

The Taxation of Personally-Owned Critical Illness Insurance

This document reviews the tax implications of personally owned critical illness policies. For information on policies that are corporately owned, refer to *The Taxation of Corporately Owned Critical Illness Insurance (PC 5772)*

I. Critical Illness Insurance

i. General Definitions

Critical illness (CI) policies are a relatively new entrant to the Canadian market place. The product was first introduced in South Africa approximately 20 years ago, and has been available in Canada for more than 10 years. CI is a member of the "Living Benefits" product group, which also includes Disability Insurance (DI) and Long-Term Care (LTC).

A CI policy typically pays a lump-sum benefit upon the diagnosis of a covered illness, subject to the insured surviving a contractually specified period after the diagnosis¹ (partial benefits may be available for certain conditions). Payments are not usually contingent on a disability at the time of diagnosis, claim or subsequently. The benefit will often be used to offset the financial impact of lost income or extra expenses arising because of the health issue (e.g., obtaining medical treatment outside of Canada). While the CI benefit is also intended to restore or maintain the individual's standard of living during the illness, recipients are free to spend the lump-sum benefit however they choose.

CI benefits are very different from DI benefits. Disability insurance is designed to protect the insured's income. It works by providing the insured with a percentage of his or her income on a periodic basis. DI policies generally provide a form of income replacement while the insured is disabled.

CI benefits are also different from LTC benefits. Generally, LTC insurance is meant to provide for care in a Long-Term Care facility (e.g., licensed convalescent, custodial, nursing or retirement homes providing for continuous nursing services) and for medically necessary services performed by qualified medical practitioners in the home of the insured. LTC plans commonly provide pre-determined amounts on a periodic basis. There is often a cap of the per-day amount that can be paid to a facility, with lower amounts applying to in-home care.²

A separate (i.e., "stand-alone") policy may be acquired for the CI coverage. CI coverage may also be available as a rider to a life insurance policy. Many policies also have a return of premium (ROP) feature.

¹ CI products are generally available in a base and enhanced version. The base version will typically cover the more common critical illnesses (cancer, coronary artery bypass surgery, heart attack and stroke). The enhanced version will typically cover approximately 20 additional illnesses. Specific insurer's policies may vary as to coverages and how these are defined. There may also be different coverages for adults and children.

² Sanderson, Ron, "Disability, Critical Illness Insurance and Other Hot Topics in an Evolving Health Care Regime", page 24, *OBA Insurance Law Section Continuing Legal Education Symposium*, September 26, 2001.

ii. Return of Premium

There are three general types of ROP features: Return of Premium on Death (ROPD), Return of Premium on Surrender (ROPS) and Return of Premium on Expiry (ROPE). ROP features vary by insurer. It may be built into the product, or may be available as a rider with additional charges applying.

ROPD features are prevalent. Typically, they work by returning premiums to the insured's estate or a designated benefit recipient if the insured dies while the coverage is in force and no claim has been made (with the exception of a claim for a partial benefit).³ Most insurers will cap the amount of the ROPD at the sum insured. Many insurers have built ROPD features into the product so that an additional amount is not charged for this coverage.

Many insurers also offer a ROPS feature. They charge a separate amount for this coverage, which is often available only as a rider. Here, the insurer will pay an amount upon the surrender of the policy. Different insurers may offer different ROPS features for their various products, that is, there will be variances in what percentage of the premiums paid will be refunded at what intervals.⁴ For example, the ROPS benefit may only be available after a certain period has elapsed (e.g., upon the 5th or 10th anniversary of the policy). Any ROPS may also be subject to the insured's having attained a specific age. There may be a sliding scale (e.g., 25% of premiums paid may be available at the 5th or 10th anniversary, with an additional 5% being available at each anniversary). Since the same insurer may have different ROPS structures for different products, it is always important to complete an appropriate analysis.

