Canadian Health Insurance Tax Guide
Individually owned health insurance policies
September 2021

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INTRODUCTION

Other articles in this series discuss the tax issues that arise when an employer provides health insurance coverage through a group benefits plan, like a private health services plan (PHSP), group sickness or accident insurance plan (GSAIP) or employee life and health trust (ELHT).

Individuals and businesses may own health insurance policies in their individual capacities, outside of group health insurance plans. This article discusses the tax issues that arise when an individual or business owns a health insurance policy in their individual capacity. The tax treatment described in this article is confined to persons and businesses that are resident in Canada.

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GENERAL TAX CONSEQUENCES APPLICABLE TO ALL FORMS OF HEALTH INSURANCE

PREMIUMS NOT DEDUCTIBLE

Generally, insurance premiums are not deductible from income, either at the personal or business level. The denial of deductibility stems from two sections in the Income Tax Act[1] (ITA). ITA paragraph 18(1)(h) denies a deduction for "personal or living expenses", while paragraph (b) in the definition of "personal or living expenses" under ITA subsection 248(1) includes insurance premiums as "personal or living expenses":

> *[T]he expenses, premiums or other costs of a policy of insurance ... if the proceeds of the policy or contract are payable to or for the benefit of the taxpayer or a person connected with the taxpayer by blood relationship, marriage or common-law partnership or adoption*.

We briefly discuss this issue in our article, "Private Health Services Plans." What follows is a fuller explanation.

Although the definition of personal or living expenses refers to people connected to a taxpayer by relationships that only living people could have, denying deductibility extends also to a corporation through use of the words, "for the benefit of the taxpayer." The word "taxpayer" refers to non-corporeal (i.e. not living) people, like corporations, trusts or partnerships, as well as to living people.

However, a business may deduct insurance premiums if it can characterize the payment of those premiums as a reasonable business expense "made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."[2] For example, if an employee owned a health insurance policy but the employer paid the premiums, as long as the employee's total compensation package was reasonable, the employer could deduct the premium payment as a reasonable business expense. The employee would have to treat the employer's premium payment

[1] Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.
[2] ITA paragraph 18(1)(a).

as a taxable employee benefit. The tax result would be the same as if the employer had paid the employee a salary and the employee had used the salary to pay the premiums.

Health insurance premiums may also be deductible when paid as part of a PHSP or GSAIP. We discuss these plans in our articles, "Private Health Services Plans" and "Group Sickness or Accident Insurance Plans." This article discusses health insurance policies when those policies are not included in a PHSP or GSAIP.

Shareholders who are also employees of their businesses can have their businesses pay premiums for their personal insurance policies, provided they receive the benefit of the premium payments as employees, not owners. The Canada Revenue Agency (CRA) treats a benefit paid to a shareholder as a shareholder benefit, unless persuaded otherwise: "Furthermore, the Department has always started with the presumption that an employee-shareholder receives a benefit by virtue of his or her shareholdings...."[3] See our article, "Private Health Services Plans" for further details. Shareholder benefits are not deductible, and are taxed as income to the shareholder. The dividend tax credit does not apply to a shareholder benefit.

A corporation could pay a shareholder's insurance premiums by declaring and paying a dividend, which the shareholder could use to pay insurance premiums. Dividends are not deductible for the corporation and are treated as income to the shareholder. But the shareholder can use the dividend tax credit to reduce the tax they pay on the dividend. One difficulty with this strategy is that dividends are paid to all shareholders in proportion to the shares they own. If the corporation has more than one shareholder, all shareholders receive a dividend. The dividend could also be too large or too small

[3] ITA subsection 15(1), and CRA Document 9908430, June 30, 1999. 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 (ATRs) 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.

to pay the health insurance premium, or some shareholders may not own insurance, making the dividend payment superfluous.

Subject to one exception, proprietors and partners may not deduct the health insurance premiums they pay for themselves or their family members. The exception is found in ITA section 20.01, where self-employed persons may deduct premiums paid for PHSPs. The exception in ITA section 20.01 was created to put self-employed persons on a more equal footing with shareholder/employees. See our article, "Private Health Services Plans" for more details.

Though an individual may not deduct premiums they pay for themselves or their family members, if the policy is a PHSP they may be able to treat the premiums as medical expenses and count them towards a claim for the medical expense tax credit (METC). See our article, "The Medical Expense Tax Credit" for more details.

TAX TREATMENT OF INSURANCE POLICY BENEFITS

There is no provision in the ITA that taxes health insurance policy benefits, so generally they are tax-free. The benefit must come from a policy that the CRA regards as insurance. In discussing PHSPs, the CRA has set out five qualities that a plan must have to be treated as insurance:

- An undertaking by one person,
- To indemnify another person,
- For an agreed consideration,
- From a loss or liability in respect of an event,
- The happening of which is uncertain.[4]

Although the CRA provided this definition to help define PHSPs, it generally indicates the Agency's thinking on what is and is not insurance. The CRA has agreed that these requirements apply also to GSAIPs.[5] Although the CRA's guidance was given in the context of group plans, the CRA has

[4] Interpretation Bulletin IT-339R2 – Meaning of "Private Health Services Plan", August 8, 1989, paragraph 3.
[5] CRA Document 2010-0374891E5, March 14, 2011.

confirmed the tax-free nature of individual health insurance policy benefits in several opinions, as discussed below.

