

The Taxation of Corporately-Owned Critical Illness Insurance

This document will review the tax implications of critical illness (CI) policies that are corporately-owned. We refer you to the companion piece: *The Taxation of Personally-Owned Critical Illness Insurance (form 5771-11-2005)*. It contains information that would be of value to readers of this document, including a discussion of policy features, etc.

I. Corporate Need for Critical Illness Insurance

As stated in the companion piece, interest in CI policies is growing. Corporations will be interested in CI in two general types of situations. The first involves providing CI coverage for employees. The second concerns shareholders who want to protect the value of their shareholdings. This includes ensuring that funds will be available for acquiring and/or redeeming shares, or ensuring for their own financial well-being in the event that they are diagnosed with a covered condition.

II. CI Coverage Provided to Employees

Many employers already provide their employees with a wide range of employee benefits, including group term life insurance, disability, and health coverage, etc. However, employers and employees are recognizing that there are still gaps in the coverage. For example, employees who become disabled may be entitled to income replacement benefits (say, 70% of their salary) via group disability coverage. The disabled employee may well have a significant mortgage on his or her home. If the person was also diagnosed as having one of the conditions covered by the CI policy, the lump-sum payable could be used to retire the mortgage. It could also be used to travel outside of Canada to pay for medical care that the person's group (or government) plan does not fund.

We will review the personal and corporate tax implications relating to employer-provided CI coverage. The result will depend upon how the arrangement is structured.

(a) Grouped CI Plans

The first arrangement is where the employer puts in place an arrangement whereby individuals are covered under individual CI contracts as part of a "common plan." Here, the company is the policyholder, and the employee is the benefit recipient. We will refer to this as a Grouped CI arrangement. (This is distinct from a Group CI arrangement, where a group of employees is covered under a single contract.)

From both an employer and employee perspective, there are tax advantages where an arrangement is considered a "group sickness or accident insurance plan" or a "Private Health Services Plan" (PHSP) for purposes of the Income Tax Act (Canada) (ITA):

- The employer will not have to report the employer-paid premiums as a taxable benefit to the employee¹ (except in the case of Quebec for provincial tax purposes only²);
- The benefits paid under the group sickness or accident insurance plan or PHSP will also be tax-free (except for certain wage-loss type benefits)³, and;

¹ See subparagraph 6(1)(a)(i) of the Income Tax Act (Canada) (ITA).

² For Quebec provincial income tax purposes, employer-paid premiums for PHSPs and group insurance plans (other than certain wage-loss plans) are a taxable benefit, pursuant to C. I-3, s.37.0.1.1 of the Taxation Act (Quebec). The appropriate sales taxes will also form part of the taxable benefit. Professional advice should be sought as to whether the particular CI product is non-taxable because of the exemption provided for a group insurance plan that provides "coverage against the loss of all or part of the income from an office or employment".

- The employer will be able to deduct premiums as part of its salary and benefit costs⁴.

As discussed in *The Taxation of Personally-Owned Critical Illness Insurance*, most CI contracts do not place limits on how benefits paid under the contract are spent. Recipients are free to spend the amount as they please. Hence, Canada Revenue Agency's (CRA) position is that the CI contract will not qualify as a PHSP.⁵

While CRA accepts that a PHSP may have a single member, a "group" arrangement (including a "group accident and sickness plan") must cover two or more members. CRA, in looking at a group disability plan, commented:

"... a wage loss replacement plan can include the situation where employees are covered under individual contracts but pursuant to a common plan ...".⁶

And in looking at a group accident or sickness plan, stated:

"A 'group sickness or accident insurance plan' means a plan under which a number of employees are insured either under a single contract between the insurer and the employer contracting with the insurer or under individual contracts but pursuant to a common plan."⁷

Such a "common plan" might also be referred to as a "grouped individual" type plan. However, a "common plan" would not include an arrangement whereby an insurer has a product created for sale to employees of *any* employer.⁸

The existence of a "common plan" will have to be documented. We recommend that the employer have a "plan document," and distribute a copy to employees. Here the employer would state that it is implementing the (group accident and sickness) arrangement, and would describe the arrangement, including its purpose, and how it is to be funded (i.e., with the employer paying the premiums for the individual CI contracts being acquired). It is important, as described below, that the purpose of the arrangement not be to provide for lost wages.

