consider several factors listed in IC 89-3 including:

- the policy's face value,
- the insured person's state of health and life expectancy,
- conversion privileges, and
- replacement value.

The actuary would not be limited to these factors, and could consider other factors to arrive at an appraisal of the policies' value. Although we often think it's best to avoid paying taxes wherever possible, Clark may benefit from not paying for the policies, and including the value of the transferred policies as income. The out-of-pocket cost for him to pay the tax would be less than the cost of paying for the policies. While SmallCo would receive nothing for a policy that could have a substantial value, Lois and Jim don't consider the policy as a valuable corporate asset, but instead as protection for SmallCo in case Clark has a critical illness. Once Clark retires, Lois and Jim are content to allow SmallCo to let the policies go, having no further need for them.

OPTIONAL COVERAGE

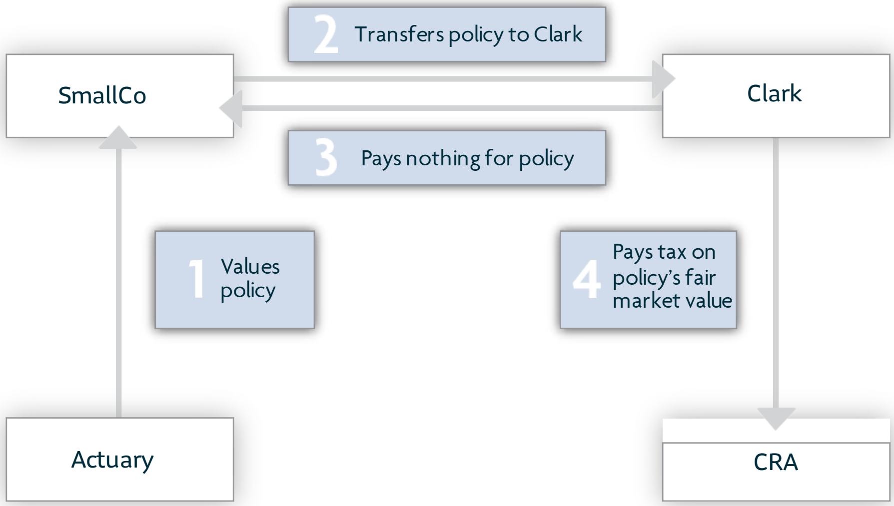
SmallCo could add features to its policies that could benefit Clark in retirement (Clark could also add these features to the policies he personally owns):

- A conversion privilege on its CII policy that could let Clark convert the policy's CII coverage to LTCI coverage (the rationale for the conversion is that if Clark has a critical illness at an advanced age he could need long-term care).
- Limited pay options that could allow any or all policies to be fully paid up before Clark retires (Clark would have coverage in retirement but no premiums to pay).
- Inflation protection for the LTCI policy benefits.

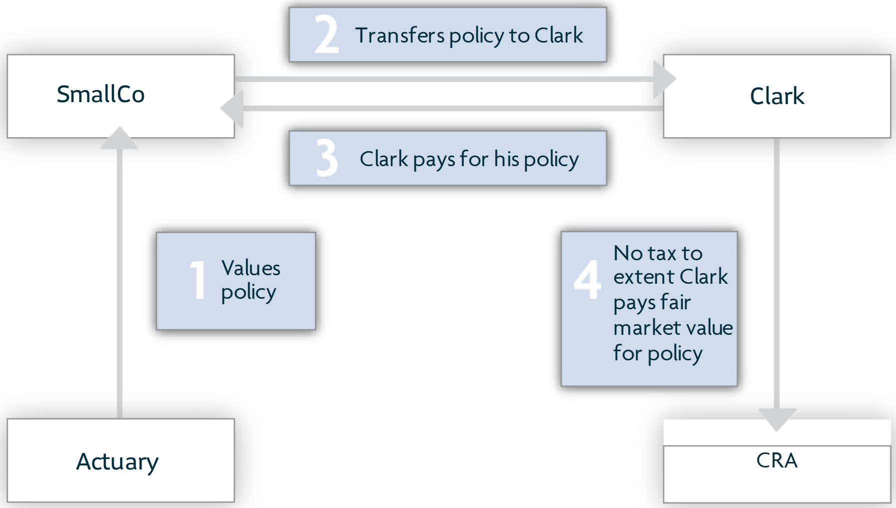
Any of these optional features could add to the value of the policy(s) for transfer purposes.

TWO WAYS TO DO THE TRANSFER

TRANSFER POLICY FOR NO COST



CLARK PAYS SMALLCO FOR THE POLICY



ADVANTAGES AND CONSIDERATIONS

There are several advantages to this arrangement for Clark and SmallCo, but there are also considerations against which these advantages must be balanced.

Advantages

- The insured person and employer each have coverage to protect them in the event of a critical illness or need for long-term care during the insured person's working years.
- At retirement, the addition of coverage formerly owned by SmallCo provides Clark with a measure of inflation protection.
- If SmallCo transfers paid up policies to Clark, Clark's ongoing premium payment will not change in retirement, but his coverage will increase. Of course, the FMV for a paid up policy will be higher than it would be for an otherwise identical policy that was not paid up on the date of transfer.

Considerations

- The transfer of an insurance policy at retirement will likely entail significant tax consequences, especially if the policy is fully paid up at the time. SmallCo may be willing to pay a bonus to Clark at retirement to partially or fully offset those costs.
- Assets owned by SmallCo (including insurance policies and the benefits from those policies) are subject to seizure for the benefit of SmallCo's creditors. If SmallCo runs into financial difficulty before transferring insurance policies to Clark, he may never receive them. On the other hand, neither policy has a cash value, and a creditor who maintained the policies in the hope of making a claim if Clark had a covered critical illness or needed long-term care would need Clark's cooperation in providing medical evidence to support the claim.