Critical illness insurance (CII) policies:

> Where a policy provides benefits only in the event of critical illness, we agree with your view that the policy should be viewed as a "sickness" policy rather than a life insurance policy for purposes of the Act, notwithstanding that such policies are primarily issued by life insurers. In our view, the proceeds of disposition of such a policy would generally not be included in the policyholder's income under section 3 of the Act.[6]

Disability income insurance (DII) policies:

> As we indicated previously, we are maintaining our current practice, which is not to apply paragraph 56(1)(d) of the Act to include such periodic payments received under a disability policy in the recipient's income.[7]

Long-term care insurance (LTCI) policies:

> Benefits received from a LTC Plan would not be subject to tax where the individual paid all of the required premiums.[8]

Private health insurance (PHI) policies:

> Subparagraph 6(1)(a)(i) of the Act however, specifically excludes benefits derived from the contributions of the taxpayer's employer to or under a Private Health Services Plan (a "PHSP") .... In general terms ... it is our position that medical and hospital insurance plans offered by

[6] CRA Document 2003-0004265, June 18, 2003. See also CRA Document 2003-0034505, December 9, 2003 (the CRA's opinion was considering a CII policy that was part of a group benefits plan) and CRA Document 2003-0054571E5, December 24, 2004.

[7] CRA Document 2001-0092985, October 29, 2001. ITA paragraph 56(1)(d) taxes annuity payments.

[8] CRA Document 2003-0048461E5, March 5, 2004.

> Blue Cross and various other life insurers would be considered a PHSP within the meaning of 248(1) of the Act.[9]

This beneficial tax treatment should apply to individuals who own health insurance policies on themselves and their family members, and to employers who own health insurance policies on their key people.

In the context of a corporation receiving insurance benefits, there is a difference in tax treatment between life insurance and health insurance benefits. Corporations receive both kinds of insurance benefits tax-free. But generally speaking, under ITA subsection 89(1) a corporation may post to its capital dividend account (CDA) that part of a life insurance policy death benefit that exceeds an amount equal to its adjusted cost basis (ACB) in the policy immediately before the life insured person's death. Capital dividends may be paid tax-free to shareholders. The same tax treatment does not apply to health insurance policy benefits. If a corporation wants to pay a health insurance policy benefit to a shareholder, the payment will be treated as a taxable shareholder benefit or dividend. Neither type of payment is deductible to the corporation.

Instead of receiving the health insurance policy benefit, and then paying it to the employee or shareholder, an employer or corporation could instruct the insurance company to pay the insurance benefit directly to the employee or shareholder. Though insurance policy benefits are paid tax-free, the payment would still be treated as a taxable employee or shareholder benefit because the employer or corporation would be diverting money to which it was entitled to the shareholder or employee.

While shareholder benefits and dividends are not deductible to a corporation, an employee benefit can be deductible if the employer can show that the payment was a reasonable business expense, paid to earn income from a business or property. The employer would need to consult with their tax advisors on whether it could get such a deduction.

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[9] CRA Document 2006-0175931E5, July 25, 2006.

The rules governing life insurance policy benefits under ITA subsection 89(1) apply with necessary modifications to partnerships under ITA subparagraph 53(1)(e)(iii). As with corporations, this provision applies only to life insurance policy death benefits.

The ITA and CRA are silent on the tax consequences that would apply if a partnership owned a health insurance policy on a partner, received a health insurance benefit, and wanted to distribute it to the insured partner. But based on the adjusted cost base[10] rules that apply to partnerships, and assuming that all partners dealt with each other at arm's length, the following rules would likely apply. The partnership would receive the health insurance policy benefit tax-free. Each partner's adjusted cost base would rise in proportion to their share of the health insurance policy benefit, based on their ownership share in the partnership. Each partner would have to draw down their adjusted cost base in an amount equal to their share of the insurance benefit and give that amount to the insured partner. While this process would not result in tax to any of the partners, it would be cumbersome to administer, and would depend on each partner's cooperation or on a prior agreement.

If a partnership owned a health insurance policy for key person purposes, it could retain the benefit and use it to offset any financial losses it suffers because of the partner's or key employee's illness. If any expenses it paid from the insurance benefit were deductible, it could pass the deduction through to the partners in proportion to their partnership interests, even though the money used to pay the deductible expense was tax-free.

[10] "Adjusted cost base" is a similar concept to "adjusted cost basis". "Adjusted cost base" is generally the taxpayer's cost of property, and is used in determining capital gains and losses on the disposition of that property. "Adjusted cost basis" is generally the cost to a policy owner of acquiring all their interests in an insurance policy and is used in determining whether the policy owner has a gain when a disposition of their interest in an insurance policy occurs.

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HEALTH INSURANCE COVERAGE OFFERED AS A RIDER TO A LIFE INSURANCE POLICY

Health insurance policy riders provide coverage in addition to that provided by the base life insurance policy. Some riders are incorporated into the base coverage, while others are options that can be added to the base policy or left off.

The CRA touched on this distinction in an opinion that discussed the addition of extra, employee-paid DII coverage as a rider to a GSAIP offering employer-paid DII coverage. The CRA said:

> *We would consider that the establishment of this plan by way of an addition of a rider to the base plan would not jeopardize the current tax status of the original plan to the extent that the employer can demonstrate that the rider does, in fact, constitute a separate contract of insurance.*[11]

While the CRA's opinion in this case dealt with the tax treatment of employer versus employee-paid DII, it's important to note that the CRA believed that if you could show that the rider was a separate contract of insurance the rider would receive tax treatment appropriate to the type of insurance it provided. The same reasoning should apply to health insurance offered as additional coverage to a life insurance policy. Provided the coverage is its own separate insurance contract, the same rules that apply to stand-alone coverage should apply to the extra coverage.