In our discussion, we presume that the CI coverage provides for a lump-sum benefit and not periodic payments. The ITA contains specific rules governing the taxability of employer-funded wage-loss plans. Specifically, paragraph 6(1)(f) of the ITA provides that the employee will have an income inclusion for:

"... amounts received ... in the year that were payable to the taxpayer on a *periodic basis in respect of the loss of all or any part of the taxpayer's income* from an office or employment, pursuant to

- (i) a sickness or accident insurance plan,
- (ii) a disability insurance plan, or
- (iii) an income maintenance insurance plan

to or under which the taxpayer's employer has made a contribution ...".

Thus, we would want to be sure that benefits payable under the CI product are not included in income pursuant to the above provision. That is, the arrangement should not provide for periodic payments, which are intended to replace the employee's lost income. Nor should a lump-sum benefit be paid, where the amount is in lieu of periodic payments that are meant to replace the employee's lost income. (A recent Supreme Court case dealt with the taxation of a lump-sum settlement, where the lump-sum represented compensation for past periodic disability benefits, and also included the present value of

³ See subparagraph 6(1)(f) of the ITA.

⁴ See subsection 9(1) of the ITA.

⁵ See Technical Interpretation 2002-0160155 dated April 3, 2003.

⁶ Technical Interpretation, August 31, 1993, Document # 9311685.

⁷ Technical Interpretation, December 11, 1991, Document # 9126876.

⁸ See above.

future benefits. The court held that the arrears portion represented payments that would have been taxable if they had been paid. Thus, under the *surrogatum principle*, the amounts were taxable pursuant to paragraph 6(1)(f) of the ITA. The amount received on account of future benefits was, however, held to be a tax-free capital receipt.⁹⁾

There are several technical interpretations in which CRA states that the possible impact of paragraph 6(1)(f) should be assessed when reviewing lump-sum benefits paid under employer-provided CI arrangements. In one technical interpretation, CRA states:

“It remains a question of fact and law as to whether the lump-sum benefit would be taxable under paragraph 6(1)(f) of the Act. For example, if a lump-sum benefit was considered to represent a payment in respect of the employee foregoing the right to receive periodic payments that were otherwise taxable under the policy, or under another sickness or accident insurance plan, the lump-sum payment could, in our view, be taxable under paragraph 6(1)(f) of the Act.”¹⁰⁾

In another technical interpretation, CRA when asked about the taxability of a lump-sum paid out under a CI policy, again cited the possible application of paragraph 6(1)(f):

“Whether or not amounts received under a group sickness or accident insurance plan are taxable is a question of fact. However, we understand that critical illness insurance policies do not provide for payments on a periodic basis. Therefore, it is our general view that a lump sum payment under such a critical illness insurance policy is non taxable.”¹¹⁾

If paragraph 6(1)(f) were applicable, employer-paid premiums under the arrangement would not be taxable.¹²⁾ However, the employee would include benefits received in the year in income, net of any post-1967 premiums paid by him or her. Note that this is to the extent the employee-paid premiums had not already been netted out against benefits included in income in a preceding taxation year.¹³⁾

Thus, it is advantageous from a tax perspective when an employer “groups” individual CI policies (assuming of course that paragraph 6(1)(f) does not apply). The caveat is that the individual coverage must be considered a “sickness” policy for this result to arise. Please refer to the discussion of this in *The Taxation of Personally-Owned Critical Illness Insurance*. As discussed therein, CI products vary considerably. CRA has provided considerable comfort (but not absolute certainty) in the case of “vanilla” CI policies.

