

## **SHARED OWNERSHIP OF CRITICAL ILLNESS INSURANCE**

XYZ Ltd. wants to buy a critical illness insurance (CII) policy on Bob, its key employee and sole shareholder. The policy is a term to age 75 (T75) policy that pays a \$250,000 base benefit if Bob has a covered critical illness. The premiums are \$5,587.50 per year until the policy anniversary closest to Bob's 75th birthday.<sup>1</sup> At that point, coverage expires and can't be renewed.

Bob understands that if he had a covered critical illness, XYZ would suffer financially. But even though he's satisfied that XYZ needs to own a CII policy on him, he's concerned about the premium expense. CII is different from permanent life insurance policies, where, provided the policy remains in force, someone eventually benefits from the premiums paid. With CII, if Bob remains healthy, coverage could expire with no benefit payable.<sup>2</sup> Although he'd be happy to have his health, and understands that the CII policy provides necessary coverage, **he wonders if there's a way to get the premiums back if he reaches retirement age in good health? There is.**

## **RETURN OF PREMIUM ON CANCELLATION OR EXPIRY BENEFIT**

XYZ can add a return of premium on cancellation or expiry (ROPC/E) benefit to the policy. After 15 years, as long as Bob doesn't have a covered critical illness during that time, XYZ can cancel coverage for a return of all returnable premiums paid to that date.<sup>3</sup>

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<sup>1</sup> Based on rates in effect as of November 4, 2020 for a term to age 75 CII policy with the ROPc/e benefit, 50 year-old male non-smoker, \$250,000 base benefit

<sup>2</sup> One way to address this is to purchase a term to 100 (T100) CII policy. Premiums are \$7,027.50 per year payable until the policy anniversary nearest to the insured person's 100th birthday, at which time premiums stop, coverage becomes paid up and continues for the insured person's life. Based on rates in effect on November 4, 2020 for a 50 year-old male non-smoker, \$250,000 base benefit.

<sup>3</sup> Returnable premiums with the return of premium at death and at cancellation or expiry benefit include all the premiums paid to death or to cancellation or expiry except the premiums paid for the long-term care insurance conversion option, and minus any unpaid premiums plus interest.

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Bob likes the idea. He's 50 years old now, but in about 15 years, he'll be getting ready for retirement. When he retires, XYZ won't need the coverage, and Bob already owns personal CII coverage.

XYZ could also add a benefit that pays a return of premiums if Bob dies while the policy is in force. However, this case study focuses on the ROPC/E benefit.

If XYZ buys a CII policy with the ROPC/E benefit, the policy's base premiums will remain the same, but the ROPC/E benefit will add \$3,322.50 per year in premiums, for a total annual premium payment of \$8,910.00.<sup>4</sup>

Bob believes XYZ can afford the premiums, and is optimistic he'll still be healthy in 15 years. He decides to have XYZ add the ROPC/E benefit to its CII policy on him. At the end of 15 years, XYZ could cancel coverage and get a \$133,650.00 ROPC/E benefit ( $\$8,910.00 \times 15$ ). However, Bob must know that if he has a covered critical illness, the ROPC/E benefit will pay nothing. Since premiums for the base benefit are the same with or without an ROPC/E benefit, the ROPC/E premiums are wasted if Bob has a covered critical illness.

XYZ won't be able to deduct the premiums it pays because it owns the CII policy for key person protection.<sup>5</sup> But XYZ pays tax on its first \$500,000 in income at a low small business rate: 12.2%.<sup>6</sup> At that rate, it needs to earn \$6,363.90 per year to pay the premiums ( $\$5,587.50 / (1 - 12.2\%)$ ).

Provided XYZ doesn't deduct the premiums, the Canada Revenue Agency (CRA) says the ROPC/E benefit should be tax-free.<sup>7</sup> This makes sense to Bob, because XYZ will pay all the premiums with

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<sup>4</sup> Based on rates in effect as of November 4, 2020 for a term to age 75 CII policy with the ROPC/e benefit, 50 year-old male non-smoker, \$250,000 base benefit.

<sup>5</sup> Insurance premiums are defined in the Income Tax Act (ITA) as 'personal or living expenses' (ITA subsection 248(1), c.f. 'personal or living expenses'). Personal or living expenses aren't deductible (ITA paragraph 18(1)(h)).

<sup>6</sup> 2020 combined federal/provincial rate for Ontario. Rates vary from province to province and in the territories.

<sup>7</sup> CRA Document 2002-0117495, March 4, 2002. 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

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after-tax money, and the ROPC/E benefit won't exceed the cumulative premiums XYZ will have paid to the date of cancellation.

But Bob's concerned that XYZ will receive \$133,650.00 in cash around the time he retires. Bob thinks that money could help fund his retirement. But the only way he could get the money would be as a dividend or shareholder benefit. Dividends are taxed as income, but the dividend tax credit reduces the amount of tax Bob pays. Shareholder benefits are taxed as income with no credit available to reduce the tax impact. Neither payment is deductible to XYZ.

