



EXECUTIVE BONUS PLAN WITH CRITICAL ILLNESS INSURANCE

CLIENTS

ABC Manufacturing Ltd. employs 56 people, six of whom are managers. It provides health benefits for all its employees through an employee life and health trust (ELHT). ABC wants to offer critical illness insurance (CII) as a benefit for its managers only, to encourage them to work hard and stay with the company.

SITUATION

ABC can't offer this benefit through its ELHT because it can't offer benefits to its key employees that are more advantageous than the benefits it offers to the rest of its employees.¹ However, there is some flexibility with grouped plans.² Grouped plans are governed largely by Canada Revenue Agency (CRA) guidance, while ELHTs are governed by the Income Tax Act³ (ITA). For grouped plans, the CRA permits some variation from the rule that all employees must receive the same benefits. For example, the CRA has said that all employees in a grouped plan must receive similar, not identical, benefits.⁴

Even if ABC can offer CII exclusively to its managers through a grouped plan, there are still restrictions. Each manager must receive similar benefits. Additional benefits, like a Return of premium on cancellation or expiry benefit (ROPC/E) or a long-term care (LTC) conversion benefit, are not allowed.

Further, all contributions ABC makes to its plan to pay for CII will be taxable to the managers receiving the benefit.⁵ Because of this complexity and inflexibility, ABC wants to consider another

¹ Each member of a class of beneficiaries under an ELHT must receive identical benefits (subsection 144.1(1), c.f. "class of beneficiaries"). There can be different classes of beneficiaries, but key employees, like ABC's managers, may not receive benefits that are "more advantageous" than those that other beneficiaries receive. (ITA paragraph 144.1(2)(f)).

² CRA Interpretation 5-7982, July 12, 1989. The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the Income Tax Act and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

³ Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.

⁴ CRA Documents 2006-0174121C6, May 9, 2006 and 2011-0422621E5, August 24, 2012.

⁵ Under ITA paragraph 6(1)(e.1) employer contributions to a group sickness or accident insurance plan (such as a CII policy offered through a grouped plan or ELHT) are taxable to the employee if the insurance benefits paid from the plan are tax-free. Since CII benefits are paid tax-free, the premiums paid by an employer would be taxable income to the employee.

strategy: providing CII coverage for its managers through individual policies that each manager would own personally.

STRATEGY

ABC will make no changes to its existing ELHT, but it will offer an executive bonus plan consisting of CII coverage to its six managers by offering them each the opportunity to own a CII policy personally, with ABC paying the premiums. ABC does not offer to pay equal amounts for all, or to provide each manager with identical coverage. Instead, it evaluates each manager's performance before deciding how much it will spend for each manager. It also lets each manager tailor their coverage to suit their individual needs. Some managers may add a Return of premium on cancellation or expiry benefit at death, or on cancellation or expiry of coverage, while others may choose a long-term care conversion option.⁶ However, others could choose coverage that will be paid up in ten or fifteen years, while some may choose a renewable ten-year term CII policy.

IMPLEMENTING THE STRATEGY

ABC notifies each manager of its intention to alter their employment contracts to add CII as a benefit. Each manager will need to apply for their own individual policy, and will need to be individually underwritten.

Once a manager is approved for coverage, ABC will start paying premiums as per its agreement. ABC may pay all the premiums, or the parties may share the premium burden. It all depends on the agreements between ABC and its managers, and on the amount and type of coverage that each manager acquires.

⁶ The long-term care insurance conversion option allows the policy owner to convert critical illness insurance coverage into long-term care insurance, according to the terms in the policy.

ABC should be able to deduct the premiums it pays, as long as the premiums are a reasonable business expense.⁷ Each manager will have to treat ABC's premiums as a taxable benefit, and include the premium expense in income. If a manager has a covered critical illness, the CII base benefit will be paid to them tax-free. Managers who have chosen the ROPC/E or LTCI conversion option may exercise those options as they wish, provided they also satisfy the conditions under the policy for exercising the option.