The ITA has specific rules dealing with DII coverage offered as a rider to a life insurance policy. Any additional DII coverage will not affect the tax treatment of the life insurance policy as long as the additional coverage is ancillary to the base coverage.[12] Premiums paid for a rider offering a DII benefit are excluded from the definition of premiums for a life insurance policy, and therefore do not affect the life insurance policy's ACB.[13] Nor will the payment of a disability or accidental death benefit be treated as a disposition of the policy.[14]

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[11] CRA Document 59070, September 10, 1990.
[12] CRA Document 9531875, January 19, 1996.
[13] ITA subparagraph 148(9), c.f. "premium", paragraph (c).
[14] ITA paragraph 148(9), c.f. "disposition", paragraph (h).

The ITA has no provisions dealing with the premiums paid for other types of insurance coverage added to an insurance policy through a rider. Before amendments to ITA subsection 148(9) arising from the 2014 federal Budget became law (December 16, 2014), the definition of "premium" in ITA subsection 148(9) referred to "any other prescribed benefit that is ancillary to the policy."[15] However, no regulations were ever passed describing such other prescribed benefits, and the reference to such prescribed benefits has been removed from the current version of ITA subsection 148(9).

We discuss riders to health insurance policies later in this article.

OWNERSHIP OPTIONS FOR INDIVIDUALLY OWNED HEALTH INSURANCE POLICIES

Although the health insurance policy owner is usually the insured person and beneficiary, other arrangements are possible. For example, one spouse may be the owner and beneficiary of a health insurance policy with the other spouse as the insured person. The advantage to such an arrangement is more apparent with CII and LTCI. The healthy spouse can arrange for benefit payouts and manage the insurance proceeds if the other spouse suffers a critical illness or needs long-term care. Even though one spouse receives the insurance benefit while the other spouse receives the health care, either spouse may claim the METC. See our article, "The Medical Expense Tax Credit" for more details.

A parent could own and be the beneficiary of a health insurance policy on their child. The advantage to that arrangement lies in preserving the child's insurability. If an event occurs that triggers a claim, the parents can receive the benefit and use it to pay for their child's medical expenses. If the child reaches the age of majority without any claims, the parent can transfer ownership of the policy to the child. There are no provisions in the ITA that tax the transfer of a non-life insurance policy between family members.

[15] ITA subparagraph 148(9), c.f. "premium", subparagraph (c)(vii), as it read before December 16, 2014.

The attribution rules should also be considered. Under the attribution rule if a spouse transfers an asset to the other spouse, or a parent transfers an asset to their minor child, any income from the asset is attributed back to the transferor. There are some exceptions. Among them are transfers between spouses on marriage breakdown, transfers for fair market value, loans where the recipient pays interest at a commercial rate, and capital gains earned on an asset owned by a minor.

Because most health insurance policies do not have cash values it would not be possible to trigger the attribution rules by accessing policy cash values, as it is for cash value life insurance policies.

Further, a health insurance benefit is paid tax-free, so it should also not trigger attribution. Finally, a return of premium (ROP) benefit is also paid tax-free, so there should be no attribution of that benefit.

As a result, transferring health insurance policies between family members should not attract any tax consequences.[16]

Although in the cases noted above it could be beneficial for someone other than the insured person to own a health insurance policy, in other cases it may not be a good idea.

For example, while it's possible for an adult child to own and be the beneficiary of a health insurance policy (such as an LTCI policy) on their elderly parents, such an arrangement risks financial abuse of the parent. Instead, the parent should own their own policy. The children can contribute through paying the premiums. The adult child could count the premium payments as medical expenses under the METC if the premiums qualified as medical expenses and the parent resided in Canada and was dependent on the child for some time during the year. We discuss the METC in more detail in our article, "The Medical Expense Tax Credit." One child, or all, could administer the policy and its benefits, if need be, through a continuing power of attorney for property and personal care. See our article, "Guardianship, powers of attorney, trusts and health insurance" for further details.

[16] The same cannot be said when a business transfers a policy it owns on a shareholder or key employee.

When someone owns a health insurance policy on another person, it's important to consider what happens if the policy owner dies before the insured person. All provincial and territorial insurance acts except Newfoundland and Labrador's allow a health insurance policy owner to name a contingent owner.[17] If the policy owner dies, policy ownership moves directly to the contingent owner without passing through the deceased policy owner's estate. Without a contingent owner designation, the process follows Newfoundland and Labrador's process.

In Newfoundland and Labrador, if the deceased left a will naming someone to receive the policy, or if only one person received all the deceased's property, policy ownership would move through the deceased policy owner's estate to that person. If the will did not name someone, and/or there were multiple beneficiaries, the executor would need to obtain agreement from all the beneficiaries on who would own the policy. Without that agreement, the executor could keep the estate open and manage the policy for the insured person's benefit. Failing that, the executor could be put in the position of having to name each beneficiary of the will as a joint owner of the policy, however impractical that might be.