Bob's in the 53.53% federal/provincial marginal tax bracket.<sup>8</sup> After accounting for the dividend tax credit, his rate on ineligible dividends should be 47.74%.<sup>9</sup> If he took the ROPC/E benefit as a dividend, he'd receive \$69,845.49 after tax ( $\$133,650.00 \times (1 - 47.74\%)$ ).

Although Bob likes the idea of getting a large lump sum near retirement, he doesn't like the idea of losing almost half of it to taxes.

### SHARED OWNERSHIP CII WITH ROPC/E

A different idea is for Bob to own and pay the premiums for the ROPC/E benefit, with XYZ owning the base benefit. That's a shared ownership arrangement. Bob's tax advisor cautions him that the CRA hasn't ruled on all the tax consequences of a CII shared ownership arrangement. In light of the tax uncertainty, Bob must carefully consider whether he and XYZ should have a shared ownership arrangement and how they should administer it.

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remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

<sup>8</sup> 2020 combined federal/provincial rate for Ontario. Rates vary from province to province and in the territories.

<sup>9</sup> 2020 combined federal/provincial ineligible dividend rate in Ontario. Rates vary from province to province and in the territories. To the extent that XYZ earns income at the low small business tax rates, its dividends must be paid out at the higher ineligible dividend rate.

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Under a CII shared ownership arrangement, Bob and XYZ jointly own a CII policy with the ROPC/E benefit. They'd have a written agreement whereby XYZ owns and pays the premiums for the base benefit while Bob owns and pays the premiums for the ROPC/E benefit.

If Bob had a covered critical illness while the policy was in force, XYZ would collect the base benefit, tax-free. Bob would receive nothing for the ROPC/E premiums he paid. But if Bob remained healthy, after 15 years he and XYZ could cancel coverage. Bob would receive an ROPC/E benefit equal to the premiums that both XYZ and Bob paid to that point (\$133,650.00).

The CRA has provided guidance on the tax consequences associated with receipt of the ROPC/E benefit. Keep in mind that each of the following points deals with sole, not shared, ownership:

- ROPC/E benefits paid on cancellation or expiry of coverage are tax-free if they're "solely a return of premiums paid-in".<sup>10</sup>
- ROPC/E benefits from an individually-owned disability insurance policy are tax-free "unless the policyholder previously deducted such premiums." The same reasoning should apply to individually owned CII policies.<sup>11</sup> Since the premiums paid aren't deductible, the ROPC/E benefits should be tax-free.
- ROPC/E benefits paid at death are tax-free in Quebec because the Civil Code states that the tax treatment for a policy's ancillary benefits should be the same as the tax treatment for the base benefit.<sup>12</sup> The situation isn't as clear in the common law provinces and territories, though the CRA says the ROPC/E benefit at death could be treated as a life insurance policy death benefit, which is received tax-free.<sup>13</sup>

When asked about the tax treatment of the ROPC/E benefit in a shared ownership scenario, the CRA had this to say:

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<sup>10</sup> CRA Document 2003-0054571E5, December 24, 2004.

<sup>11</sup> CRA Document 2002-0117495, March 4, 2002.

<sup>12</sup> CRA Document 2003-0004265, June 18, 2003. Article 2394 of the Quebec Civil Code.

<sup>13</sup> CRA Document 2003-0004265, June 18, 2003.

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*Notwithstanding that an employee or shareholder may pay all of the premiums payable with respect to the ROPC/E portion of a CII policy, it remains a question of fact whether an ROPC/E payment received by an employee or shareholder would be taxable. Without specific and complete details regarding the particular policy and the jurisdiction to which it pertains, it would not be possible to advise you on the taxability of any ROPC/E or other payment from the plan.<sup>14</sup>*

It's clear from this statement that the CRA regards shared ownership as different from sole ownership, believing that the tax consequences may not necessarily be the same, but hasn't reached any firm conclusions.

Revenue Quebec has recently provided guidance on the tax consequences associated with a CII with ROPC/e shared ownership arrangement between a shareholder and its solely owned corporation.<sup>15</sup> Revenue Quebec concluded that the arrangement between the corporation and its sole shareholder was [translation] "a bona fide commercial transaction" and that the ROPC/e benefit in the shareholder's hands was therefore not taxable for provincial tax purposes.<sup>16</sup> Note that while Revenue Quebec's opinion applies to Quebec provincial taxation, it does not apply to federal taxation. The CRA administers the federal tax laws and all provincial and territorial tax laws except Quebec's.

Bob's tax advisor expects that at least part of the ROPC/E benefit Bob receives (the part equal to the ROPC/E premiums Bob paid using his own after-tax money) should be tax-free. That amount is \$49,837.50 ( $\$3,322.50 \times 15$ ). But Bob's tax advisor cautions that the CRA may treat the rest of the ROPC/E benefit, \$83,812.50, as a taxable employee or shareholder benefit because it's equal to what XYZ paid. If it was taxed at Bob's marginal rate, 53.53%, he'd keep only \$38,947.67 ( $\$83,812.50 \times (1 - 53.53\%)$ ), for a total after-tax payment of \$88,785.17 ( $\$49,837.50 + \$38,947.67$ ).