We are aware of a very recent technical interpretation dealing with group sickness and accident insurance policy. (The arrangement does not appear to be a Grouped CI type arrangement). CRA has affirmed that lump-sum benefits received would be non-taxable.¹⁴⁾ Since CRA has elsewhere affirmed that grouped individual contracts (i.e., a “common plan” type arrangement) may be considered a group sickness and accident insurance plan, this technical interpretation confirms that lump-sum benefits payable under a Grouped CI arrangement would be non-taxable. (We note that there is no discussion of the arrangement’s providing ROP benefits.)

There is less certainty in the case of CI policies having ROP (return of premium) features. In a December 2003 technical interpretation, CRA was asked what the impact of an ROP option would be if it were included in CI insurance policies provided on a group basis, where CRA presumed that the arrangement otherwise qualified as a sickness and accident insurance plan. CRA stated:

⁹⁾ See *Vasiliki Tsaprailis vs. the Queen*, Supreme Court of Canada decision of February 25, 2005 (2005 DTC 5119 (Eng.), 2005 DTC 5126 (Fr.)). CRA has adopted this position in recent Technical Interpretations. See Technical Interpretation # 2005-0141511E5 dated September 13, 2005.

¹⁰⁾ See Technical Interpretation # 9711505 dated June 2, 1997.

¹¹⁾ See Technical Interpretation # 2003-0034505 dated December 9, 2003.

¹²⁾ See subparagraph 6(1)(a)(i) of the ITA.

¹³⁾ See paragraph 6(1)(f) of the ITA.

¹⁴⁾ See Technical Interpretation # 2004-0105491E5 dated January 14, 2005.

“ ... On the basis that the critical illness insurance constitutes a ‘group sickness or accident insurance plan’, it is our view that the exemption in subparagraph 6(1)(a)(i) would likely apply to premiums on critical insurance policies provided on a group basis, as long as the policies only provide for critical illness insurance and do not contain any return of premium (“ROP”) benefits.”¹⁵

CRA then went on to state:

“We have no general conclusion to offer at this time on the appropriate treatment of policies providing ROP benefits in addition to critical illness benefits. Some ROP benefits may well be life insurance. We have undertaken a comprehensive review ... However, our review is not yet complete.”¹⁶

One year later (December 2004), CRA stated:

“... in our view, the presence of a ‘return of premium on expiry’ benefit ... 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”¹⁷

Where such an arrangement is implemented, additional tax considerations arise where a shareholder also participates. With shareholder participation, CRA may be expected to query whether the shareholder received the benefit in his capacity as a shareholder or as an employee. If the benefit arose because of the shareholding, the benefit will be included in the shareholder’s income pursuant to subsection 15(1) of the ITA, and the employer will not have a deduction for the premium.¹⁸

CRA, in comments made at an industry forum, stated that it must be determined whether the benefits were received in an employee or shareholder capacity. However, CRA affirmed it always starts with the presumption that an employee-shareholder who can significantly influence business policy will have received the benefit by virtue of this shareholding. When looking at a situation where the entire “group” participating in a plan consists of shareholders, the same presumption applies.¹⁹

At this same forum, CRA provided additional insight on this issue. There are additional factors, which would lead CRA to conclude that a benefit was received in a shareholder capacity. CRA would look at:

- whether plan participation was made available to non-shareholders or those not related to shareholders;
- whether similar benefits are provided to all employees, and;
- when all participants are shareholders, is similar coverage provided for non-shareholder employee groups for similar businesses?²⁰

It may also be possible to have the “group” limited to just executives, and argue that the shareholder-employee participated in a group arrangement limited to just the executive group, provided that there are non-shareholders in this group. It would likely be problematic if the group consisted only of shareholder-employees, especially where the company introducing the plan cannot establish that the (industry) norm is to introduce such arrangements.

We are aware of a technical interpretation, which dealt with a Grouped CI arrangement (via a Health and Welfare Trust, or HWT) for a corporation having only three employees, two of whom were shareholders. CRA expressed the usual caveats, but then proceeded to answer certain questions posed by the

¹⁵ See Technical Interpretation # 2003-0034505 dated December 9, 2003.

¹⁶ See above.

¹⁷ See Technical Interpretation # 2003-0054571E5 dated December 24, 2004.