Another issue concerns estate administration tax (EAT), or probate fees. Although a health insurance policy has no cash value, a policy owned by one person on another person's health may have some value for EAT purposes if the owner dies. If the insured person's health was poor when the policy owner died, the health insurance policy may have a substantial value. The executor would need to retain an actuary to value the policy and would have to include the value of the policy in the policy owner's estate when calculating EAT. This is not a concern in those provinces and territories that

[17] British Columbia: Insurance Act, RSBC 2012, c. 1, s. 68; Alberta: Insurance Act, RSA 2000, c. I-3, s. 734; Saskatchewan: The Insurance Act, SS 2015, c I-9.11, s. 8-131; Manitoba: The Insurance Act, CCSM 140, s. 176; Ontario: Insurance Act, RSO 1990, c. I-8, s. 317.3; Quebec: Civil Code of Quebec, CCQ-1991, Article 2445; New Brunswick: Insurance Act, RSNB 1973, c. I-12, s. 160; Nova Scotia: Insurance Act, c. 231, RSNS 1989, s. 201; Prince Edward Island: Insurance Act, RSPEI 1988, c. I-4, Yukon Territory: Insurance Act, RSY 2002, c. 119, s. 104; Northwest Territories: Insurance Act, RSNWT 1988, c. I-4, s. 97; Nunavut: Consolidation of Insurance Act, RSNWT 1988, c. I-4, s. 97. All provinces and territories except Newfoundland and Labrador have provisions in their insurance laws dealing with contingent owner designations for health insurance policies. Newfoundland and Labrador's Life Insurance Act (RSNL 1990, c. L-14, s. 30) deals with life insurance contingent owner designations. However, there is no corresponding provision in Newfoundland and Labrador's Accident and Sickness Insurance Act, RSNL 1990, c. A-2.

allow for contingent ownership because the rules also exclude an accident and sickness policy from the insured person's estate when a contingent owner is named.

TRUST-OWNED HEALTH INSURANCE POLICIES

Where it makes sense for someone other than the insured person to own a health insurance policy, it may also make sense for a trust to own the policy. Typical cases arise where the insured person lacks capacity to own a policy, either because they are a minor or because they have lost the capacity to manage their own affairs. In such cases, a trust could be created to own the policy, or an existing trust used, provided the trust's language allowed it to own a health insurance policy.

At its most basic, a trust is a relationship between three persons:

- A settlor, who provides the money and assets to be owned by the trustee,
- A trustee, who owns the money or assets, but only for the benefit of the trust beneficiary, and
- A trust beneficiary, for whose benefit the trustee owns the money or assets,

It's possible to have the same people in different roles. For example, the settlor could also be the trustee.

There are two kinds of trusts, inter vivos and testamentary. "Inter vivos" means "during life" and refers to trusts that are created during the settlor's lifetime. "Testamentary" refers to trusts that are created in a person's will and come into existence only when that person dies.

Although a trust is a relationship between the settlor, trustee and beneficiary, the ITA treats a trust as an individual and makes the trustee responsible for paying any taxes the trust owes. Subject to two exceptions, all trusts pay income tax at their top marginal rate. The first exception covers estates that are testamentary trusts. As long as they meet the requirements for being treated as graduated rate estates, they will be taxed at graduated rates for the first 36 months following the date of death. The second exception concerns testamentary trusts established for the benefit of a person who qualifies

for the disability tax credit. Those trusts will continue to be taxed using graduated rates.[18] Both trusts may use deductions and credits to reduce tax on capital gains and dividends, but neither trust may benefit from personal tax credits. See our article, "Guardianship, powers of attorney, trusts and health insurance" for further details.

Where the trust document allows the trustee to pay trust income to the beneficiary, the trustee may pay that income to the beneficiary, deduct the tax due on that income, and report the income to the beneficiary. The beneficiary will pay tax on the income using their personal tax rates, credits and deductions. A trust may own a health insurance policy for a minor. The arrangement can ensure that even if both parents have died, someone owns the policy for the minor at least until the minor reaches legal age (or the age specified in the trust document).

When the minor reaches the proper age, the trust's language may allow or require the trustee to transfer the policy to the beneficiary. The transfer should be tax-free. Although insurance policies are not treated as capital assets for capital gains tax purposes, they are treated as part of a trust's capital. ITA subsection 107(2) permits a tax-free transfer of trust capital to the beneficiary. The CRA has confirmed that trust-owned life insurance policies benefit from a tax-free rollover from the trust to a capital beneficiary.[19] The same reasoning should apply to trust-owned health insurance policies.

Trust-owned insurance policies are unaffected by the 21-year deemed disposition rule. The rule deems trusts to dispose of and reacquire their assets every 21 years so that the trust will have to recognize any deferred capital gains on those assets and pay tax on the taxable part of those gains.[20] However, as noted above, insurance policies are not treated as capital assets and therefore are not covered by the deemed disposition rule. Even if the deemed disposition rule applied to insurance policies, most health insurance policies do not have any cash value or deferred policy gains.

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[18] Inter vivos trusts are taxed generally under ITA section 104. Testamentary trusts are taxed specifically under ITA subsection 104(23).

[19] CRA Documents 9908430 and 2011-0391781E5, June 30, 1999 and January 18, 2012.

[20] ITA subsection 104(4).

Therefore, for health insurance policies without any cash value, there should be no tax consequences arising from a deemed disposition and reacquisition of a health insurance policy. As a result, it's possible for a trustee to own a health insurance policy, for decades if necessary, without worrying about the 21-year deemed disposition rule.

A person may also lack the capacity to own a health insurance policy because of diminished mental capacity. In anticipation of such a need, and for other reasons (usually estate planning and reducing estate administration taxes), individuals may create a trust to manage their assets and transfer those assets tax-free into the trust. There are three different types of trusts that can manage this need: alter ego, joint partner and spousal trusts.

Individuals over age 65 may transfer their assets tax-free into an alter ego or joint partner trust.[21] During their lifetimes, the individual(s) who established the trust (the settlors) are the only people who can receive any income from the trust, or use any of the trust's assets. Other trust beneficiaries may be named to receive income and assets after the settlors have died. Since the trustee does not have to be the same person as the settlor, a trustee can manage a trust-owned health insurance policy for the benefit of the settlors during their lifetimes, and for the benefit of other trust beneficiaries after the settlors have died. Alternatively, the trust document may say that the trust ends at the settlors' deaths, and require that any remaining trust assets be transferred to the surviving trust beneficiaries at that time.

