STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

Shared Ownership Critical Illness Insurance with Return of Premium Strategy: CI Protect Plus

The following are comments on a corporation/shareholder shared ownership critical illness insurance (CI) strategy using **Empire Life CI Protect Plus®**.

What is Critical Illness or CI Coverage?

A critical illness insurance policy provides a tax-free lump sum cash benefit upon diagnosis of a range of covered critical illnesses and life-altering conditions, such as a Heart Attack, Cancer, Stroke and Loss of Independent Existence . It also includes some non- life threatening illness benefits. Payment of the non-life threatening Illness Benefit will not reduce the CI Protect Plus coverage,and will not cause the CI Protect Plus coverage to terminate. Empire Life's product offers medical concierge services at no additional cost. Please refer to the critical illness product guide for more product information.

Comments on the shared ownership strategy are in relation to the CI Protect Plus which is a "stand-alone critical illness" policy, including two, optional Return of Premium (ROP) benefits. It does not deal with critical illness coverage under a life insurance policy nor does it relate to group sickness or accident insurance plans, nor to corporately funded grouped individual critical illness insurance plans.

What is the Shared Ownership CI strategy and who is it for?

- The strategy involves a corporation and a shareholder or key employee where they jointly purchase a critical illness insurance policy and enter into a formal 'splitting' of rights agreement, including the potential return of premiums paid optional benefits. The agreement specifies the ownership of each interest, their rights, payment of benefits, obligations, the allocation of the cost of the policy to each party, surrender and change of ownership scenarios.

This strategy may be attractive for corporations and their shareholders or key employees where:

- There is a need for critical illness protection. Small business owners are looking for protection to help fund day-to-day business expenses or funding additional wages for new hires to maintain productivity. Key employees may seek protection to help pay for health and living expenses in the event of a covered critical illness.

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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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- The strategy benefits all parties in the agreement.
- It is prudent for interested parties to seek independent legal and tax advice before embarking on any transaction or structure.

A few possible Structures for this Strategy

First Structure

- Insured: Shareholder,
- Owner and beneficiary of critical illness insurance coverage: Corporation,
- Owner and beneficiary of Return of Premium benefits: Shareholder,
- Payment of benefit: To owners (one cheque) or to designated beneficiaries/directions to pay, depending on the Province,
- Corporate Premiums: paid with after tax dollars,
- Shareholder Premium

Second Structure

- Insured: Shareholder,
- Owner and beneficiary of critical illness insurance and Return of Premium on Death benefit: Corporation, then the corporation pays out a dividend to the shareholder
- Owner and beneficiary of Return of Premium on Surrender or Maturity benefit: Shareholder,
- Payment of benefit: To owners (one cheque) or to designated beneficiaries/directions to pay, depending on the Province,
- Corporate Premiums: paid with after tax dollars
- Shareholder Premiums: paid with after tax income (salary or dividend)

Third Structure

- Insured: Employee,
- Owner and beneficiary of critical illness insurance coverage: Employee,
- Owner and beneficiary of Return of Premiums Benefits: Corporation,
- Payment of benefit: To owners (one cheque) or to
- designated beneficiaries/directions to pay, depending on the Province,
- Corporate Premiums: paid with after tax dollars
- Employee Premiums: paid with after tax income (grossed up salary or taxable benefit)

Fourth Structure

- Insured: Employee,
- Owner and beneficiary of critical illness insurance coverage: Corporation,
- Owner and beneficiary of Return of Premiums Benefits: Employee,
- Payment of benefit: To owners (one cheque) or to designated beneficiaries/directions to pay, depending on the Province,
- Corporate Premiums: paid with after tax dollars,
- Employee Premiums: paid with after tax income (grossed up salary or taxable benefit)

The corporation could also be the sole owner of the critical illness insurance coverage policy with Return of Premium benefits, where the shareholder or employee enters into an agreement for their respective rights. On the other hand, we do not think that the shareholder or employee should be the sole owner of the critical illness insurance policy with Return of Premium benefits and enter into an agreement with the corporation for their respective rights, as it could trigger a taxable benefit to the shareholder or the employee.