A NOTE ON COVERAGE OPTIONS WHEN AN EMPLOYEE LEAVES AN EMPLOYER

An employee in a group benefits plan doesn't have an absolute right to keep their benefits when they leave their employer. While the trust or employer could transfer the policy to the departing employee, the employee would have to pay fair market value (FMV) for the policy, as determined by an independent actuary, or treat receipt of the policy as a taxable benefit to the extent they did not pay FMV.

Employees who already own their policies in certain grouped plans would not have to pay for those policies at termination or retirement. But if the policy was paid up at the employee's termination, with no further premiums required to maintain coverage, the employee would have to report a taxable benefit.⁸

Some employers offer their employees the right to "port" coverage. Porting means that a departing employee can move their coverage from the employer's group plan to a different group plan (although with potentially different rates) and pay premiums for their coverage. A departing

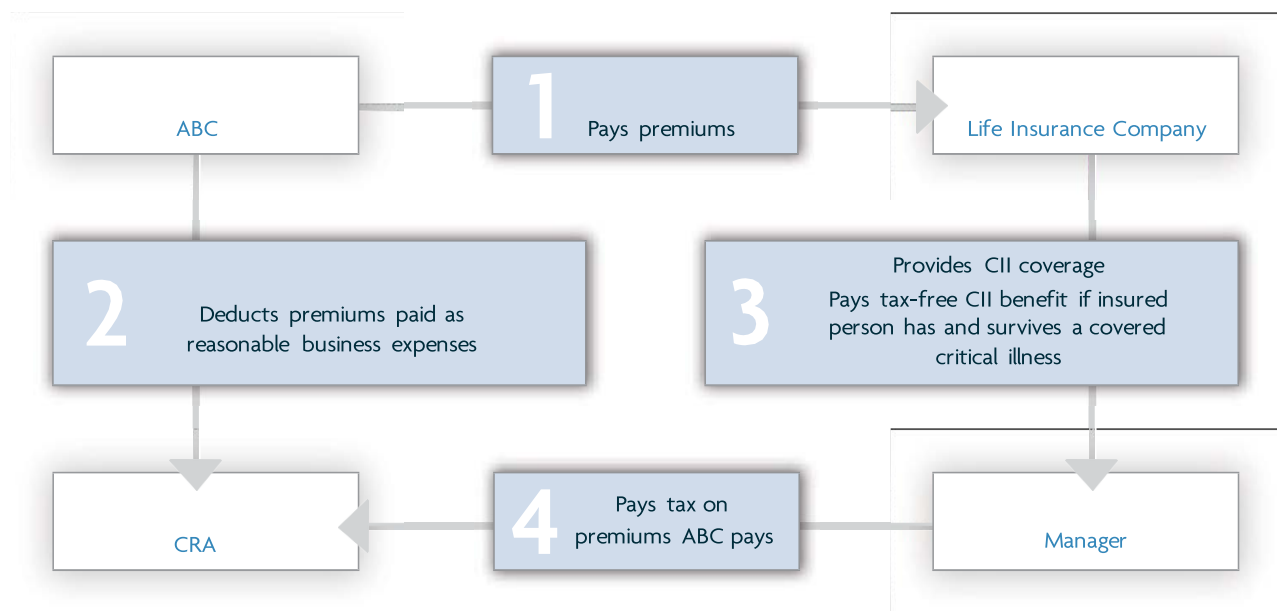
⁷ Insurance premiums are included under paragraph (b) of the definition, "personal or living expenses", in ITA subsection 248(1). Under ITA paragraph 18(1)(h) personal or living expenses are not deductible, but under paragraph 18(1)(a) reasonable business expenses are.

⁸ CRA Document 2009-0314871E5, March 3, 2011. The CRA did not provide guidance on how it would determine the value of the benefit. One measure would be the present value of the premium payments needed to provide continuing coverage.

employee could also convert their group term life insurance coverage into a permanent or term life insurance policy that they would own as if they had applied for the policy on their own.