An individual may also arrange to transfer their assets to a spousal trust at death, for the benefit of their surviving spouse.[22] The same tax-free rollovers that are available at death to transfer property to a surviving spouse personally are available for transfers to a spousal trust. A spousal trust serves a purpose similar to that which a power of attorney over the spouse's assets serves – it allows the trustee to manage property for the spouse's benefit if that person can't manage property themselves.

The CRA has said that if a spousal trust owns life insurance, the trust would be tainted because the trust would pay premiums for a policy that would not pay a benefit to the spouse during their life. It

[21] ITA subparagraph 104(4)(a)(iv).
[22] ITA subsection 70(6).

would therefore provide a benefit – life insurance coverage – for persons other than the income beneficiary:

> [A]s a result of the duty to pay insurance premiums out of trust property it would appear that persons other than the survivor may, before the survivor's death, obtain the use of the trust income or capital. Therefore, we are of the view that the trust would not satisfy the conditions of subparagraph 70(6)(b)(ii) of the Act.[23]

That objection should not apply to health insurance owned by a spousal trust because health insurance benefits are enjoyed by the insured person during their lifetime. However, care must be taken in selecting the type of coverage. Additional benefits, like a return of premium (ROP) at death rider, could taint the trust because the benefit would be paid only after the surviving spouse had died. The CRA could view any premiums the trust paid for an ROP benefit as paid for the benefit of someone other than the surviving spouse. One way to avoid this problem is to have the insurance policy owned by a separate trust that is not an alter ego, joint partner or spouse trust.

Alter ego, joint partner and spousal trusts are often established by individuals wishing to avoid EAT on the disposition of their wealth. But they also function as a substitute for a power of attorney when the individual can no longer make decisions for their own care. Since the trustee should be able to claim insurance benefits from trust-owned policies tax-free, the same as an individual, such a trust should also be able to receive health insurance policy benefits. The trust could use those benefits to pay medical expenses for the insured person, or transfer the benefits to the insured person so that they could pay those expenses and claim an METC if allowed.

BUSINESS OWNED HEALTH INSURANCE POLICIES

A business may own and be the beneficiary of a health insurance policy with the owner or employee as the insured person. For example, a proprietor could own a CII policy on himself or herself to keep the business open while the proprietor recovered from a critical illness. A proprietor could also own a

[23] CRA Document 2012-0435681C6, May 8, 2012.

CII policy on a key employee for the same reason. We do not discuss PHSP policies in this section because PHSP policies pay benefits only to reimburse an individual's covered medical expenses.

Partnerships and corporations may own health insurance policies on their employees, partners or shareholders. There are several reasons why a business may want to own health insurance policies on its key people:

- Key person insurance to protect the business,
- Key person insurance where the benefit is paid to the business, and then given to the key person,
- Key person insurance where the benefit is paid to someone other than the business or key person,
- Preserving insurability for a key person,
- Business succession, and
- Overhead insurance.

Not all of these uses for key person insurance produce desirable tax consequences. We discuss each purpose below.

KEY PERSON INSURANCE TO PROTECT THE BUSINESS

Key person insurance is intended to protect the business from the financial consequences of losing a key person's services. A business typically uses the insurance benefit to replace lost profits, reassure creditors and customers that the business is sound, hire and train a temporary replacement, keep special projects going and pay overhead expenses.

When considering health insurance, CII and lump sum DII provide the best fit for key person health insurance coverage. Although LTCI could provide a benefit if the insured person could not work, generally LTCI pays a benefit towards the end of life, not while a key employee is employed. LTCI policies also pay benefits periodically, while a business may instead need the flexibility of receiving a lump sum. LTCI coverage is not underwritten based on an employer's business needs, but on an

insured person's needs for LTC. CII and lump sum DII coverage can be underwritten to provide amounts that an employer would need to temporarily replace a key person.

A business may not claim a deduction for the premiums it pays for health insurance on a key person. But if the business is a corporation, it may get the benefit of the small business tax rate, meaning it could pay premiums using less heavily taxed dollars than an individual or an unincorporated business. If the insured person suffers a health event that triggers payment of the benefit, the business gets the benefit tax-free. To the extent that the business uses the insurance benefit to pay reasonable business expenses, it can deduct those expenses.

KEY PERSON INSURANCE WHERE THE BENEFIT IS PAID TO THE BUSINESS, AND THEN PAID TO THE KEY PERSON

A business may own a health insurance policy but pay the insurance benefit to the insured person. The following tax rules would apply.

The business could not deduct the premiums. But if the business was a corporation, it could benefit from the small business tax rate and pay premiums with less heavily taxed dollars. If the insured person suffered a health event justifying payment of the benefit, the business would receive the insurance benefit tax-free.

However, paying the benefit to the insured person would generate tax consequences. An insured person who was an employee would have to include the entire benefit in income. The business would get a deduction only if it could show that the payment was a reasonable business expense. If the insured person was a shareholder, the payment would be treated as a shareholder benefit or dividend. Neither payment would be deductible for the business. Shareholder benefits and dividends are treated as income, though the shareholder could use the dividend tax credit to reduce taxes on the dividend. If the business had more than one shareholder, all shareholders would share in the dividend payment in proportion to their ownership interests.