TAX AND LEGAL ISSUES

The ITA does not specifically discuss health insurance policies, and the 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.[12]

- **Premiums paid by individuals or entities for their own or 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 or to a person connected with the taxpayer by blood relationship, marriage or common-law partnership, or adoption.[13] Personal or living expenses are not deductible.[14]

[12] Available at www.sunlife.ca/advisor/v/index.jsp?vgnextoid=f69b0c0a4ee28310VgnVCM10000047d2d09fRCRD&vgnextfmt=default&vgnLocale=en_CA&authgroup=SLFDEFPUB.

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

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

- **The CII and LTCI base benefits are paid tax-free**. If a CII or income style LTCI 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 income style LTCI policies sold in Canada meet the provincial and territorial definitions of health insurance. Reimbursement LTCI policies (policies that reimburse the policy owner for covered long-term care costs) may meet the definition of a private health services plan (PHSP). PHSP benefits are paid tax-free. According to CRA guidance, the base benefits from a CII or LTCI policy (income or reimbursement) are paid tax-free.[15]

- **Reasonable business expenses are deductible**. As long as the CRA agrees that the payment of premiums for an employee-owned insurance policy is a reasonable business expense, like salary or bonus, the business can deduct that payment even if the payment is for insurance premiums that would otherwise not be deductible.[16] If the premium payment is paid to or for a person who is both a shareholder and an employee, that person will need to receive the benefit in their capacity as an employee in order for the employer's payment to be deductible. Shareholder benefits are not deductible.

- **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.

- **You may not count CII or income style LTCI premiums towards a claim for the medical expense tax credit (METC).** According to CRA guidance, one of the requirements for counting insurance premiums towards a claim for the METC under ITA paragraph 118.2(2)(q) is that all or substantially all of the benefits paid under the policy relate to medical expenses that are eligible

[15] 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. Regarding LTCI, see CRA Document 2003-0048461E5, March 5, 2004.
[16] ITA section 67 and paragraph 18(1)(a).

for the METC (the CRA defines "all or substantially all" to mean at least 90%).[17] Because CII and income style LTCI policies pay benefits with no restriction on how you may use them, the benefits do not relate to medical expenses, and the premiums do not count towards a claim for the METC.[18] See our article "The Medical Expense Tax Credit" for more details.

- **Medical expenses may be claimed even if paid from tax-free insurance benefits**. If the insured person has a covered critical illness or needs long-term care, and uses the CII or income style LTCI benefit to pay hospital, medical, and/or nursing home expenses, the policy owner may be able to count those expenses towards 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. Note: any expenses for which the policy owner received benefits from a reimbursement style LTCI policy may not be used as part of a claim for the METC (except any unreimbursed part of the expense, such as deductibles, co-payments, and claims over the policy limits).

- **Employees must include in income their employers' payment of their CII and/or LTCI premiums**. Employees must include in income the cost of all benefits they receive as a result of their employment.[19] Exceptions include the cost of some benefits provided under a group sickness or accident insurance plan (GSAIP) or private health services plan (PHSP). However, the strategy referred to in this article is neither a GSAIP nor a PHSP. Its purpose instead is to allow the employer to offer a small group of employees a more flexible benefits package than the employer could offer under a GSAIP or PHSP.

- **Shareholders must include in income as shareholder benefits the premium payments that their corporations pay for their coverage.** The CRA presumes that any benefit a shareholder receives from their corporation they receive because they own the corporation, and can

[17] CRA Document 2015-0610751C6, November 24, 2015. See additional CRA commentary at www.cra-arc.gc.ca/whtsnw/tms/phsp-rpam-eng.html.
[18] CRA Document 9711505, June 2, 1997.
[19] ITA paragraph 6(1)(a).

significantly influence business policy, not because they are employed by it.[20] Shareholder benefits are taxed as income to the shareholder,[21] but generally are not deductible to the corporation.[22] Only if the parties can show that the shareholder has received their benefit as an employee, not as a shareholder, will the shareholder be treated as having received an employee benefit, which the corporation could deduct if it was a reasonable business expense.

- **It's not certain whether converting a CII policy to LTCI is tax-free**. The issue is not discussed in the ITA, and the CRA has not provided any guidance. In guidance dealing with the FMV of life insurance policies, the CRA said that "conversion privileges" were among the elements that contributed to a life insurance policy's FMV, but did not say whether the exercise of such a privilege produced any tax consequences.[23]

CONCLUSION

Individuals may understand they require CII and LTCI coverage, especially to take care of anticipated needs in retirement. But they may not be able to afford a complete package of insurance products. If consumers wait, they may become uninsurable, or the premiums may become too expensive. One strategy is to have their business buy insurance on them for key person purposes, then transfer ownership of those policies at retirement.

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[20] CRA documents 2003-0034505, December 9, 2003; 2005-0163771E5, March 14, 2006; 2016-0635351E5, January 11, 2017; and Income Tax Folio S2-F3-C2, "Benefits and Allowances Received from Employment," October 12, 2016, paragraph 2.3.
[21] ITA subsection 15(1).
[22] Spicy Sports Inc. et. al. v. The Queen, [2004] 5 C.T.C. 2090, 42 C.C.P.B. 316.
[23] Information Circular IC 89-3, August 25, 1989.

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