These restrictions don't apply to the strategy discussed in this case study. Unless they own a paid up policy, a retiring manager will have to pay their own premiums after leaving ABC.

HOW IT WORKS



TAX AND LEGAL ISSUES

The ITA does not specifically discuss health insurance policies, and the CRA has provided little guidance on their taxation. What follows is a general discussion. Further details on the tax treatment of health insurance policies are available in the Canadian Health Insurance Tax Guide:⁹

- **Premiums paid by individuals for their own or their family's coverage are not deductible.** The ITA defines insurance premiums as "personal or living expenses" if the

⁹ Available at www.sunlife.ca/advisor/HealthTaxGuide.

proceeds of the policy or contract are paid to or for the benefit of the taxpayer or to a person connected with the taxpayer by blood relationship, marriage or common-law partnership, or adoption.¹⁰ Personal or living expenses are not deductible.¹¹

- **The CII and LTCI base benefits are paid tax-free.** If a CII or income style LTCI policy meets the definition of health insurance under provincial or territorial law, the CRA treats it as a sickness or accident insurance policy (SAIP). Most CII and income style LTCI policies sold in Canada meet the provincial and territorial definitions of health insurance. Reimbursement LTCI policies (policies that reimburse the policy owner for covered long-term care costs) may meet the definition of a private health services plan (PHSP). PHSP benefits are paid tax-free. According to CRA guidance, the base benefits from a CII or LTCI policy (income or reimbursement) are paid tax-free.¹²
- **The ROPC/E benefit is paid tax-free.** The CRA has said that a return of premium at cancellation or expiry (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.¹³ 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.

¹⁰ ITA subsection 248(1). See paragraph (b) of the definition, "personal or living expenses".

¹¹ ITA paragraph 18(1)(h).

¹² There are no sections in the ITA that tax CII benefits. The CRA has said that a CII policy should be viewed as a "sickness" policy, and that the disposition (i.e. payment of the base benefit) from a CII policy is not taxable: CRA Document 2003-0004265, June 18, 2003. See also CRA Document 2003-0054571E5, December 24, 2004. Regarding LTCI, see CRA Document 2003-0048461E5, March 5, 2004.

¹³ 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.

- **Reasonable business expenses are deductible.** As long as the CRA agrees that the payment of premiums for an employee-owned insurance policy is a reasonable business expense, like salary or bonus, the business can deduct that payment even if the payment is for insurance premiums that would otherwise not be deductible.¹⁴ If the premium payment is paid to or for a person who is both a shareholder and an employee, that person will need to receive the benefit in their capacity as an employee in order for the employer's payment to be deductible. Shareholder benefits are not deductible.
- **Small business tax rate.** A corporation that qualifies for the small business tax rate under the ITA and provincial or territorial tax legislation will usually pay premiums using less heavily taxed dollars than its shareholders.
- **You may not count CII or income style LTCI premiums towards a claim for the medical expense tax credit (METC).** According to CRA guidance, one of the requirements for counting insurance premiums towards a claim for the METC under ITA paragraph 118.2(2)(q) is that all or substantially all of the benefits paid under the policy relate to medical expenses that are eligible for the METC (the CRA defines "all or substantially all" to mean at least 90%).¹⁵ Because CII and income style LTCI policies pay benefits with no restriction on how you may use them, the benefits do not relate to medical expenses, and the premiums do not count towards a claim for the METC.¹⁶ See our article, "The Medical Expense Tax Credit" for more details.
- **Medical expenses may be claimed even if paid from tax-free insurance benefits.** If the insured person has a covered critical illness or needs long-term care, and uses the CII or

¹⁴ ITA section 67 and paragraph 18(1)(a).

¹⁵ CRA Document 2015-0610751C6, November 24, 2015. See additional CRA commentary at www.cra-arc.gc.ca/whtsnw/tms/phsp-rpam-eng.html.