¹⁸ See Technical Interpretation # 9924375 dated December 15, 1998.

¹⁹ See CRA document # 9908430 dated June 30, 1999 (CRA Roundtable at the 1999 CALU Conference).

²⁰ See above.

taxpayer, having made the presumption that the CI coverage was provided to the shareholder-employees in their capacity as employees.²¹ It appears that it is feasible to implement Grouped CI arrangements for corporations with small numbers of employees, most of who are shareholders.

We urge anyone establishing arrangements that cover shareholders to proceed with caution. Always obtain appropriate professional advice.

(b) Employee Acquires Personally Owned CI Contract Paid for with Increased Salary

Here we are not looking at corporately owned CI. Instead, an employee acquires a CI policy that is owned personally. That is, the employee is the policyholder, as well as the benefit recipient. The employer increases the employee's salary, so the employee has a source of funds to pay the premiums.

The tax implications to the employer are straightforward: The employer will be able to deduct the salary (and any associated payroll and other taxes), provided that the amounts are reasonable.

The tax implications to the employee are two fold. First, the employee will include the additional salary in income. Next, we have to look at the acquisition of the individual CI contract. The tax implications are as discussed in *The Taxation of Personally-Owned Critical Illness Insurance*. In brief, the employee will not have a deduction for premium costs. The taxation of any lump-sum benefits will depend upon the nature of the CI policy. For "vanilla" products, the CRA has confirmed that lump-sum benefits received are generally not taxable. CRA and the Department of Finance are continuing their review of products having ROP features. (The industry argues that the addition of a ROP feature should not "taint" a policy, that is, cause it to be characterized as a life insurance policy.)

Whether or not the employee is also a shareholder does not alter the result. The employer will be able to deduct any salary paid, provided that the amount is reasonable and was incurred to earn income from a business.

(c) Employee Acquires Personally-Owned CI Contract, with the Employer Paying the Premiums

In this situation, the employee is the policyholder as well as the benefit recipient. However, instead of paying employees an additional salary so that they may pay the premiums with the after-tax salary, the employer pays the premiums. (Here, we are presuming that the arrangement is not a Grouped CI arrangement.)

Again, the tax implications to the employer are rather straightforward: The employer will be able to deduct the taxable benefit (and any associated payroll and other taxes), provided of course that the amounts are reasonable and the expense was incurred for the purpose of earning income. (Here we presume that the benefit did not arise by virtue of the employee's being a shareholder.)

If the taxable benefit arose because the employee was also a shareholder, the corporation will not have a deduction for the taxable benefit. The shareholder will nevertheless have to include the amount in income.²²

When we look at benefits paid under the CI policy, the tax implications are as discussed in *The Taxation of Personally-Owned Critical Illness Insurance*.

²¹ See Technical Interpretation # 2003-0034505 dated December 9, 2003.

²² See subsection 15(1) of the ITA.

(d) Employee Acquires Personally-Owned CI Contract, with the Employer Reimbursing Employee

An employee may pay the premiums personally, and then recover the amount from the employer. CRA has confirmed that where the employee is reimbursed for premiums he or she paid for the CI insurance, a taxable benefit must be reported on a T4 slip.²³ (No details of the actual “employer-provided” CI arrangement are provided in the technical interpretation.) CRA, in looking at the benefits received under the CI contract, stated that the benefits (which appear to be lump-sum benefits only) would *generally* be non-taxable. This technical interpretation must be read with caution, since CRA specifically stated its comments were not definitive.

The reimbursed amount will be deductible to the employer, provided it is reasonable and was incurred for the purpose of earning income. Where the employee is also a shareholder, the company should specify that the amount is additional salary, so that it is not denied a deduction. (If it is simply a shareholder benefit, a deduction will not be available.)

(e) Employer-Provided Coverage via a Health and Welfare Trust

Employers may contemplate offering CI coverage via a HWT. The ITA does not contain specific legislation governing HWTs. There is no legal basis for HWTs under the ITA. Instead, HWTs became administratively recognized by CRA in the manner set out in *Interpretation Bulletin IT-85R – Health and Welfare Trusts for Employees* (“IT-85R2”), after extensive consultations with the tax and employee benefit consultant communities in the 1970s.