Finally, a ROPE may also be available, either included in ROPS or available for an additional charge. A typical ROPE provision specifies that coverage expires at a specific age (say 65 or 75). At that time, the premiums paid will be refunded (provided a lump-sum benefit has not been paid, with perhaps an exception for partial benefits).

II. Tax Treatment

i. General Comments

As indicated above, CI policies have been offered in Canada for about 10 years. Neither the Income Tax Act (Canada) (ITA) nor the provincial income tax legislation includes provisions relating to this new product. Thus, we are in the situation of having to attempt to apply tax legislation to product offerings not contemplated by the legislation.

Bear in mind that the situation vis-à-vis the tax legislation is not unlike the situation with the various provinces' insurance acts. Insurers may take different approaches to categorizing the policies. As we understand it, most insurers are of the view that CI policies are more appropriately treated as "sickness" policies.

When we look at the categorization of policies, an interesting situation arises in how "beneficiaries" are to be designated for the various benefits. There may be sound reasons for seeking to designate different "beneficiaries" for the various amounts that may be payable under the policy (i.e., the lump-sum (or partial) benefit, the ROPD, and the ROPS or ROPE). A good example of how the insurance statutes do not contemplate CI products is when we consider how designating a beneficiary for the ROPD may affect the categorization of the policy.

Some insurers have certain "default beneficiaries". For example, the default beneficiary for the ROPD may be the owner's estate. However, should a policyholder not believe this to be appropriate, many insurers offer the policyholder the flexibility of designating a different "beneficiary" (or "benefit recipient"). Of course, insurers should urge the policyholder to seek independent tax advice.

³ Insurers vary in their calculations of the ROPD. Some will refund all premiums paid, including annual policy fees and extra charges. Others may refund a lesser amount.

⁴ See 2 above.

Other insurers are taking a cautious approach. That is, they are of the view that it is not appropriate to designate a beneficiary for the ROPD benefit, as this might be a factor contributing to the policy's being categorized as a "life insurance policy". Thus, these insurers may insist that ROPD benefits are automatically payable to the deceased's estate. But in doing so, they have eliminated the flexibility that many policyholders are seeking.

The ITA contains detailed provisions governing the taxation of life insurance policyholders.⁵ However, "life insurance policy" itself is not defined. Thus, we are placed in the situation of having to determine whether CI policies are life insurance policies for tax purposes, or whether they are something else. With this being the case, it is necessary to look to the common usage of the term "life insurance policy," particularly as employed by the insurance industry. Definitions of this term in the relevant provincial insurance statutes are relevant, but not necessarily conclusive. It may also be appropriate to look at how classes of insurance are dealt with in *The Insurance Companies Act*, which governs federally regulated insurance companies.

When examining how a disability policy might be categorized, the Canada Revenue Agency (CRA) states:

"The Act does not contain a detailed definition of what constitutes a "life insurance policy." Paragraphs 138(12)(f) and (g) of the Act provide some guidance as to what will constitute a "life insurance policy" for purposes of the Act, however, this is not an exhaustive definition. It is, therefore, necessary to look to the common usage of what constitutes a life insurance policy particularly as employed by the insurance industry. In this regard, the definitions of this term in the relevant provincial insurance statutes will be relevant although not necessarily conclusive. One should also take into account the classes of insurance that are referred to in *The Insurance Companies Act*, S.C. 1991, c.47 which governs the federally regulated insurance companies."⁶

Thus, prior to having to deal with the categorization of CI for tax purposes, CRA had already taken the position that the various insurance statutes might be referred to. In technical interpretations dealing specifically with CI, we see CRA holding true to this position.⁷ (CRA is also considering definitions used for other purposes.⁸)

The various insurance regulators and the Office of the Superintendent of Financial Institutions together form the Canadian Council of Insurance Regulators (CCIR). In 2002, CCIR developed a set of standard insurance classes. However, all of the provinces have yet to adopt these definitions.

Two industry groups, the Canadian Life & Health Insurance Association (CLHIA) and the Conference for Advanced Life Underwriting (CALU), have devoted considerable efforts to reviewing issues relating to the taxation of CI. In early 2004, these groups made a submission to the Department of Finance and CRA in this regard.