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<sup>14</sup> CRA Document 2009-0342541M4, January 18, 2010.

<sup>15</sup> Revenue Quebec document 16-034655-001, June 15, 2018.

<sup>16</sup> Revenue Quebec's guidance in responses to taxpayer inquiries is its interpretation of the law on a given subject and can help Quebec taxpayers plan their affairs in order to comply with their obligations under Quebec's provincial income tax law. However, Revenue Quebec is not bound by what it says in its responses to taxpayer inquiries. It is bound by the Quebec Taxation Act and Regulations, and by judicial decisions, all of which have the force of law. In the common law provinces and territories, the CRA administers the tax law for the federal, provincial and territorial governments. Quebec administers its own income tax law for provincial tax purposes, not federal.

## **TAXABLE BENEFITS**

Bob's puzzled by the tax rules governing a CII shared ownership arrangement. One reason may be that even in a shared ownership arrangement, the life insurance company won't likely report the payment of the ROPC/E benefit as a taxable transaction, so it won't issue a tax reporting slip when it makes the payment. That's because the life insurance company isn't a party to the shared ownership agreement. From its perspective, it issued a policy to two joint policy owners. Between them, they have all the rights and obligations under the policy without any division of those rights and obligations between them.

When the life insurance company collects premiums, it collects them from both policy owners; the life insurance company isn't concerned about who pays what part of the premium as long as the premiums are paid in full. Similarly, when the company pays the ROPC/E benefit, it pays the benefit to both policy owners, and isn't concerned whether or how they split the benefit. From the life insurance company's perspective, the ROPC/E benefit represents a return of all premiums received to those who paid those premiums, so it's not a taxable transaction.

But the fact that there are no tax consequences from the life insurance company's perspective doesn't mean there are no tax consequences at all. While the life insurance company doesn't distinguish between the rights and obligations of the shareholder and corporation, the shared ownership agreement does, assigning different rights and obligations to each party, with potential tax consequences based on the distribution of those rights and obligations.

## **EMPLOYEE BENEFITS**

As Bob's tax advisor indicated, the CRA may treat that part of the ROPC/E benefit equal to the total premiums that XYZ paid as an employee or shareholder benefit. An employee benefit is defined in

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paragraph 6(1)(a) of the Income Tax Act<sup>17</sup> (ITA) as a benefit "... of any kind whatever received or enjoyed ... in respect of, in the course of, or by virtue of the taxpayer's office or employment..."<sup>18</sup>

Since most small business owners are employees of the corporations they own, this rule can apply to them.

In *R. v. Savage*, the Supreme Court of Canada gave a wide interpretation to ITA paragraph 6(1)(a). Defining what 'in respect of' means in the phrase, "in respect of ... the taxpayer's office or employment", the Court adopted the following language from one of its previous decisions:

*The words 'in respect of' are, in my opinion, words of the widest possible scope. They import such meanings as 'in relation to', 'with reference to' or 'in connection with'. The phrase 'in respect of' is probably the widest of any expression intended to convey some connection between two related subject matters.*<sup>19</sup>

Therefore, almost any benefit Bob receives in connection with his employment at XYZ could be a taxable employee benefit, including the part of an ROPC/E benefit exceeding what he paid in ROPC/E premiums. There are exceptions, outlined here, but they may not apply to a shared ownership case:

- **An employee receives a benefit, but gets no enjoyment from it.** In *Rachfalowski v. R.*, the taxpayer had to accept a golf club membership as a condition of employment, though he disliked golf and played only once at a company sponsored event. The Court ruled that since he didn't "enjoy" the benefit, he didn't have to include its value in income. This exception will likely not apply to the payment of an ROPC/E benefit because the ROPC/E benefit is just money.<sup>20</sup>
- **A benefit serves the employer's interests, not the employee's.** In *Anderson v. R.*, the employer provided specially equipped trucks for employees to use to perform their duties. The employees were on call twenty-four hours a day, seven days a week. Since they had to be with

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<sup>17</sup> Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.

<sup>18</sup> ITA paragraph 6(1)(a).

<sup>19</sup> *R. v. Savage*, [1983] 2 S.C.R. 428 at p. 441, citing *Nowegijick v. R.*, [1983] 1 S.C.R. 29, at p. 39.

<sup>20</sup> *Rachfalowski v. R.*, 2008 TCC 258; 2008 DTC 3626; [2009] 1 CTC 2073.