HWTs are arrangements under which employers are able to provide certain benefits to their employees and former employees. Essentially, the employer operates their health and welfare programs through a “trust” arrangement. There is no registration process. Employers (and their advisors) contemplating implementing a HWT should refer to IT-85R2 to gain a clear understanding of CRA’s requirements (non-reversion of funds to employer, non-gratuitous contributions, exclusive purpose, limitations with respect to types of benefits that may be provided, etc).

HWTs can only offer specific types of benefits. These are limited to: group sickness and accident insurance plans, PHSPs, group term life insurance plans, or any combination of the foregoing.²⁴ Earlier in this paper, we discuss how CI is to be categorized. Thus, where a CI is to be offered via a HWT, the employer will need to be certain that the coverage will be considered to be either a “group sickness accident and insurance plan” or a PHSP. For example, if an individual CI contract qualifies as a “sickness or accident insurance plan”, these could be grouped so that there will be a group sickness or accident insurance plan. CRA does contemplate such an arrangement in one of its technical interpretations.²⁵

Where a HWT is established, the employer may take a deduction for contributions made in the taxation year in which the legal obligation to make the contribution arises. However, the deduction will only be allowed where the amount of the contribution is reasonable and is being incurred to earn income from a business or property.²⁶ (There may be issues as to the timing of any deductions, that is, whether the prepaid expense rules apply.²⁷) Where benefits are being provided for arms’ length employees, or in a negotiated setting, there are usually few issues as to reasonableness. However, when we are looking at benefits being provided to non-arm’s length persons (say shareholders or their family members), we again have to consider whether the benefit was received in the person’s capacity as a shareholder or an employee. “Reasonableness” will have a bearing on whether the shareholder benefit rules in subsection 15(1) will apply. These can serve to deny employers a deduction for HWT contributions.

²³ See Technical Interpretation # 1999-0013605 dated January 28, 2000.

²⁴ See paragraph 1 of *Interpretation Bulletin IT-85R2 – Health and Welfare Trusts for Employees* (IT-85R2).

²⁵ See Technical Interpretation # 9311685, dated August 31, 1993.

²⁶ See paragraph 8 of IT-85R2.

²⁷ See page 6 of *Income Tax Technical News No. 25*, dated October 30, 2002.

CRA's view is that a HWT is essentially a conduit:

"Essentially, CCRA [now CRA] allows these trusts to be treated as conduits: an employee does not receive or enjoy a benefit at the time the employer makes a contribution to a health and welfare trust. Further, any income tax advantage that an employee would otherwise get is not affected because of the health and welfare trust. For example, payment by the trustees of health and welfare trusts of all or a part of an employer's contribution to a private health services plan, does not give rise to a taxable employment benefit. The legislative exemption in subparagraph 6(1)(a)(i) flows through to the employees."²⁸

CRA's position is that the tax implications to the employee will not change because an employer is providing health and welfare benefits through a HWT. The tax implications to the employee should be identical to those that would arise if the employer were providing the benefits directly.

Should the arrangement not be considered a HWT (which could happen if the CI coverage being offered is not considered a PHSP or a group sickness or accident insurance plan), the arrangement could be either an "employee trust" or "employee benefit plan" for purposes of the ITA, with the tax rules specific to that arrangement then applying.²⁹ (If post-employment type benefits were being provided, the Retirement Compensation Arrangement rules would also have to be considered.³⁰)

III. CI Coverage Provided for Shareholders

A shareholder could have a need for CI coverage. The CI could be for his or her direct personal protection (e.g., to provide a benefit in the event of his or her being diagnosed with a covered condition), or to protect the value of his or her shareholding. This could include providing the necessary funds for: (a) a redemption or acquisition of shares, (b) for the repayment of various loans, or (c) key person protection.

In considering the tax implications, the result will be fact specific. The results will vary, depending upon who is the policyholder and who is the benefit recipient.