The industry view is that pure CI is properly viewed as accident and sickness insurance, with the (lump-sum) benefits under such policies being non-taxable in most circumstances. While there is a lack of clarity with respect to ROP benefits (particularly ROPD), the primary purpose of the insurance should be determinative. (Thus, while CRA in a review of the current legislation could contend that having a ROP payable at death would cause the policy to be a "life insurance policy", this is entirely inappropriate from a policy perspective. The application of the taxation rules applying to life insurance policies to CI (and LTC) policies would be extremely difficult and would create anomalous and inappropriate results.)

The current regime for the taxation of life insurance policies was implemented so that deferral of tax on the savings component of such policies could be capped. CI (and LTC) policies that are offered by the industry do not have a significant "savings" element. Thus, the industry is of the view that extending the rules introduced for

⁵ See sections 12.2 and 148 of the ITA, and 138.1 for segregated funds.

⁶ See CRA document # 9214825, dated March 9, 1993.

⁷ See Technical Interpretation # 2003-0160155, dated April 3, 2003; also Technical Interpretation S # 2005-0112781E5, dated February 2, 2005.

⁸ See CRA document # 9908430, dated June 30, 1999, where CRA resorts to looking at the Insurance Institutes' Dictionary of Insurance.

life insurance policies to CI and LTC policies is entirely inappropriate. Nor would it be appropriate to introduce an equally cumbersome set of parallel rules.

Unfortunately, it is difficult to anticipate when a response from the government might be received, given the complexity of the topic, as well as the fact that the taxation of CI is only one of many tax issues that the government has to resolve.

Given the variety (as well as complexity) of the CI product offerings, we will review the various types of arrangements separately, starting with the least complex.

ii “Vanilla” Product – Stand-Alone CI without a ROP feature

The first product we will review is the most straightforward: “vanilla” CI without a return of premium feature. Here a separate policy is obtained for the CI. The coverage is not obtained as a rider.

Not unexpectedly, CRA has confirmed that a lump sum benefit received under a “vanilla” CI policy is generally not taxable. This confirmation was provided at the 2003 CALU Conference, an industry forum that carries considerable weight. CRA stated the following:

“A key concern evidenced by your submission is how stand-alone critical illness policies will be characterized for purposes of the Act. In this respect, we think it may be relevant whether the policy includes ROP benefits and if so, the terms and conditions of the various benefits under the policy.

Where a policy provides benefits only in the event of critical illness, we agree with your view that the policy should be viewed as a “sickness” policy, rather than a life insurance policy for purposes of the Act, notwithstanding that such policies are primarily issued by life insurers. In our view, the proceeds of disposition of such a policy would generally not be included in the policyholder’s income under section 3 of the Act.”⁹

Thus, policyholders of “vanilla” CI can take comfort in knowing that the benefits they receive upon the diagnosis of a covered condition will, in most situations, not be taxable. (It would be interesting to know in what circumstances CRA contemplates that the lump sum CI benefit *would* be taxable.)

We are pleased that the view expressed at the industry forum has been confirmed in numerous subsequent technical interpretations.¹⁰ CRA looked at the situation where a policy is paid up over a 10-year period, with coverage to age 100. CRA has indicated that “Where the terms and conditions of a critical illness policy provide benefits only in the event of critical illness and the provision of that insurance is clearly the purpose of the contract, the policy in our view would likely be a sickness policy for purposes of the Act.”¹¹

Taxpayers who have received lump-sum CI benefits may spend some or the entire amount on medical expenses. We discuss whether amounts spent on medical expenses qualify for the non-refundable medical expense credit below (see “Impact on Medical Expense Credit” on page 8).

iii Stand-Alone CI with a ROP Feature

As stated above, CRA has conceded that lump sum CI benefits paid pursuant to a “vanilla” CI policy without ROP features are generally not taxable. However, ROP benefits are very popular. Some products have a built-in ROP feature, and other products offer ROP as a rider.

