

Shared Ownership Critical Illness Insurance with Return of Premium Strategy

The following are comments on a corporation/shareholder or employee 'shared ownership' **Critical Illness Insurance (CI)** strategy using Empire Life Vital Link products. Please review the closing paragraph below with respect to the scope of this document.

What is CI?

A CI 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. Comments on this strategy are in relation to the Vital Link product, which is a "stand-alone CI" policy, including the Return of Premium (ROP) benefits. It does not deal with CI coverage under a life insurance policy (e.g. Trilogy Life Plus Advance/Addition policy), nor does it relate to group sickness or accident insurance plans, nor to corporately funded grouped individual CI plans.

What are some of the features of a Vital Link CI Policy?

Built in features:

- Eligibility for a benefit payment to the policyholder, following the diagnosis of:
 - One of the 23 covered illnesses; and
 - Life-altering conditions,
- Single Life or Multi-Life (2 lives) coverage,
- Return of Premium on Death (ROPD),
- Return of Premium at Expiry (ROPE): Vital Link 100,
- Cost of Insurance (COI):
 - Vital Link 10: 10 YRT COI
 - Vital Link 75: Level to age 75 COI
 - Vital Link 100: Level to age 100 COI

Optional or rider features:

- Return of Premium at Surrender/Maturity (ROPS)*: Vital Link 10, 75 & 100.
Schedule as follows:
 - Age 60-64: 70%
 - Age 65-69: 80%
 - Age 70-74: 90%
 - Age 75+: 100%

*Policyholder must be a minimum of age 60 and policy must be in force for 10 years.



Peter A. Wouters,
Director of Tax & Estate
Planning and Risk
Product Marketing
STEPUP Team
Empire Life

Peter A. Wouters is Director of Tax & Estate Planning and Risk Product Marketing for the Empire Life Insurance Company. He devotes much of his time working with independent advisors, their affluent clients and other professionals, uncovering needs and presenting information and options aimed at improving their tax and legacy plans and lifestyle priorities. He heads a team of accredited professionals providing case consultation, technical and advanced marketing support across Canada.

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

Peter can be reached at
peter.wouters@empire.ca



- Policy Anniversary Return of Premium (ROPA): Vital Link 10, 75 and 100. Schedule as follows:
 - 10th+ Policy Anniversary: 50%
 - 11th+ Policy Anniversary: 60%
 - 12th+ Policy Anniversary: 70%
 - 13th+ Policy Anniversary: 80%
 - 14th+ Policy Anniversary: 90%
 - 15th+ Policy Anniversary: 100%

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

The strategy involves a corporation and a shareholder or employee where they jointly purchase a Vital Link policy and enter into a formal 'splitting' of rights agreement, including the potential ROP paid. The agreement specifies the ownership of each interest, their rights, payment of benefits, obligations, and the allocation of the cost of the policy to each party.

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

- There is a need for CI protection,
- The strategy benefits all parties in the agreement,
- Independent legal and tax advice is obtained before embarking on any transaction

A few possible Structures for this Strategy

First Structure

- Insured: Shareholder,
- Owner and beneficiary of CI/ROPD: Corporation,
- Owner and beneficiary of ROPS/ROPE or ROPA: 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)

Second Structure

- Insured: Shareholder,
- Owner and beneficiary of CI/ROPD: Corporation, then the corporation pays out a dividend to the shareholder
- Owner and beneficiary of ROPS/ROPE or ROPA: 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 CI/ROPD: Employee,
- Owner and beneficiary of ROPS/ROPE or ROPA: 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 CI/ROPD: Corporation,
- Owner and beneficiary of ROPS/ROPE or ROPA: 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 CI policy with ROP 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 CI policy with ROP 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 CI:

The *Income Tax Act* (I.T.A.) Canada does not presently contain particular rules for the taxation of CI, 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 CI. As of now, stand-alone CI, including ROP, is considered by the industry as accident and sickness insurance, 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 common law provinces, this is not as clear. CRA has yet to confirm that CI, more particularly ROPD, is A&S insurance, not life insurance. The insurance industry is taking the position that in Quebec and common law provinces, stand-alone CI with ROPD is A&S insurance.