KEY PERSON INSURANCE WHERE THE BENEFIT IS PAID TO SOMEONE OTHER THAN THE BUSINESS OR KEY PERSON

If a business owns an insurance policy but names an employee, shareholder or relative of either as the beneficiary of the policy, the employee or shareholder will have to treat the premium payments as an employee or shareholder benefit. The CRA has provided several opinions on this issue. One opinion described a case where a parent company owned all the shares of a subsidiary company. The subsidiary company owned a life insurance policy on the parent company's sole shareholder but named the parent company as the beneficiary. The CRA said:

> *We are of the view that Subco would have conferred a benefit on its shareholder, Parentco, in paying the premiums relating to the life insurance policy of which Parentco would be the beneficiary.*[24]

In a different case, where a corporation owned a life insurance policy on the shareholder's life but named the shareholder's wife as beneficiary, the CRA said that the premium payments were a shareholder benefit.[25]

The CRA applied the same reasoning in a case where a corporation owned a life insurance policy with a rider that named the shareholder's wife as beneficiary:

> *[I]t is our general view that the payment of the premium by the corporation for the additional rider, of which the shareholder's wife and child would be beneficiaries, would constitute a taxable benefit received by the shareholder pursuant to subsection 15(1) of the Income Tax Act.*[26]

The good news in these cases is that the CRA believed that the death benefit from the life insurance policy would still be tax-free to the beneficiary even though the premiums were a taxable benefit to the shareholder.

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[24] CRA Document 2009-0329911C6, October 9, 2009.

[25] CRA Document 2004-008190117, June 29, 2004.

[26] CRA Document 2000-0002575, March 29, 2000, discussing a rider to a corporate owned life insurance policy where the shareholder's spouse was named as beneficiary.

Although these cases dealt with life insurance, the reasoning on which the CRA based its opinion should apply equally to health insurance. If a business owns an insurance policy it should be able to name itself as the beneficiary. To the extent it names someone else it is giving them the benefit of the insurance protection. The cost of that protection, the premiums, is a benefit to that person. If that person is an employee or shareholder, or a relative of the employee or shareholder, the premiums are a taxable employee or shareholder benefit.

PRESERVING INSURABILITY FOR A KEY PERSON

A business may own and pay the premiums for a health insurance policy on an employee or shareholder. When it first buys the policy, the business's reason may be to protect itself from the consequences of the employee or shareholder suffering a health incident. However, when the employee or shareholder leaves or retires, the business could transfer ownership of the policy to them so that the employee or shareholder could enjoy the same protection. CII and LTCI are examples of where this use for key person insurance could benefit the business and insured person.

We discuss the tax issues of transferring a health insurance policy from a business to an employee or shareholder in our article, "Group Sickness or Accident Insurance Plans." In brief, the employee or shareholder would have to pay fair market value (FMV) for the policy or include the value of the policy in income to the extent they did not pay FMV.

The advantage to this arrangement is that the employee's or shareholder's age or health when they leave the business may be such that they could no longer purchase health insurance on favourable terms, or at all. By owning a policy on the insured person and then transferring it to the insured person, the business preserves the insured person's insurability. Preserving insurability may be more important to the parties than the tax cost associated with transferring the policy to the insured person.

A disadvantage to the arrangement is that if the insured person suffers a health event that triggers payment of the health insurance benefit before the employee leaves, the health insurance benefit

cannot be paid to the employee or shareholder except as a taxable employee or shareholder benefit, or, if the insured person was the company's sole shareholder, as a dividend.

BUSINESS SUCCESSION

When a business owner becomes permanently unable to work due to disability, the business may have a buy-sell agreement obligating the remaining owners to buy the disabled owner's share of the business. A disability buy-out insurance policy can provide the money needed to fund the buy-out. Generally, the policy's coverage can be tailored to support the buy-sell agreement. Often the most important term is the survival period. It's important to structure the agreement so that the obligation to buy the disabled owner's share of the business is not triggered until it's certain that the insured person won't return to work. The disability buy-out policy should be tailored so that it does not pay a benefit until that time.

Disability buy-out insurance is rare in Canada, though, so it's reasonable to consider CII as an alternative. However, CII is not DII, and there are some important points on which the two types of coverage differ.

First, the survival period under a CII policy cannot be adjusted, as it can with a disability buy-out policy. If the insured person suffers a covered critical illness and survives for the time prescribed in the policy, the benefit may be paid regardless of whether the insured person ever returns to work or recovers and is back at work in a few months.

While it may not seem like a bad thing for a business to have money, it will now have to hold that money until the insured person suffers a disability serious enough to trigger the buy-out provisions in the agreement, assuming that ever happens.

Further, if the business is a corporation, holding cash can expose its shareholders to potential negative consequences. One is the possible loss of the lifetime capital gains exemption (LCGE).[27] The rules that determine whether shares qualify for the exemption are complicated. One requirement is

[27] ITA subsection 110.6(2.1). For 2021 the exemption is $892,218. Each year it increases with the rate of inflation.

that more than 90 per cent of the value of the assets must be used in an active business, at least half of which is carried on in Canada through the corporation or subsidiary corporations.[28] Cash from a health insurance policy benefit set aside to fund a disability buyout may not qualify as an asset used in an active business.

If the size of the benefit was too large, the shareholders might not qualify for the LCGE when they sell their shares. While it's possible to purify the corporation and regain the exemption, that involves moving non-business assets out of the corporation, thereby losing at least some of the benefit of that money for any potential disability buy-sell.