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their trucks at all times, their use of the trucks wasn't an employee benefit. The reasoning in Anderson probably also doesn't apply to an ROPC/E benefit.<sup>21</sup>

- **Reimbursement for business expenses incurred by the employee.** To the extent the ROPC/E benefit reimburses employees for premiums they pay, this exception applies. But this exception shouldn't apply to any part of the ROPC/E benefit exceeding the premiums the employee paid.<sup>22</sup>
- **A benefit isn't related to employment.** In *McNeill v. R.*, the taxpayer was relocated for reasons entirely unrelated to work performance. He received a relocation allowance. The Court decided the payment wasn't related to his employment. This exception probably doesn't apply to an ROPC/E benefit because the benefit is only available to those who are employees or shareholders.<sup>23</sup>

While this discussion suggests that an employee has very little room to claim that the ROPC/E benefit isn't an employee benefit, there's a different approach: Bob can agree that the ROPC/E benefit is an employee benefit, but assert that the premiums he pays represent a payment of fair market value (FMV) for it. The CRA referred to this approach in CRA Document 2004-0090181E5, November 30, 2004 [translation]:

*[T]he value of the benefit could correspond to the amount that the shareholder should pay in similar circumstances to obtain the same benefit resulting from the transactions in question from a person with whom the shareholder deals at arm's length.*

This guidance addresses shareholder benefits, but the reasoning may also apply to employee benefits. If Bob pays FMV for the ROPC/E benefit, it shouldn't be taxable. One measure of FMV is the premiums the insurance company charges for the base and ROPC/E benefits. Given that the life insurance company deals at arm's length with the corporation and shareholder, if the premium for

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<sup>21</sup> *Anderson v. R.*, 2002 DTC 1876; [2002] 4 CTC 2008.

<sup>22</sup> *R. v. Huffman*, [1990] 2 CTC 132, 90 DTC 6405.

<sup>23</sup> *McNeill v. R.*, (1986), 86 DTC 6477.



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the base benefit is the same with or without the ROPC/E benefit, it may be reasonable to conclude that the premium charged for the ROPC/E benefit reflects the FMV for that benefit, and that Bob shouldn't have to treat any part of the ROPC/E benefit he receives as a taxable employee benefit. However, the fact that the health benefit premiums the life insurance company charges are the same with or without the ROPC/E benefit would not necessarily persuade the CRA that the ROPC/E benefit premiums represented FMV for the ROPC/E benefit. In later guidance the CRA said:

*Specifically, we cannot conclude that there is no benefit to the shareholder under subsection 15(1) if an insurance company determines the amount of premiums payable for a policy with or without an endorsement with respect to the refund of the premiums, and that as part of a shared ownership arrangement, the company pays the annual premiums for the critical illness insurance policy of which it is the beneficiary, while its sole shareholder pays the additional annual premiums related to the endorsement to which he or she is a beneficiary.<sup>24</sup>*

Notwithstanding this caution, Bob likes this approach. But his tax advisor cautions that he must recognize its limits, for at least four reasons. First, the CRA's guidance deals with shareholder, not employee, benefits. The ITA defines shareholder benefits differently from employee benefits, so it's not certain the CRA will apply its guidance on shareholder benefits to employee benefits without modification. Second, the CRA doesn't have to agree that the ROPC/E benefit's FMV equals the premiums Bob paid. The CRA could instead say that the benefit's FMV equals the benefit payment Bob receives minus the premiums he paid. Third, even if Bob can show that the ROPC/E benefit isn't an employee benefit, the CRA can still assert that it's a shareholder benefit.

A fourth problem requires more analysis. It's not certain that the CRA would regard an ROP benefit as an insurance benefit. Under the CRA's guidance on Private Health Services Plans (PHSPs), the CRA listed five requirements that a plan would have to satisfy to be treated as a plan in the nature of insurance.<sup>25</sup> Two of those requirements are that it insure "from a loss or liability in respect of an event ... the happening of which is uncertain." The CRA has said that this guidance applies also to

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<sup>24</sup> CRA Document 2006-0178561E5, November 3, 2006.

<sup>25</sup> Interpretation Bulletin IT-339R2 – Meaning of "Private Health Services Plan," August 8, 1989, paragraph 3.

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GSAIPs.<sup>26</sup> Since Bob and XYZ can decide when to cancel coverage and trigger payment of the ROP benefit, it can't be said that the happening of the event is uncertain. It's also questionable whether the ROP benefit is paid to insure against a "loss or liability" because the ROP is paid not in respect of a loss, but to refund premiums paid.

### SHAREHOLDER BENEFITS

In contrast to an employee benefit, a shareholder benefit is not received. Instead, it's 'conferred' on the shareholder by the corporation.<sup>27</sup> The leading case is *Del Grande v. R.*,<sup>28</sup> where the Tax Court of Canada ruled that the shareholder would have to be economically enriched (and the corporation economically diminished to the same extent) by the transaction for the corporation to have conferred a benefit on the shareholder. In Bob's case, the CRA may assert that he's enriched when he and XYZ cancel CII coverage because he'll receive more money in ROPC/E benefits than he paid in premiums, and that XYZ is economically diminished by giving up its CII coverage on Bob.

But if Bob can show that XYZ hasn't been economically diminished when coverage is cancelled, he will not have received a shareholder benefit. That determination depends on the facts of each case. However, if the parties plan for the time when they'll cancel coverage, they may be able to increase the chances of a favourable outcome. The following example shows how the argument could work, but Bob's tax advisor reminds him that all facts are important when determining the tax outcome.