⁹ See CRA document # 2003-0004265, dated June 18, 2003.

¹⁰ See CRA document # 2003-005457, dated December 24, 2004.

¹¹ See Technical Interpretation # 2003-0026385, dated December 10, 2003.

As may be seen from comments made at the 2003 CALU Conference, CRA was unwilling to take a position on what impact ROP features might have. Subsequent to the 2003 CALU Conference, a number of documents are available in which CRA discusses ROP features.

(a) ROPE Feature

In December 2004, CRA issued a technical interpretation dealing with a policy having a ROPE feature.¹² For example, a policyholder might pay premiums until he or she attains a specific age (say 75), at which time the policy expires. At that time, the policyholder would receive a refund of 100% of premiums paid, provided the policy is in force and no lump sum benefits have been paid. In the document, CRA stated:

“As insurance products vary broadly in their terms and conditions, it must always be kept in mind that the characterization of a particular policy, including a CI policy, depends upon all the terms and conditions of the policy and the applicable insurance legislation. That being said, where the terms and conditions of a critical illness policy provide benefits only in the event of critical illness and the provision of that insurance is clearly the purpose of the contract, the CRA has generally taken the position that the policy is a sickness policy for purposes of the Act ... In our view, the presence of a “return of premium on expiry” benefit that provides for a benefit that is solely a return of premiums paid-in ... would be unlikely, in and of itself, to result in the CI policy being viewed as having a different character for purposes of the Act. Of course, it would be a question of fact, determined with reference to all the terms and conditions of the particular policy, whether a particular benefit represents solely a return of premiums.”

What is interesting here is that when one examines the standard insurance classes, as agreed to by OSFI and CCIR, it is reasonable to conclude that a policy containing only CI benefits (i.e., no ROP benefits) would be classified as accident and sickness insurance, and not life insurance. With the addition of ROP, particularly on death, whether or not the policy is still an accident and sickness policy may not be as clear. Irrespective of this, from a reading of the above it does appear that CRA is open to the argument that a ROP feature may not necessarily “taint” the policy, i.e., to cause it to be characterized as a life insurance policy.

At various industry forums, including the 2005 CALU Conference, officials of The Department of Finance have verbally indicated that they are just starting their in-depth review of CI ROP taxation. However, we would argue that it is entirely reasonable that an ancillary benefit should not affect the characterization of the policy. Considerable weighting should be given to the primary purpose of the policy!

Nevertheless, when looking at the above comments made by CRA, the reader is left with the question of how much comfort they believe has in fact been provided. Absolute certainty is not available.

(b) ROPS Feature

The same document dealt with a ROPS feature. The policy could be surrendered at age 65, with the policyholder then receiving 50% of premiums paid in. An additional 5% would be received for each additional year that the surrender is postponed, with 100% of the premiums paid in being available at age 75. CRA's position was the same as for the ROPE feature discussed above.

(c) ROP Features and Quebec's Civil Code

As earlier noted, CRA has been looking at the various insurance statutes in determining how to categorize CI for tax purposes. In this regard, we note that Quebec has insurance legislation that is significantly different from that of other jurisdictions.

In 2002, CRA issued a technical interpretation regarding a CI contract in Quebec that included ROP features. The employer was offering individual plans on a “common plan” basis. CRA examined the appropriate

¹² See CRA document # 2003-005457, dated December 24, 2004.
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insurance legislation (*Loi sur les assurances*), as well as the appropriate provisions of the Civil Code. CRA concluded that a contract that provided only CI (with no ROP features) would be sickness and accident insurance. However, a ROP feature is a feature of life insurance. The Civil Code had specific provisions dealing with “accessory” (i.e., ancillary) features. Section 2394 specifically provided that:

“Clauses of accident and sickness insurance which are accessory to a contract of life insurance and clauses of life insurance which are accessory to a contract of accident and sickness insurance are governed by the rules governing the principal contract.”