A second problem is that a disability buy-out policy can be better tailored to support a buy-out agreement than a CII policy. Items such as survival periods and conditions that trigger disability can all be selected from a range of options so that they match or support the buy-out agreement. CII policies lack the same degree of flexibility.

Third, there may be a mismatch between the terms of a disability buy-out agreement and a CII policy. Not all events that qualify as a critical illness necessarily disable an individual, nor do all disabilities result from a critical illness. It's possible that an individual could be disabled to the point where they could never work again without having had a critical illness.

As a final note, CII or DII can also be used where the key person is the business, and where there can be no sale to another party if the insured person suffers a career ending disability. In such cases, the insurance benefit provides the insured person with money to help replace the lost value from the business having to end because of disability or critical illness.

OVERHEAD INSURANCE

Business overhead insurance helps keep a business going while an owner recovers from an illness, injury or condition that forces them to temporarily leave the business. Both CII and DII can be used.

[28] ITA subsection 110.6(1), c.f. "qualified small business corporation share".

However, CII and DII policies that are used to cover business overhead expenses receive different tax treatment:

- CII premiums are not deductible, but the CII policy insurance benefit should be paid tax-free.
- DII premiums paid for business overhead insurance are deductible, but only to the extent that the insurance benefit that could be paid to the business does not exceed the business' actual overhead expenses. Assuming the contract language says that the insurance benefit will be limited to actual business overhead expenses incurred, the premiums should be deductible. The DII benefit will be taxable.[29]

Actual reasonable business expenses are still deductible, whether paid in full or in part from a CII or DII policy benefit.

The same problem with disability buy-out insurance occurs with overhead insurance. CII and DII coverage may be mismatched, so that a benefit may or may not be payable under either policy, or an event that triggers the need for an insurance benefit may or may not be covered.

OPTIONAL COVERAGE FOR DIFFERENT HEALTH INSURANCE PRODUCTS

This section discusses the tax treatment of riders offered on health insurance policies.

CII WITH THE RETURN OF PREMIUM (ROP) RIDER

An ROP rider returns an amount equal to all or part of the premiums paid upon cancellation, surrender or expiry of the base contract, or at the policy owner's death. Some ROP riders are part of the base coverage, while others may be obtained by paying an extra premium. As is the case with premiums paid for the base coverage, ROP premiums are not deductible, nor do they count towards a claim for the METC. The CRA has said that the ROP benefit is tax-free in Quebec because the Quebec Civil Code specifies that accident or sickness insurance benefits that are accessory to a

[29] Interpretation Bulletin IT-223 Cancelled – Overhead Expense Insurance versus Income Insurance, May 26, 1975, paragraph 2. Although IT-223 has been cancelled, the CRA has confirmed that the guidance in this bulletin still represents the CRA's view: CRA Document 2010-0378521C6 (F), dated March 25, 2011. See also Beliveau v. The Queen, May 29, 2018, (Dossier: 2015-3395(IT)G), at paragraphs 28 – 30.

contract of life insurance, and vice versa, are governed by the rules of the principal contract.[30] In the common law provinces, the CRA supports the same position for a different reason. Where an ROP benefit is paid at the expiry of coverage, the CRA has been prepared to view that benefit as tax-free, provided the benefit does not exceed the value of the premiums paid:

> *In our view, the presence of a "return of premium on expiry" benefit in a CI policy that provides for a benefit that is solely a return of premiums paid-in ... would be unlikely, in and of itself, to result in the CI policy being viewed as having a different character for purposes of the Act.*[31]

The CRA holds the same view with respect to an ROP benefit paid on cancellation of the policy:

> *[T]he refund or return of the premiums would not be required to be included in the policyholder's income unless the policyholder previously deducted such premiums in computing income.*[32]

This case dealt with a hypothetical DII policy owned by an individual and not part of a group benefits plan, where the individual paid all the premiums. Although the case dealt with DII, the principles should apply equally to CII.

But the CRA declined to provide an opinion on the tax consequences of an ROP benefit received at the policy owner's death:

> *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.*[33]

The CRA's concern that the ROP benefit may be life insurance is understandable if the amount of money paid under the benefit could exceed the total amount of all premiums paid. But if the ROP benefit is less than or equal to the amount of premiums paid, it's difficult to see that benefit as life insurance because the insurance company would not be assuming any mortality risk.

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[30] Article 2394 of the Quebec Civil Code.

[31] CRA Document 2003-0054571E5, December 24, 2004.

[32] CRA Document 2002-0117495, March 4, 2002.

[33] CRA Document 2003-0034505, December 9, 2003.

RIGHT TO CONVERT CII POLICY TO LTCI

Some CII policies contain a rider that lets the policy owner convert their CII coverage to LTCI, subject to terms and conditions set out in the policy. The advantage to this feature is that past a certain age the financial harm from needing LTCI may exceed that from having a critical illness. There is no provision in the ITA that taxes a conversion feature, nor has the CRA considered whether such a conversion would generate any tax consequences.

LTCI ROP AT DEATH

LTCI policies generally offer an ROP benefit at death, not on cancellation or expiry of the policy. The same reasoning that the CRA used in considering the ROP rider in CII and DII could apply here.

DII ROP AT CANCELLATION OR EXPIRY

As discussed above, the CRA's opinion in Document 2002-0117495 suggests that a DII ROP benefit would be tax-free on cancellation or expiry.

LUMP SUM DII CLAIM SETTLEMENTS

An insurance company sometimes disputes the insured person's claim to be disabled under a DII policy. Unlike other forms of health insurance, whether the insured person is disabled sometimes depends on assessments of the insured person's condition throughout the benefit payment period. Sometimes the insurer and insured person disagree, resulting in litigation. A lawsuit could be settled with the payment of a lump sum amount, or a court could order the insurance company to pay a lump sum.