Assume that XYZ and Bob share ownership of a 10-year term CII policy with ROPC/E. They carefully documented XYZ's need for the base benefit when they bought the policy. Twenty years later, coverage was renewed once and is up again for renewal. Bob is now age 70 and retiring. After Bob retires, none of the reasons they originally documented regarding XYZ's need for CII will apply.

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<sup>26</sup> CRA Document 2010-0374891E5, March 14, 2011.

<sup>27</sup> ITA subsection 15(1).

<sup>28</sup> 1992 CarswellNat 1329, [1993] 1 C.T.C. 2096, 93 D.T.C. 133.

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Rather than renew coverage, Bob and XYZ decide to cancel it (or let it expire), and Bob receives the ROPC/E benefit. Bob and XYZ could assert that XYZ is no better or worse off, and hasn't suffered financially, for the following reasons:

- A T10 CII policy has no residual value that would allow coverage to continue after premiums stop. For coverage to continue, premiums must continue.
- XYZ has no need for CII coverage on Bob after he retires. XYZ isn't financially diminished by giving up CII coverage it no longer needs, and would waste money by continuing to pay for such coverage.
- Over the past 20 years, XYZ paid no more for its CII coverage than it would have paid had it owned the CII policy itself without the ROPC/E rider. Therefore, the fact that Bob gets an ROPC/E benefit on cancellation of coverage does not affect XYZ financially.

The same arguments would apply if Bob and XYZ shared ownership of a T75 CII policy. Bob's and XYZ's right to continue coverage from age 70 to 75 is functionally the same as their right to renew their T10 coverage after age 70. Like a T10 policy, a T75 policy has no residual value. Nor are the premiums for the base benefit on a T75 CII policy affected by the addition of the ROPC/E rider.

Considering this, it may be hard for the CRA to say that XYZ is financially diminished by agreeing to cancel coverage it no longer needs (and would have to pay to keep), even though Bob receives the ROPC/E benefit due to that decision.

Not all CII shared ownership arrangements use a T10 or T75 policy, though. Some use a limited pay CII policy, where premiums are paid for 10 or 15 years, but coverage continues for the insured person's lifetime. With these policies, the first two arguments previously outlined – that the policy has no residual value and that continuing to pay premiums would be a waste of money – probably don't apply. Since there are no premiums to pay to keep coverage in force, the policy probably has a residual value.

But the third argument may still be valid. Although XYZ paid higher premiums for its coverage than it would have using a T10 or T75 policy, it still paid no more under the shared ownership arrangement than it would have if it owned the policy alone.

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Considering all the points in these arguments – in favour or against a taxable benefit – Bob's tax advisor cautions him that none of the arguments has been the subject of CRA comment, and none has been tested in court. If Bob wants to proceed with a CII shared ownership arrangement, he'll need to make sure that he thoroughly documents the need for CII and, later, the reasons justifying cancellation of coverage.

### COMPARING TAX OUTCOMES

Bob's discouraged by the uncertainty so his tax advisor suggests a different approach. Rather than trying to predict the tax outcome without CRA or judicial guidance, he asks Bob to consider how the different tax outcomes would affect him in four different scenarios:

1. **XYZ owns the CII policy with the ROPC/E benefit.** XYZ pays premiums with money that's been taxed at XYZ's low corporate tax rate. After 15 years, XYZ cancels coverage, collects the ROPC/E benefit tax-free and pays it to Bob as a taxable dividend.
2. **Bob owns the CII policy with the ROPC/E benefit.** He pays premiums with money that's been taxed at his high personal tax rate. After 15 years, he cancels coverage and collects the ROPC/E benefit, tax-free.
3. **Bob and XYZ share ownership of the CII policy.** XYZ owns the base benefit; Bob owns the ROPC/E benefit. Each pays premiums using money taxed at their own rates. After 15 years, they cancel coverage. The part of the ROPC/E benefit equal to the total premiums Bob paid is treated as a tax-free return of his premiums. The rest is treated as a taxable employee or shareholder benefit.
4. **Same as the shared ownership arrangement,** except that the entire ROPC/E benefit is tax-free to Bob.

The chart at the end of this case study shows the tax results for each scenario. In scenario 1, XYZ owns the base and ROPC/E benefits. Over the next 15 years it pays \$133,650.00 in premiums

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Life's brighter under the sun

(\$8,910.00 × 15). It has to earn \$152,220.96 over that time to pay those premiums ( $\$133,650.00 / (1 - 0.122)$ ). But it pays the ROPC/E benefit to Bob as an ineligible taxable dividend. After tax, the ROPC/E benefit in Bob's hands is worth \$69,845.49 ( $\$133,650.00 \times (1 - 0.4774)$ ). That means this scenario has a total tax cost of \$82,375.47 ( $\$152,220.96 - \$69,845.49$ ).