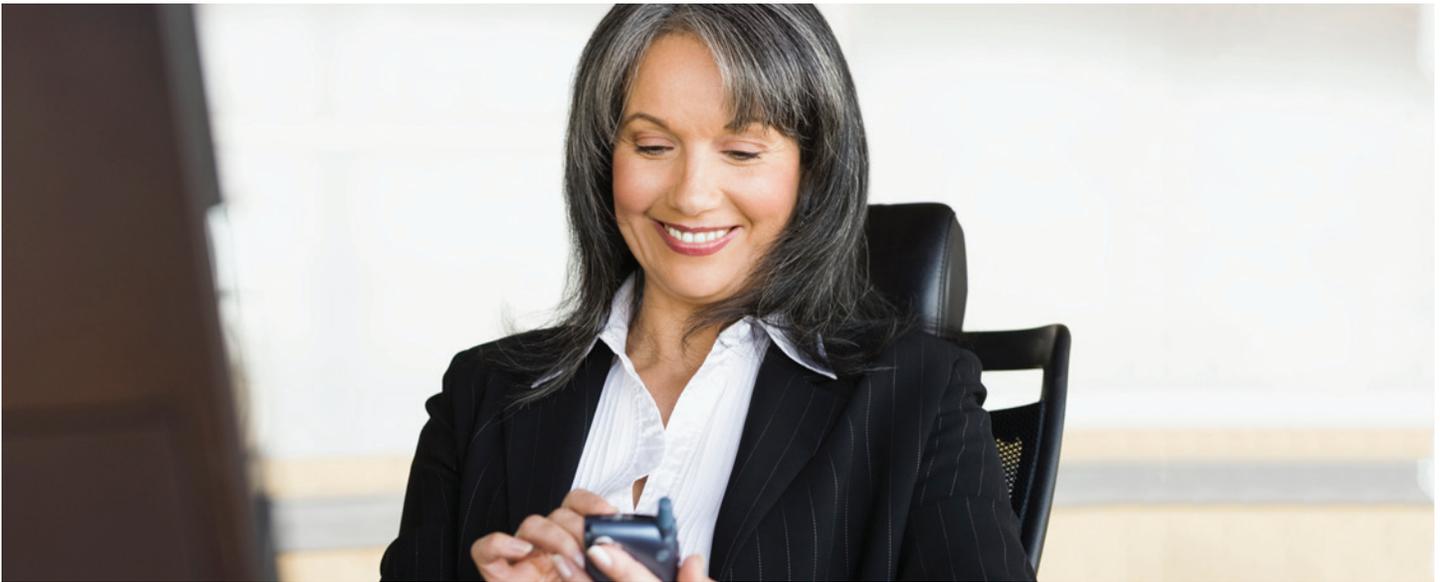
In addition, benefits received from a CI policy by a private corporation, will not be credited to the corporation's capital dividend account (CDA).

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 grouped funded individual CI plans including ROP benefits, but should not affect stand-alone CI 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, their rights, payment of benefits, obligations, and the allocation of the cost of the policy to each party. 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 to an employee a ROP 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 Vital Link 75 is purchased with a ROPA (100% of ROP at year 15) option going to the employee. The corporation only needs protection for 15 years and it purchases a CI 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 year coverage that it does not need (see example below). One must also remember that ROP cannot be purchased on its own; it is always accessory to a CI policy.

If the shareholder pays a fair share for the ROPS (as with a person dealing at arm's length), then the company would not be impoverished. Again, bear in mind that pursuant to Paragraph 22 of Information Circular 70-6R5, 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.

In addition, CRA Technical Interpretation 2006-0178561E5, dated November 30, 2006 suggests that the cost of the ROP 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:

- Compare the cost of CI coverage and ROP riders of Vital Link 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 ROP benefit, as to minimise potential premium split valuation problems with CRA. As the ROP gets closer to being payable, the value of the benefit should be higher each year. Evidently, there is a cost attached to this approach.
- 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 ROP benefit would be paid or not. If the shareholder or employee is critically ill, the ROP will never be paid.

One should consult as to ensure that the parties involved are comfortable with the approach taken in splitting the costs.

Let us look at two examples

First example

Mrs. Tremblay, 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 CI policy for key person coverage in Opco. Her Advisor explained to her that additional ROP 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 Vital Link 75 policy with ROPS. The annual premium for the CI coverage including ROPD is \$9,620 (53% of the total premium), and the annual premium for the ROPS is \$8,600 (47% of the total premium).

The considered strategy involves the sharing or 'splitting' of rights under the Vital Link 75 individual CI policy between Mrs. Tremblay and Opco, including the potential ROPS paid. The following steps would normally be taken in setting up this strategy:

- Opco is owner and beneficiary of the Vital Link 75 CI policy with ROPD to guard or protect itself financially in the event of a diagnosed critical illness by Mrs. Tremblay in accordance with the definitions and conditions in the contract. Assuming Mrs Tremblay dies at policy year 10, and had never made a CI claim, Opco would receive an amount of \$182,800 of ROPD;
- Mrs. Tremblay is owner and beneficiary of the ROPS paid in the event that no CI claim is made by the maturity of the policy. In this event, at retirement age (68), Mrs. Tremblay would receive a ROPS of \$219,360;
- A 'shared ownership' agreement between Mrs. Tremblay and Opco would be prepared by legal counsel describing both parties' rights;
- A fair split of the premium would be determined between Mrs. Tremblay and Opco using a documented survey of competitive companies' products and applying averages or obtaining an Actuarial calculation. Thus, a different split as obtained above. The split could for instance be 55%-45%, 30%-70%, etc...instead of 53%-47% obtained with the Empire Life Vital Link 75 with ROPS policy. 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 ROPD vs. the portion of the premium representing the cost of the benefit for the ROPS. The policy would be set up as follows:

- Opco would be owner and beneficiary of the CI benefit/ROPD. The premium will be paid with corporate after-tax dollars;
- Mrs Tremblay, the shareholder would be owner and beneficiary of the ROPS benefit. She decides to receive a taxable dividend from Opco and use 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. Tremblay 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. Tremblay and Opco.