Issues to be considered

Taxation of critical illness insurance

The Income Tax Act (ITA) Canada does not presently contain particular rules for the taxation of critical illness insurance, as it does for owners of life insurance policies. One must rely on provincial insurance legislation, Canada Revenue Agency (CRA) technical interpretations and case law in order to determine the tax treatment of critical illness insurance. As of now, stand-alone critical illness insurance, including Return of Premiums is considered by the industry as accident and sickness insurance (A&S), and is not tax deductible. Section 2394 of the Quebec Civil Code states that it is the primary coverage that determines the characterization of a policy, meaning that ROP benefits would also be considered accident and sickness (the same principle applies to Manitoba, Alberta and British Columbia). In respect of the other common law provinces, this is not as clear. CRA has yet to confirm that critical illness insurance, more particularly Return of Premiums on Death is A&S insurance, not life insurance. The insurance industry is taking the position that in Quebec and common law provinces, stand-alone critical illness insurance with Return of Premiums Benefits on Death is A&S insurance.

In addition, benefits received from a critical illness insurance policy by a private corporation, will not be credited to the corporation's capital dividend account (CDA). The March 29, 2012 Federal Budget proposed tax changes in respect of employer contributions made to group A&S insurance plans. Employees will be subject to tax on the employer contributions made in respect of these benefits. These changes will also affect corporately funded grouped individual critical illness insurance plans including Return of Premiums benefits, but should not affect standalone critical illness insurance policies and more particularly, this strategy.

Fair Market Value (FMV) of the ownership interest

As mentioned above, the formal 'splitting' of rights agreement will specify the ownership of each interest, the parties' rights, payment of benefits, obligations, the allocation of the cost of the policy to each party and surrender and maturity options. An important issue for the owners from a tax perspective is to consider whether each party has paid for its fair share (FMV of the premium split) for what they will get out of the agreement.

Canada Revenue Agency's (CRA) Technical Interpretation 2004-0090181E5, dated November 30, 2004, states; "Thus, when a company is the owner of a critical illness insurance policy for which the benefit is payable to the company, we consider that the payment of the premiums by the company would not normally trigger a taxable benefit to the shareholder under Subsection 15(1). However, if the shareholder is the beneficiary of the benefit or the refund of premiums under the policy, the payment by the company of the respective premiums will be considered a benefit for which the shareholder will have to include the said benefit amount in the calculation of his/her income under Subsection 15(1) and this, for the year the said premiums are paid. The same applies when the company pays the premiums for the critical illness insurance and the shareholder pays the premiums relating to the return of premiums, if the company is impoverished due to these transactions. The value of the benefit could correspond to the amount the shareholder would disburse, under similar circumstances, to obtain from a person with whom s/he is dealing at arm's length, the same benefit which results from the said transaction."

Corporate impoverishment is not really explained by CRA, it remains a question of fact. CRA could contend that the corporation is economically poorer as a result of paying a higher premium than it should in order to provide an employee the return of premiums benefit. For example, a 50 year old key employee wants to retire at age 65 and enters into a splitting of rights agreement with the employer where a CI Protect Plus 75 is purchased with a Return of Premiums on Surrender or Maturity option going to the employee. (see table below for percentage of eligible premiums returned.) The corporation only needs protection for 15 years and it purchases a critical illness policy that expires at age 75. The corporation is economically poorer as a result of paying a higher premium than it should. A fair share of the premium split could mean lowering the corporation's portion of the premium, considering that it is paying a higher premium for an extra 10 years of coverage that it does not need (see following examples). One must also remember that the return of premium benefit cannot be purchased on its own; it is always accessory to a critical illness insurance policy.

% of Eligible Premiums Returned (CI Protect Plus)

Life Insured's Attained Age	Percentage
60 – 64	70%
65 – 69	80%
70 – 74	90%
75	100%

The new CI Protect Plus 100 15 Pay offers lifetime coverage and a Return of Premium on Surrender equal to 100% of eligible premiums provided coverage has been in force for at least 15 years and no critical illness benefit has been paid.

If the shareholder pays a fair share for the return of premiums benefit ,(as with a person dealing at arm's length), then the company would not be impoverished. Again, bear in mind that pursuant to Paragraph 6 of Information Circular 70-6R10, this Technical Interpretation is not a ruling, and consequently is not binding on CRA in respect of any particular situation, and therefore may not represent its current position. The same applies to the following.