In scenario 2, Bob owns the base and ROPC/E benefits. Over the next 15 years he pays the same \$133,650.00 in premiums as XYZ paid in scenario 1 ( $\$8,910.00 \times 15$ ). But Bob has to earn more money than XYZ to pay those premiums: \$287,604.91 ( $\$133,650.00 / (1 - 0.5353)$ ). However, Bob gets the ROPC/E benefit tax-free: \$133,650.00. Scenario 2's total tax cost is higher than when XYZ owned the policy: \$153,954.91 ( $\$287,604.91 - \$133,650.00$ ) versus \$82,375.47.

Scenarios 3 and 4 show shared ownership arrangements. Scenario 3 assumes that the part of the ROPC/E benefit equal to XYZ's total premiums will be taxable in Bob's hands as an employee or shareholder benefit. Scenario 4 assumes the entire ROPC/E benefit will be tax-free in Bob's hands.

In scenarios 3 and 4 XYZ pays the premiums for the health benefit (\$5,587.50) for 15 years: \$83,812.50. After tax, XYZ has to pay \$95,458.43 ( $\$83,812.50 / (1 - 0.122)$ ). Bob pays the premiums for the ROPC/E benefit (\$3,322.50) for the same 15-year period: \$49,837.50. After tax, Bob has to pay \$107,246.61 ( $\$49,837.50 / (1 - 0.5353)$ ). Between them, XYZ and Bob pay \$202,705.04 after tax ( $\$95,458.43 + \$107,246.61$ ).

In scenario 3 we assume that Bob receives the part of the ROPC/E equal to XYZ's premium payments (\$83,812.50) as a taxable shareholder benefit. At Bob's marginal rate, he pays \$44,864.83 in tax ( $\$83,812.50 \times 0.5353$ ). He pays no tax on the part of the ROPC/E benefit equal to the premiums he paid, \$49,837.50. After tax, therefore, his ROPC/E benefit is \$88,785.17 ( $\$133,650.00 - \$44,864.83$ ). The difference between what XYZ and Bob pay after tax is \$113,919.87 ( $\$202,705.04 - \$88,785.17$ ). This tax result is worse than the result in scenario 1, but better than the result in scenario 2.

In scenario 4 we assume that the entire ROPC/E benefit, \$133,650.00, is tax-free to Bob. The after-tax amounts that XYZ and Bob have paid are the same as in scenario 3 (\$202,705.04), but the tax

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difference is \$69,055.04 (\$202,705.04 - \$133,650.00). Scenario 4 therefore produces the best tax result of all four scenarios.

What should Bob make of this? His tax advisor explains a few things about the exercise:

- Current tax rates will probably change during the next 15 years. Each scenario is therefore only a way to look at how the strategy works, not a prediction of what each scenario will deliver.
- The purpose of the exercise is not to guess which way the CRA will rule, but to help Bob compare outcomes under a given set of assumptions.
- If the CRA has not ruled on the concept after 15 years, Bob should treat the CRA's silence as an unfavourable ruling. If he receives the ROPc/e benefit, and fails to report it as a taxable employer or shareholder benefit, and the CRA later determines on audit that he should have reported it, he could owe negligent reporting penalties in addition to the tax he owes, plus interest on what he should have paid.

With that in mind, Bob's tax advisor asks him how he would feel about various outcomes:

- If Bob has a covered critical illness at some point during the next 15 years, he'll lose the ROP benefit premiums he's paid, and XYZ will only be able to pay the health benefit to him as a taxable dividend. This result doesn't depend on how the CRA may rule on this strategy.
- If Bob decides not to pursue the CII shared ownership strategy, he will forgo the benefits of the strategy if the CRA rules in favour of it.
- On the other hand, if Bob pursues the strategy, and the CRA rules unfavourably, Bob will have to report a taxable shareholder benefit for the part of the ROP benefit equal to the premiums XYZ has paid.

## NON-TAX ASPECTS OF A SHARED OWNERSHIP ARRANGEMENT

Although Bob has considered mostly the tax issue, there are reasons for XYZ and Bob to have a shared ownership CII arrangement that can benefit Bob even if the CRA taxes part of Bob's ROPC/E benefit:

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- **The ROPC/E benefit can be a form of forced savings.** Many business owners reinvest profits in their businesses instead of removing or saving those profits, so that their businesses represent most of their net worth. While this strategy makes sense for a profitable and growing business, it still results in a lack of diversification. An ROPC/E benefit represents a potential asset that's not tied as closely to a business's fortunes as the money reinvested in the business. The drawbacks are that there's no growth on the premiums paid for the ROPC/E benefit and the ROPC/E benefit is lost if the insured person has a covered critical illness.
- **The ROPC/E benefit isn't carried on XYZ's books as an asset.** Many business owners assume that the shares in their corporations qualify for the lifetime capital gains exemption (LCGE).<sup>29</sup> But that tax advantage depends on the corporation satisfying a set of rules in the ITA. One of those rules is that when the capital gain is realized, all or substantially all of the corporation's assets must be used principally in an active business carried on in Canada. The CRA interprets "all or substantially all" to mean 90 per cent. Investments owned by the corporation but not used in the corporation's active business count against the 90 per cent threshold. But the ROPC/E benefit isn't carried on the corporation's books as an asset and therefore doesn't count against the 90 per cent threshold. This conclusion holds true whether Bob or XYZ owns the ROPC/E benefit.