(a) Deductibility of Premiums

Let's first discuss the situation where the corporation is the policyholder as well as the benefit recipient. The ITA does not permit a deduction for payments on account of capital.³¹ Thus, premiums for CI will not be deductible. Also, the provisions of the ITA that permit a deduction where the insurance is required as collateral specify that the premiums must be payable under a life insurance policy (other than an annuity contract).³²

We could have a situation where the corporation is the policyholder and the shareholder (or a person related to the shareholder) is the benefit recipient. This is generally a very costly approach, as the premiums are not deductible, yet the shareholder has a shareholder benefit pursuant to subsection 15(1) of the ITA. Where the shareholder is to be the benefit recipient, it would be more appropriate for the shareholder to be paid additional salary (or dividends) so he or she will have a source of funds with which to pay the premiums. The corporation would then have a deduction for the salary (and related payroll and other taxes) payable.

We are aware of CI products being promoted on a split dollar basis. The corporation pays the premiums for the base CI product, and is entitled to lump-sum benefits, as well as the ROPD. What is unusual

²⁸ See page 5 of ITTN-25.

²⁹ See paragraphs 3 and 4 of IT-85R2.

³⁰ IT-85R2 predates the introduction of the Retirement Compensation Arrangement ("RCA") rules. There are advance tax ruling requests where taxpayers ask CRA to confirm the non-application of the RCA rules (eg. Advance Income Tax Ruling # 2001-0098963 and # 2002-0124183.)

³¹ See paragraph 18(1)(b) of the ITA.

³² See subparagraph 20(1)(e.2)(i) of the ITA.

about the arrangement is that the shareholder (or employee) pays an additional premium for a ROPS feature. However, should the ROPS be exercised, the shareholder will have a return of all premiums, including those paid by the corporation. Taxpayers acquiring such products should seek professional advice. It is entirely possible for the CRA to invoke shareholder appropriation rules in these cases.³³

(b) Receipt by Corporation of CI Benefits

If a corporation were to receive a lump-sum CI benefit, the amount would be considered a capital receipt. There are no provisions in the ITA that would bring this into income. However, while life insurance death proceeds (in excess of the Adjusted Cost Basis—ACB—of the policy) could be credited to the Capital Dividend Account (CDA), this is not the case with lump-sum CI benefits.³⁴ (For further information on the CDA, please refer to *The Capital Dividend Account*, which is part of our *Taxing Issues* series.)

A corporation may also receive ROP benefits. As stated above, CRA and Finance have not completed their in-depth review of CI, especially ROP benefits. While the industry is arguing that the existence of ROP should not taint the characterization of CI benefits as “sickness” benefits, we do know that CRA and Finance have not reached a conclusion in this regard. Taxpayers should also seek professional advice when acquiring CI products, which have a ROP feature having what appears to be an investment component (i.e., where the ROP includes what appears to be an interest element).

(c) Considerations with Respect to Buy-Sell and/or Shareholder Agreements

Care should be taken when preparing buy-sell agreement and/or shareholder agreements. A shareholder's agreement will often contain provisions covering situations in which one shareholder must sell to another shareholder. It may not be appropriate to require a sale of shares upon the diagnosis of a covered condition. For example, a CI product may cover certain types of skin cancer. A shareholder having skin cancer would not necessarily be any less effective at running a business, and thus should not be forced to sell shareholdings.

Where CI insurance is put in place to fund a buy-sell arrangement, the structure will necessarily vary from an arrangement that will be funded using life insurance proceeds. The CDA mechanism comes into play only when life insurance is used. Life insurance death proceeds (in excess of the ACB) would be credited to the CDA. Tax-free capital dividends could then be paid out to shareholders resident in Canada, who could use these funds to acquire the other shares of the deceased shareholder. In the alternate, the corporation could redeem the shares held by the deceased's estate, with the appropriate amount of any deemed dividend being a capital dividend.