CRA Technical Interpretation 2006-0178561E5, dated November 30, 2006 suggests that the cost of the Return of Premiums benefit established by the insurer is not necessarily an indication of FMV. A FMV determination is a question of fact and one could possibly consider the following fair market value calculations:

- Compare the cost of critical illness insurance coverage and Return of Premiums riders of CI Protect Plus with several insurer quotes to determine if the split seems fair. This would not mean that the split is necessarily fair. Price variations could be a surprise.
- Take the average cost of each coverage of the above mentioned insurers. Again, this would not mean that the split is necessarily fair if large variations occur.
- Obtain an actuarial calculation of the Return of

Premiums benefit so as to minimize potential premium split valuation problems with CRA. As the return of premiums benefit gets closer to being payable, the value of the benefit should be higher each year. Evidently, there is a cost attached to this approach. The calculation could provide a scale of the appropriate benefit cost split.

- Contend that the original agreed FMV premium split under the agreement could hold, on the basis that you really do not know in advance if the Return of Premiums benefit would be paid or not. If the shareholder or employee is critically ill, the Return of Premiums benefit will never be paid.

One should consult as to ensure that the parties involved are comfortable with the approach taken in splitting the costs keeping in mind CRA's technical interpretations.

Let us look at two examples

First example

Mrs. Picard, 53, non-smoker owns 100% of the shares of an operating corporation (Opco) located in Quebec City, and has five employees. She is considering covering herself with a $500,000 critical illness insurance policy for key person coverage in Opco. Her Advisor explained to her that additional Return of Premiums benefits could be purchased, using the shared ownership strategy. She is considering retiring at age 68.

After consideration of all of the issues related to the strategy and her needs, she decides to go forward with the strategy. She is considering a $500,000 Empire Life CI Protect Plus 75 policy with Return of Premium benefits. The annual premium for the critical illness insurance coverage including Return of Premiums on Death is $9,280 (42.4% of the total premium), and the annual premium for the Return of Premiums on Surrender or Maturity benefits is $12,620 (57.6% of the total premium).

The considered strategy involves the sharing or 'splitting' of rights under the individual policy between Mrs. Picard and Opco, including the potential Return of Premiums paid. The following steps would normally be taken in setting up this strategy:

- Opco is owner and beneficiary of the CI Protect Plus insurance policy with Return of Premium benefits to guard or protect itself financially in the event of a diagnosed critical illness by Mrs. Picard in accordance with the definitions and conditions in the contract or her premature death. Assuming Mrs. Picard dies at the end of policy year 10, and had never made a critical illness insurance claim, Opco would receive an amount of $219,000 Return of Premiums on Death benefit tax-free.
- Mrs. Picard owner and beneficiary of the Return of Premiums at Surrender or Maturity benefit paid in the event that no critical illness insurance claim is made by

the maturity of the policy. In this event, at retirement age (68), Mrs. Picard would receive a Return of Premium benefit of $262,800;

- A 'shared ownership' agreement between Mrs. Picard and Opco would be prepared by their legal counsel describing both parties' rights;
- A fair split of the premium would be determined between Mrs. Picard and Opco using a documented survey of competitive companies' products and applying averages or obtaining an Actuarial calculation. This would produce a different split from the purely mathematical 57.6%-42.4% obtained with the Empire Life CI Protect Plus with Return of Premiums benefit policy. The split could for instance be 60%-40%, 65%-35%, etc respectively. The premium split could also change every year if an actuarial calculation has been obtained; and
- The documentation and associated designations would be made to determine who receives the different benefits.

The split of premiums would focus on the portion of the premium representing the cost of the base critical illness benefit with Return of Premiums on Death benefit vs. the portion of the premium representing the cost of the benefit for the Return of Premiums at Surrender or Maturity benefit. The policy would be set up as follows:

- Opco would be owner and beneficiary of the critical illness insurance benefit/Return of Premiums on Death benefit The premium will be paid with corporate after-tax dollars;
- Mrs. Picard, the shareholder, would be owner and beneficiary of the Return of Premiums at Surrender or Maturity benefit. She decides to receive a taxable dividend from Opco and use her after tax dividend to pay Opco for its share of the premium;
- One cheque will be made by Opco to Empire Life to pay the total premium;
- Depending on the events, payment of a benefit will go either to Mrs. Picard or Opco as per beneficiary designations.