If the parties agree or the judge specifies, the lump sum amount can be broken down into payments for disability benefits that should have been paid to the point where the claim was settled, plus interest, and those that should be paid in the future, plus the insured person's legal costs. Typically, the lump sum payment for future benefits represents a discount of the future value of those benefits, while the payment for benefits in arrears represents the payment of those benefits plus interest on the amounts owed.

In other cases, the distinction between benefits in arrears and those owed in the future may not be as clear. An insurance company may agree to settle a claim because it believes that the risk of loss and cost of litigation make the payment of a lump sum expedient, not because it accepts that the insured person has a valid claim.

We discuss this issue in our article, "Group Sickness or Accident Insurance Plans." A lump sum paid to cover arrears in taxable DII payments will be taxable to the recipient. Any amount paid to settle claims for future benefits will not be taxable.

The settlement of future rights is treated as a disposition of capital property under ITA subparagraph 39(1)(a)(iii). But an exception applies to the disposition of an insurance policy.[34] As a result, a disposition of rights in an insurance policy is not treated as a capital disposition. Therefore, a lump sum benefit that disposes of all the insured person's rights to any future benefits they may have under that policy is not taxable.

PRE-FUNDING DII POLICIES IN GROUPED INSURANCE PLANS

This section discusses a strategy that the CRA has disapproved, and therefore one that we do not promote: an employer prefunding employee-owned DII policies in a grouped plan to the point where future premiums are not required, then ending the plan so that policy benefits will be tax-free to the individual employees. This section describes the strategy and why the CRA does not allow the policy benefits to flow tax-free to the individual employees.

An employer may create a written plan to provide health insurance benefits for its employees. DII can be such a benefit. One type of plan is a grouped insurance plan, where the insurance benefits are provided through individual DII policies taken out on each employee.

Under a grouped plan it doesn't matter whether the employer or employees own the policies – the tax consequences are the same. If the employer pays any part of the DII premiums, those premiums will not be taxable to the employees and can be deducted by the employer (provided the premiums

[34] Tsiaprailis v. R., [2005] 1 S.C.R. 113, and CRA Document 2005-0141511E5, September 13, 2005.

are reasonable business expenses). Employees will have to treat any DII benefit payments they receive as income if they become disabled.

On the other hand, if the employees pay all the DII premiums, they won't be able to deduct those premiums or count them towards a claim for the METC. But they will get their DII benefits tax-free if they become disabled.

An employer can end a DII grouped insurance plan. In that case, if the employees did not own their policies, they could pay FMV to the employer in exchange for their policies, and continue paying premiums. Alternatively, if the employees already owned their policies there would be no cost to their continuing to own those policies. The CRA has said that they do not expect that a benefit would arise from an employee-owned policy no longer being part of a grouped insurance plan.[35] Moving forward, the policies would be treated as individual DII policies. The individual owners would not be able to deduct the premiums they paid, but should be able to receive insurance benefits tax-free.

Under this arrangement, there is no need to consider any ROP benefit, since none would have been allowed on a plan that was part of a grouped insurance plan.

To this point the arrangement conforms to the ITA and CRA guidance. But in some cases an employer may pay more premiums than necessary to provide coverage for the current year. The intent would be for the policy to be fully paid up by the time the plan ends, without the need for the insured person to pay any future premiums. Of course, the employer would not be able to deduct any premiums paid in a year that were greater than those needed to provide coverage for the current year. With an ELHT, the legislation specifically says that health insurance premiums paid in the current year for coverage in a future year will not be deductible until the future year.[36]

Since a potential benefit for an employee from this arrangement could be that the policy's premiums would have been paid at no tax cost to them, but the insurance benefits would be tax-free, the CRA has issued guidance on how they will determine the tax consequences arising from the arrangement.

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[35] CRA Document 2009-0314871E5, March 3, 2011.

[36] ITA paragraph 144.1(4)(b).

In such cases, the CRA has said that it's a question of fact whether the plan has really ended, regardless of the parties' stated intentions.[37] If the facts show that the plan has indeed ended, the employee will have to include the FMV of the pre-funding in income to the extent that the employee does not reimburse the employer for that pre-funding.[38] If the facts show that the plan has not ended, any benefits that the employee receives under the plan will be included in income and taxed under ITA paragraph 6(1)(f). Either way, the CRA nullifies the advantage the parties sought to achieve.

CONCLUSION

Individuals and businesses may own health insurance policies to protect their own interests from the harmful financial consequences of illness or disability. Premiums are generally not deductible, but the insurance benefit is paid tax-free. The apparent exceptions to this rule have more to do with the tax treatment of salary and benefits than they do with health insurance.

Generally, individuals and businesses should own the policy themselves if they expect the policy to protect their financial interests. The exceptions include cases where a person lacks capacity to own their policy, either because of youth or incapacity. Someone else or a trust could own the policy for the insured person's benefit. If someone else owns a policy for another, it's important to make sure that proper planning has been done in case the owner dies or becomes incapacitated themselves. This way an orderly transfer of ownership can take place.

Businesses may also own health insurance policies to protect their financial interests. Although a business may own a health insurance policy for the benefit of an employee or shareholder, there may be undesirable tax consequences associated with paying the benefit to the insured person or with transferring policy ownership to the insured person.

[37] CRA Documents 9238025 and 9411015, February 8, 1993 and July 12, 1994.
[38] CRA Document 2009-0314871E5, March 3, 2011.

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