Given that the CDA mechanism cannot apply with CI, other structures will have to be considered. For example, personally owned CI policies. Here, Shareholder A would be the policyholder and Shareholder B would be the insured. If Shareholder B were diagnosed with a covered condition, Shareholder A would then receive the lump-sum benefit with which to acquire Shareholder B's shares. Shareholder B would of course have to calculate the appropriate capital gain, but may be able to realize some tax savings to the extent that the \$500,000 capital gains exemption is available.

If the corporation were to be the benefit recipient, it could receive the lump-sum CI benefit on a tax-free basis. The lump-sum proceeds could be used to redeem shares. The appropriate deemed dividend would have to be calculated. Since the CI lump-sum proceeds are not credited to the CDA, the deemed dividend would in all likelihood be a taxable dividend. (The selling shareholder would also have to calculate the appropriate capital gain or loss.) Of course, the corporation could also pay out the CI lump-sum proceeds as a taxable dividend. However, the shareholder would only be able to use the after-tax proceeds to acquire the other shareholder's interest.

³³ See paragraph 15(1) of the ITA.

³⁴ See paragraph 89(1)(b) of the ITA.

What is clear is that life insurance death proceeds and CI lump-sum benefits are accorded very different tax treatment. Thus, shareholders should seek the appropriate tax advice so as to arrive at the solution that is appropriate in their unique circumstances. It is not appropriate to adopt “copy cat” structures implemented for life insurance!

(d) Transfer of CI Contract to Shareholder

Circumstances change, and there may no longer be a need for corporate-owned CI. Instead of letting a contract lapse, a shareholder may acquire the contract from the company. While the ITA has very specific rules that come into play where a corporation distributes a life insurance policy, there are no specific rules dealing with dispositions of CI contracts.³⁵ But even with life insurance policies, while the corporation would generally be considered to transfer the policy to the shareholder (or employee) at its Cash Surrender Value (CSV), CRA has long held that the application of the shareholder benefit (or employee benefit) rules still need to be considered.³⁶

Most tax practitioners would agree that CRA would seek to invoke the application of the shareholder benefit rules where a CI contract is transferred from a corporation to a shareholder for less than its Fair Market Value (FMV). The ITA contains very broad language – “... where at any time in a taxation year a benefit is conferred on a shareholder ... by a corporation ... the amount or value thereof shall ... be included in computing the income of a shareholder ...”.³⁷

CRA has issued guidelines that are to be used in valuing corporate-owned life insurance when valuing businesses. CRA lists a number (but not an exhaustive list) of factors that are to be considered, including: CSV; policy loans; face value; state of health of the insured and their life expectancy; conversion privileges; other policy terms (term riders, etc.), and replacement value. CRA also goes on to state that if the death of one of the insured's is “imminent”, this should be taken into consideration.³⁸

There is little doubt that similar factors would have to be considered when endeavouring to establish the FMV of a CI contract. No doubt product features that are unique to CI contracts would also have to be taken into account (e.g., ROP features).

IV. Other Tax Considerations

This document focuses primarily on income tax considerations. Certain jurisdictions (e.g., Ontario and Quebec) levy retail sales taxes on certain group insurance arrangements. Professional advice should be sought where “group” arrangements are being put in place so that the appropriate retail sales taxes may be paid, where required. Where appropriate, these will also have to be factored into taxable benefits that are reported.

³⁵ See subsection 14(7) of the ITA.

³⁶ See subsection 15(1) and paragraph 6(1)(a) of the ITA. Also, CRA document # 932730 dated January 13, 1994.

³⁷ See subsection 15(1) of the ITA.

³⁸ See paragraphs 40 and 41 of *Information Circular 89-3 – Policy Statement on Business Equity Valuations, dated August 25, 1989*.

V. Summary

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

There are a number of areas where the tax regime is not keeping apace of the products being offered by insurers. The industry has made Finance and CRA aware of the various tax issues and is working hard to resolve these. We hope that the legislators are able to make the appropriate amendments to the legislation and/or administrative practices so that CI products may be treated appropriately for tax purposes, with individuals and corporations who acquire such policies out of the after-tax incomes being able to 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.

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