Ownership structure, premium payments and benefits from the plan would be covered under the shared ownership agreement between Mrs. Picard and Opco.

Tax implications

- For the shareholder, Mrs. Picard:
    1. The premiums paid by the shareholder Mrs. Picard for the Return of Premiums benefits would not be tax deductible.
    2. One aim of the strategy would be to not incur or trigger a taxable benefit to Mrs. Picard, as long as the premiums paid by the shareholder are determined to be fair by CRA.
    3. As mentioned above, according to CRA Technical Interpretation 2004-0090181E5, the Return of Premiums at Maturity benefit would be taxable to the shareholder under subsection 15(1) ITA (Canada) if the company is impoverished by this transaction. Bear in mind that pursuant to Paragraph 6 of Information Circular 70-6R10, this Technical Interpretation is not a ruling, and consequently is not binding on CRA in respect of any particular situation, and therefore may not represent its current position.

       Referring back to the above-mentioned impoverishment example, one could argue in this case that CI Protect Plus 75 is the appropriate product for this case, even though Opco pays a higher premium to age 75 when the policy is required only up to age 68. The only two options left are a CI Protect Plus 10 policy with Return of Premiums benefit where the total premium is lower ($9,920 vs $21,900) for the first ten years, but more than doubles after policy year 11 ($24,945). Mrs. Picard could have also chosen a CI Protect Plus 20, where the total premium is about the same as coverage to age 75, but where the yearly premium for CI with Return of Premiums on Death benefits paid by Opco drops from $9,280 to $8,645, thus reducing the argument for impoverishment of Opco compared to coverage to age 75. As mentioned earlier, as Opco is paying a higher annual premium for an extra 7 years of coverage that it will not need based on Mrs. Picard's retirement plans, the corporation's premium could be reduced proportionately to represent a fair split. In this particular case, Opco would pay an annual premium of $6,327 ($9,280 – ($9,280 x 7/22) instead of $9,280, a difference of $2,953. Mrs. Picard, on the other hand, would pay this extra amount for a total of $15,573. This represents a premium split of 28.9% of the total premium for Opco instead of 42.4%, and for Mrs. Picard, a premium split of 71.1% instead of 57.6%. The case study shows that CI Protect Plus 20 may be a slightly better choice.

       Again, the parties involved may obtain several insurer quotes and apply the same split calculation as above, or obtain an actuarial calculation.

- For Opco:
    1. The premiums paid by Opco for the critical illness insurance benefit and the Return of Premiums on Death benefit would not be tax deductible for Opco if there is reliance on the following point.
    2. Current practice by the CRA is to treat the critical illness insurance benefit and the Return of Premiums on Death benefit when received, as not taxable to the company.
    3. As mentioned above, the critical illness insurance benefit and the Return of Premiums on Death benefit would not be included in the Capital Dividend Account (CDA) of Opco, since critical illness insurance is not presently considered to be life insurance and therefore not an eligible contribution under the definition of the CDA in the ITA (Canada)

Second example

Mrs. Picard is also considering a $200,000 key person critical illness insurance policy for her key employee in Opco, Mrs. Gegoux, age 45, non-smoker. Mrs. Picard explained to Mrs. Gegoux that an additional Return of Premium benefit could be purchased, using the shared ownership strategy. Mrs. Gegoux is considering retiring at age 65. After consideration of all of the issues related to the strategy and her needs, Mrs. Gegoux decides to go forward with the strategy.