## TAX AND LEGAL ISSUES

The ITA doesn't specifically discuss CII policies, and the CRA offers little guidance on their taxation. What follows is a general discussion. Further details on the tax treatment of CII policies are available in the Canadian Health Insurance Tax Guide:<sup>30</sup>

- **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

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<sup>29</sup> For 2020 the lifetime capital gains exemption is \$883,384, and is adjusted each year for inflation.

<sup>30</sup> Available at [www.sunlife.ca/advisor/healthtaxguide](http://www.sunlife.ca/advisor/healthtaxguide).

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by blood relationship, marriage or common-law partnership, or adoption.<sup>31</sup> Personal or living expenses are not deductible.<sup>32</sup>

- **The CII base benefit is paid tax-free.** If a CII policy meets the definition of health insurance under provincial or territorial law, the CRA treats it as a sickness or accident insurance policy (SAIP). Most CII policies sold in Canada meet the provincial and territorial definitions of health insurance. According to CRA guidance, the base benefits from a CII policy are paid tax-free.<sup>33</sup>
- **The ROPC/E benefit is paid tax-free.** The CRA has said that the ROPC/E benefit from a CII policy is tax-free when none of the premiums paid (including the premiums paid for the ROPC/E benefit) have been deducted, and represent no more than the total premiums paid.<sup>34</sup> 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.
- **It's unclear whether the ROPC/E benefit is paid entirely tax-free in a shared ownership CII arrangement.** The CRA doesn't provide specific guidance on whether the ROPC/E benefit is entirely tax-free. Although there are different ways to approach the question, none of the answers are approved by the CRA or the courts.
- **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.

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<sup>31</sup> ITA subsection 248(1). See paragraph (b) of the definition "personal or living expenses".

<sup>32</sup> ITA paragraph 18(1)(h).

<sup>33</sup> 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.

<sup>34</sup> 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.



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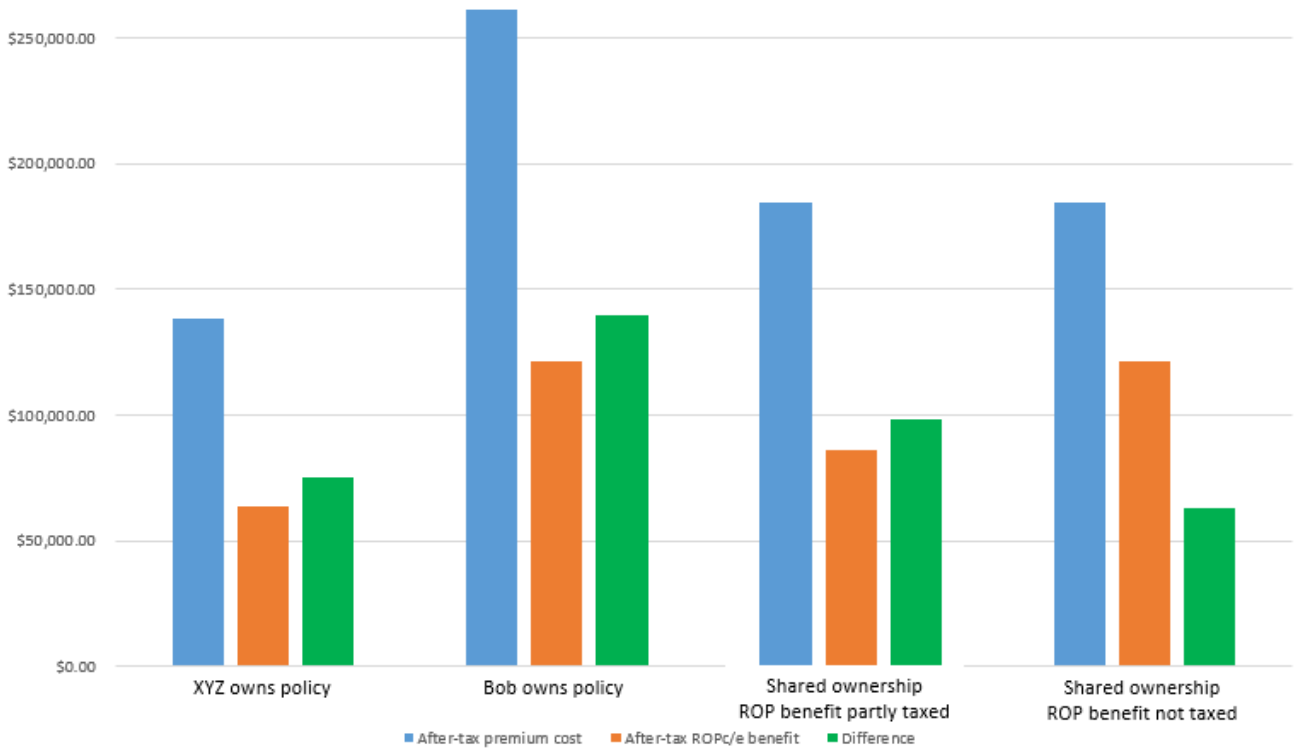
- **The CII policy with ROPC/E pays only one benefit.** If the shareholder remains healthy and if enough time passes, he or she and the corporation can cancel coverage. The shareholder will get the ROPC/E benefit, while the corporation will get nothing for the CII premiums it has paid. If the shareholder later experiences a covered critical illness, the corporation will get nothing. But if the shareholder suffers a critical illness while coverage is in force, the corporation will get the base benefit, while the shareholder will get nothing for the ROPC/E premiums he or she has paid.
- **The insurance company isn't a party to the shared ownership agreement.** The CII policy with ROPC/E benefit is jointly owned by the shareholder and corporation. This means that, from the insurance company's perspective, each party to the agreement owns an indivisible interest in both benefits. The shared ownership agreement modifies this arrangement, but only between the shareholder and corporation, not as far as the insurance company is concerned