CRA held that whether the ROP clause was accessory to a sickness and accident policy is a mixed question of fact and law. In the case at hand, this determination could only be made upon consideration of the insurer’s comments and calculations.¹³

Because of the unique provisions of the Civil Code, some contend that there is a basis for arguing that in Quebec there is a clearer basis for maintaining that CI policies with a ROP feature are “sickness” policies, not life insurance policies. It would be interesting to know what the Quebec insurance supervisory authority’s thoughts are with respect to the above.

(d) Whether ROP Includes an Interest Element

Where ROP features are implemented, most insurers will only return premiums paid, with the amount typically being capped at the sum insured. However, there are situations in which there is an investment component. Here, an additional amount (computed at say 3% per annum) is added to the refund.

Such a feature may be problematic. The ITA contains broad language in its “interest accrual” provisions. Where there appears to be an investment component, we are wondering whether CRA might contend that the policy falls into the “investment contract” (or “debt obligation”) category?¹⁴ If so, CRA may seek to tax the investment component on an annual basis. Taxpayers considering acquiring policies with such features should proceed with caution, both as it relates to the application of the interest accrual provisions and certain other provisions of the ITA.¹⁵ Prospective purchasers of CI policies having ROP features are urged to be especially cautious where they are contemplating acquiring a policy that offers an explicit return in addition to a return of the premiums actually paid.

iv. CI as a Rider to a Life Insurance Policy

CI is often sold as a rider to a life insurance policy. In our discussion, we will consider situations where the same CI coverage is obtained via the rider as is available under a stand-alone CI policy. The policyholder will realize some cost savings, as the policy fees (generally a flat amount charged by the insurer) will already have been paid for as part of the life insurance coverage. Policyholders may also find it easier to add CI as a rider, as they already have a need for life insurance and being underwritten by the same insurer for both coverages is less cumbersome.

Under current tax rules, the CI element of the policy is not considered a separate contract. The ITA does not contain provisions that would treat the CI element of the contract as a separate policy. This raises the issue of whether receiving CI benefits would be considered a “disposition” of a portion of a life insurance contract.

In the ITA, “disposition” is not exhaustively defined.¹⁶ There are no explicit references to CI (in either what is explicitly included as a disposition or what is explicitly excluded from being a disposition). It is interesting to note

¹³ Technical Interpretation, Document # 01135, May 24, 2002 was issued in French. An English translation of this is included in Theroux, M. and Millard, K, “Trends & Developments in Group Benefit Plans,” as presented to the Canadian Tax Foundation’s 54th Tax Conference, 2002.

¹⁴ See subsection 12(4) of the ITA.

¹⁵ The possible application of other provisions such as subsection 16(1) warrants review.

¹⁶ See definition of “disposition” contained in subsection 148(9) of the ITA.

that dispositions expressly exclude “a payment under a policy as a disability benefit ...”¹⁷ Thus, LTC benefits would generally be carved out from the definition of “disposition,” by virtue of their qualifying as a disability benefits.

Where CI coverage is obtained via a rider to a life insurance policy, it would be entirely appropriate not to treat the payment of a CI benefit as a disposition of a life insurance contract. Representations to this effect have been made to CRA and Finance. We await confirmation of the same from Finance and/or CRA.

The industry’s position is that the tax regime for CI benefits should be relatively straightforward and applicable as universally as possible. Additionally, the industry’s view is that the principles of clarity, simplicity, and consistency should apply. On this basis, a taxpayer who has obtained CI coverage via a rider where the coverage could have just as well been obtained as a separate CI policy should be taxed in an identical fashion. To avoid doing so would ignore the substance of the transaction!

v. Treatment of Premium Costs

A taxpayer may seek to deduct the CI premiums. Unfortunately, the ITA prohibits the deduction of personal or living expenses. A taxpayer might, of course, contend that the premiums are for medical coverage. Premiums for medical plans qualify as expenses for purposes of the non-refundable medical expense credit, provided the plan qualifies as a Private Health Services Plan (PHSP).¹⁸ As defined in the ITA, PHSP means:

- (a) a contract of insurance in respect of hospital expenses, medical expenses or any combination of such expenses, or
- (b) a medical care insurance plan or hospital care insurance plan or any combination of such plans ...¹⁹

Where a plan does not limit how the CI benefit is to be spent (that is, the recipient may spend the amount as they please), the plan will not qualify as a PHSP. This is because the requirement that the amounts be spent exclusively on medical or hospital expenses is not met. CRA has confirmed this position in several Technical Interpretations.²⁰

vi. Impact on Medical Expense Credit

CI is an attractive product for consumers who purchase the coverage to make funds available to cover medical expenses. While, as stated above, there are no requirements as to how the benefit is spent, there are no doubt many policyholders who will spend the benefit on expensive prescriptions or costly out-of-country medical treatments. Advisors may sell CI on the basis that purchasers will be able to avoid the long queues that are unfortunately part of the Canadian medical system.

The ITA allows taxpayers to claim a non-refundable medical expense credit in respect of certain expenditures. This credit may be claimed to the extent that the medical expenses exceed the lesser of: (1) 3% of net income, and (2) a threshold amount. (For 2005, this threshold amount is \$1,844 for federal income tax purposes, and is indexed each year for inflation. Not all provinces use the same threshold amount.) The value of the tax credit will represent approximately 20% to 36% of the medical expenses in excess of the threshold amount, and is therefore significant.

¹⁷ See part (h) of the definition of “disposition” contained in subsection 148(9) of the ITA.

¹⁸ See subsection 118.2(q) of the ITA.

¹⁹ See definition of Private Health Services Plan (PHSP) contained in subsection 248(1) of the ITA. CRA also outlines the additional conditions that an arrangement must meet to qualify as a PHSP in Interpretation Bulletin IT-339R2: Meaning of “Private Health Services Plan.”

²⁰ See Technical Interpretation # 9711505, dated June 2, 1997. Also Technical Interpretation # 2002-060155, dated April 3, 2003.

The ITA contains detailed rules on what qualifies as a medical expense.²¹ However, once it has been determined that an expenditure qualifies, the ITA contains rules which will not allow a credit to be claimed in respect of an otherwise qualifying amount where the amount will be reimbursed. If we look at this provision closely, we see that the amount cannot be included as a medical expense where the individual, the patient (or certain other parties) are "... entitled to be reimbursed for the expense".²²

Since the CI plan does not require that the benefit be spent on medical or hospital expenses, taxpayers could argue that they are not entitled to a reimbursement, and may therefore proceed to include the amount as a medical expense for purposes of the credit. CRA and the Department of Finance may be unhappy with this interpretation, and may argue that it goes against the spirit of this provision. This provision may change. CRA might also challenge taxpayers who file on this basis.

III. Summary

CI contracts meet a real need for Canadian taxpayers, especially given the aging population and the strains on government coffers. Insurers are addressing the needs of these taxpayers.

There are a number of areas where the tax regime is not keeping pace with products insurers are offering. The industry has made Finance and CRA aware of the tax issues and is working hard to resolve them. We hope that the legislators are able to make the appropriate amendments to the legislation and/or administrative practices so that CI products will be treated appropriately for tax purposes. This would mean that people who acquire such policies with their after-tax incomes would receive benefits on a non-taxable basis.

We await Finance's (and CRA's) review of the taxation of CI. A timely resolution of the issues would be entirely appropriate.

This document is intended for general information only. It should not be construed as legal, accounting, tax or specific investment advice. Clients should consult a professional advisor concerning their situations and any specific investment matters. While reasonable steps have been taken to ensure that this information was accurate as of the date hereof, The Standard Life Assurance Company of Canada and its affiliates make no representation or warranty as to the accuracy of this information and assume no responsibility for reliance upon it.

²¹ See subsection 118.2 of the ITA, as well as Regulation 5700.

²² See subsection 118.2(3) of the ITA.