A $200,000 Empire Life CI Protect Plus 20 policy with Return of Premiums on Death benefit is purchased to protect the company in the event that Mrs. Gegoux passes away. The annual premium for the critical illness insurance coverage including Return of Premiums on Death benefit is $1,934. Mrs. Gegoux pays $1,556 for the Return of Premiums on Surrender or Maturity benefit. The coverage type and coverage period match Mrs. Gegoux's retirement plans. The sharing or 'splitting' of rights under the CI Protect Plus individual critical illness insurance policy between Mrs. Gegoux and Opco, including the potential Return of Premiums on Death benefit paid, is as follows:

- Opco is owner and beneficiary of the CI Protect Plus 20 policy with Return of Premiums on Death benefit to guard or protect itself financially in the event of a diagnosed critical illness by Mrs. Gegoux in accordance with the definitions and conditions in the contract or her premature death. Assuming Mrs. Gegoux dies at the end of policy year 10, and had never made a claim, Opco would receive an amount of $34,900 of Return of Premiums on Death benefit tax-free. It may use this money to fund a replacement for Mrs. Gegoux or pay unforeseen expenses which may be tax deductible.

- Mrs. Gegoux is owner and beneficiary of the Return of Premiums on Surrender or Maturity benefit paid in the event that no claim is made by the maturity of the policy. In this event, at retirement age (65), Mrs. Gegoux would receive 80% of the total premiums paid or $55,840;
- A 'shared ownership' agreement between Mrs. Gegoux and Opco would be prepared by legal counsel describing both parties' rights;
- A fair split of the premium would be determined between Mrs. Gegoux and Opco using a documented survey of competitive companies' products and applying averages or obtaining an Actuarial calculation as in the previous example; and
- The documentation and associated designations would be made to determine who receives the different benefits.

The split of premiums would focus on the portion of the premium representing the cost of the base critical illness benefit with Return of Premiums on Death benefit vs. the portion of the premium representing the cost of the benefit for the Return of Premiums on Maturity benefit . The policy would be set up as follows:

- Opco would be owner and beneficiary of the critical illness insurance benefit and Return of Premiums on Death benefit. The premium will be paid with corporate after-tax dollars.
- Mrs. Gegoux, the employee would be owner and beneficiary of the Return of Premiums on Maturity benefit. She will receive a grossed up salary from which her portion of the premium will be withheld by Opco;
- One cheque will be made out by Opco to pay the total premium;
- Depending on the events, payment of a benefit will go either to Mrs. Gegoux or Opco as per beneficiary designations.

Ownership structure, premium payments and benefit from the plan would be covered under the shared ownership agreement between Mrs. Gegoux and Opco.

Tax implications

- For the employee, Mrs. Gegoux:
  1. The premiums paid by the employee, Mrs. Gegoux for the Return of Premiums on Surrender or Maturity benefit would not be tax deductible.
  2. Mrs. Gegoux will pay tax on the grossed up salary.
  3. One aim of the strategy would be to not incur or trigger a taxable benefit to Mrs. Gegoux, as long as the premiums paid by the employee are determined to be fair by CRA. The Return of Premiums on Maturity benefit would be taxable to the employee under par. 6(1)(a) ITA, if Opco is impoverished by this transaction applying the same principle as in the previous example. Again, as in the case of Mrs. Picard, the parties involved may obtain several insurer quotes and apply the same split calculation as shown earlier or alternatively, obtain an actuarial calculation.
- For Opco:
  1. The premiums paid by Opco for the critical illness insurance benefit and the Return of Premiums on Death benefit would not be tax deductible for Opco if there is reliance on the following point.
  2. Current practice by the CRA is to treat the critical illness insurance benefit and the Return of Premiums on Death benefit when received, as not taxable to the company.
  3. The grossed up salary may be deductible for Opco
  4. Any benefit under par. 6(1)(a) ITA which constitutes part of the employee's compensation, should be deductible by Opco as an expense.
  5. As mentioned above, the critical illness insurance benefit and the Return of Premiums on Death benefit would not be included in the Capital Dividend Account (CDA) of Opco.

Should you consider this strategy?

It is important to give a lot of thought before going ahead with this strategy. The corporation and the shareholder/ employee must agree, understand all the consequences and be comfortable with the premium split and value. This strategy may well be worthwhile if the insured does not become critically ill, as the owner and beneficiary of the Return of Premiums benefit will eventually receive the total of the premiums paid. On the other hand if the insured does become critically ill, the owner and beneficiary of the Return of Premiums benefit will have paid additional premiums for nothing,

Many issues must be considered before going ahead with the Shared Ownership Strategy, carefully considering, understanding and documenting the upside and downside risks.

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