## CONCLUSION

Bob enters into a shared ownership agreement with XYZ. XYZ owns and pays the premiums for the base benefit CII policy; Bob owns and pays the premiums for the ROPC/E benefit. Bob appreciates the non-tax benefits of the shared ownership arrangement. After discussing the arrangement with his tax advisor, he also recognizes the tax issues. He hopes that when it's time for him to decide whether to cancel or continue coverage, there will be further guidance from the CRA. If that guidance says he can take the ROPC/E benefit entirely tax-free, he'll be happy. But he's willing to accept the tax consequences if the CRA says that part of the benefit will be taxable.

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

**AFTER-TAX COMPARISON**



**NOTES**

- The blue bars show how much money XYZ and Bob have to earn to pay the premiums in each scenario.
- The orange bars show how much of the ROPC/E benefit Bob has after tax in each scenario.
- The green bars measure the tax-efficiency in each scenario. It shows the difference between the money XYZ and/or Bob have to generate to pay the premiums, and the size of the benefit in Bob's hands after tax. The smaller the bar, the greater the tax efficiency.

**Scenarios 1 and 2:** In scenario 1, XYZ has to earn the least money of all the scenarios to pay the premiums, but Bob gets the lowest after-tax ROPC/E benefit among all the scenarios. In scenario 2,

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Bob has to earn the most money of all the scenarios to pay the premiums, but he gets the highest after tax ROPC/E benefit (scenario 4 delivers an ROPC/E benefit equal to scenario 1's).

**Scenario 3** falls between scenarios 1 and 2. XYZ and Bob have to generate less money to pay the premiums than they do in scenario 2, but more than in scenario 1. Bob gets a higher after-tax ROPC/E benefit than he gets in scenario 1, but less than he gets in scenario 2.

**Scenario 4** is the most tax-efficient. It's the same as scenario 3 but the after-tax ROPC/E benefit is the same as scenario 2's. However, the CRA hasn't specifically commented on whether this scenario is acceptable.

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### DATA USED IN TABLE ON PREVIOUS PAGE

Shared ownership CII with ROPC/E– ownership and tax comparison				
	Scenario 1 XYZ owns policy, cancels and pays ROPC/E benefit as dividend	Scenario 2 Bob owns policy, cancels and receives tax-free ROPC/E benefit	Scenario 3 Shared ownership, ROPC/E benefit partly taxable	Scenario 4 Shared ownership, ROPC/E benefit entirely tax-free
Pre-tax base benefit premiums	\$5,587.50	\$5,587.50	\$5,587.50	\$5,587.50
Pre-tax ROPC/E benefit premiums	\$3,322.50	\$3,322.50	\$3,322.50	\$3,322.50
After-tax cost of base benefit to XYZ	\$6,363.90		\$6,363.90	\$6,363.90
After-tax cost of ROPC/E benefit to XYZ	\$3,784.17			
After-tax cost of base benefit to Bob		\$12,023.89		
After-tax cost of ROPC/E benefit to Bob		\$7,149.77	\$7,149.77	\$7,149.77
Total after-tax premium cost to XYZ	\$10,148.07		\$6,363.90	\$6,363.90
Total after-tax premium cost to Bob		\$19,173.66	\$7,149.77	\$7,149.77
Total after-tax premium cost over 15 years	\$152,220.96	\$287,604.90	\$202,705.05	\$202,705.05
Total pre-tax ROPC/E benefit	\$133,650.00	\$133,650.00	\$133,650.00	\$133,650.00
After-tax ROPC/E benefit to Bob	\$69,845.49	\$133,650.00	\$88,785.17	\$133,650.00
Total after-tax ROPC/E benefit to Bob minus after-tax premium cost	(\$82,375.47)	(\$153,954.91)	(\$113,919.87)	(\$69,055.04)

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