¹⁶ CRA Document 9711505, June 2, 1997.

income style LTCI benefit to pay hospital, medical, and/or nursing home expenses, the policy owner may be able to count those expenses towards a claim for the METC. It will not matter that the source of the money used to pay those expenses was a tax-free insurance benefit.

Note: any expenses for which the policy owner received benefits from a reimbursement style LTCI policy may not be used as part of a claim for the METC¹⁷ (except any unreimbursed part of the expense, such as deductibles, co-payments, and claims over the policy limits).

- **Employees must include in income their employers' payment of their CII and/or LTCI premiums.** Employees must include in income the cost of all benefits they receive as a result of their employment.¹⁸ Exceptions include the cost of some benefits provided under a group sickness or accident insurance plan (GSAIP) or private health services plan (PHSP). However, the strategy referred to in this article is neither a GSAIP nor a PHSP. Its purpose instead is to allow the employer to offer a small group of employees a more flexible benefits package than the employer could offer under a GSAIP or PHSP.
- **Shareholders must include in income as shareholder benefits the premium payments that their corporations pay for their coverage.** The CRA presumes that any benefit a shareholder receives from their corporation they receive because they own the corporation, and can significantly influence business policy, not because they are employed by it.¹⁹ Shareholder benefits are taxed as income to the shareholder,²⁰ but generally are not deductible to the corporation.²¹ Only if the parties can show that the shareholder has received their benefit as an employee, not as a shareholder, will the shareholder be treated as having

¹⁷ Ibid.

¹⁸ ITA paragraph 6(1)(a).

¹⁹ CRA documents 2003-0034505, December 9, 2003; 2005-0163771E5, March 14, 2006; 2016-0635351E5, January 11, 2017; and Income Tax Folio S2-F3-C2, "Benefits and Allowances Received from Employment," October 12, 2016, paragraph 2.3.

²⁰ ITA subsection 15(1).

²¹ *Spicy Sports Inc. et. al. v. The Queen*, [2004] 5 C.T.C. 2090, 42 C.C.P.B. 316.

received an employee benefit, which the corporation could deduct if it was a reasonable business expense.

CONCLUSION

An executive bonus plan for a select few employees can be an attractive alternative to offering exclusive benefits to those employees through an ELHT or grouped insurance plan. With an ELHT or grouped plan employees will get the same coverage, the employer will be able to deduct the premiums paid, and the employees will have to include the premiums in income and pay tax on them. The same rules apply to individually owned plans where the employer pays the premiums. But with an individual plan, each employee will be able to tailor their base and optional coverage, and their premium payment duration, to suit their individual needs and circumstances, making the benefit more valuable for them.

Author: Stuart L. Dollar, M.A., LL.B., CFP®, CLU®, ChFC®, TEP, Director Insurance Tax Solutions. First published July 2013. Last revised September 2021.

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Canadian Health Insurance Tax Guide

Case study – Executive bonus plan



Life's brighter under the sun

| Providing CII benefits under an Employee Life and Health Trust, Grouped Plan or Executive Bonus Plan | | |
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| | ELHT or Grouped Plan | Executive Bonus Plan |
| Contributions to pay premiums deductible to employer? | Yes | Yes |
| Contributions to pay premiums taxable to employee? | Yes | Yes |
| CII insurance benefit paid tax-free? | Yes | Yes |
| Additional benefits allowed (ROPC/E, LTCL conversion)? | No | Yes |
| Different coverage levels for different employees allowed? | No for ELHTs. Possibly for grouped plans, though not as flexible as Executive Bonus Plans. | Yes |
| Can the policy be transferred to the employee after they leave the employer? | Yes, but the employee will have to pay fair market value for the policy or treat receipt of policy as a taxable benefit. | Not applicable. Employee already owns the policy. |
| If the employee owns the policy, are there any tax consequences to an employee retaining their policy after they leave the employer? | Only applicable to grouped plans. If policy has been pre-funded, employee may have to include present value of prefunding in income. | No |
| May employer vary amount of contribution from year to year? | Yes, subject to notice to affected employees. | Yes, subject to terms of agreement with employee. |