Tax implications

- For the shareholder, Mrs. Tremblay:
 1. The premiums paid by the shareholder Mrs. Tremblay for the ROPS would not be tax deductible.
 2. One aim of the strategy would be to not incur or trigger a taxable benefit to Mrs. Tremblay, 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 ROPS would be taxable to the shareholder under subsection 15(1) I.T.A. if the company is impoverished by this transaction. Bear in mind that pursuant to Paragraph 22 of Information Circular 70-6R5, 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 Vital Link 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 Vital Link 10 policy with ROPS where the total premium is lower (\$15,035 vs \$18,220) for the first ten years, but more than doubles after policy year 11 (\$34,085). Mrs. Tremblay could have also chosen a Vital Link 100, where the total premium is about the same, but where the CI with ROPD yearly premium for Opco passes from \$9,620 to \$12,565, thus an argument for impoverishment of Opco. Another option is to consider the above with a ROPA instead of a ROPS option, but premium costs are higher. As mentioned earlier, as Opco is paying a higher premium for an extra 7 year coverage that it will not need, the corporation's premium could be reduced proportionately to represent a fair split. In this particular case, Opco would pay a premium of \$6,559 ($\$9,620 - (\$9,620 \times 7/22)$) instead of \$9,620, a difference of \$3,061. Mrs Tremblay on the other would pay an amount of \$11,661 ($\$8,600 + \$3,061$) instead

of \$8,600. Thus, representing now a premium split of 36% of the total premium for Opco instead of 53%, and for Mrs. Tremblay a premium split of 64% instead of 47%.

Again, the parties involved may enquire on 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 CI benefit and the ROPD 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 CI benefit and the ROPD, when received, as not taxable to the company.
3. As mentioned above, the CI benefit and the ROPD would not be included in the Capital Dividend Account (CDA) of Opco, since CI is not presently considered to be life insurance and therefore not in the definition of the CDA in the Income Tax Act (ITA).

Second example

Mrs. Tremblay is also considering a \$200,000 key person CI policy for her key employee in Opco, Mrs. Girard, 45, non-smoker. Mrs. Tremblay explained to Mrs. Girard that an additional ROP benefit could be purchased, using the shared ownership strategy. Mrs. Girard is considering retiring at age 65.

After consideration of all of the issues related to the strategy and her needs, Mrs. Girard decides to go forward with the strategy. A \$200,000 Empire Life Vital Link 75 policy with ROPS is purchased. The annual premium for the CI coverage including ROPD is \$2,556 (70% of the total premium), and the annual premium for the ROPS is \$1,086 (30% of the total premium).



The sharing or 'splitting' of rights under the Vital Link 75 individual CI policy between Mrs. Girard and Opco, including the potential ROPS paid, is as follows:

- Opco is owner and beneficiary of the Vital Link 75 CI policy with ROPD to guard or protect itself financially in the event of a diagnosed critical illness by Mrs. Girard in accordance with the definitions and conditions in the contract. Assuming Mrs. Girard dies at policy year 10, and had never made a claim, Opco would receive an amount of \$37,020 of ROPD;
- Mrs. Girard is owner and beneficiary of the ROPS paid in the event that no claim is made by the maturity of the policy. In this event, at retirement age (65), Mrs. Girard would receive a ROPS of \$59,232;
- A 'shared ownership' agreement between Mrs. Girard and Opco would be prepared by legal counsel describing both parties' rights;
- A fair split of the premium would be determined between Mrs. Girard 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 ROPD vs. the portion of the premium representing the cost of the benefit for the ROPS. The policy would be set up as follows:

- Opco would be owner and beneficiary of the CI benefit/ROPD. The premium will be paid with corporate after-tax dollars;

- Mrs. Girard, the employee would be owner and beneficiary of the ROPS 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. Girard 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. Girard and Opco.

Tax implications

- For the employee, Mrs. Girard:
 1. The premiums paid by the employee Mrs. Girard for the ROPS would not be tax deductible.
 2. Mrs. Girard 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. Girard, as long as the premiums paid by the employee are determined to be fair by CRA.

The ROPS would be taxable to the employee under par. 6(1)(a) I.T.A., if Opco is impoverished by this transaction applying the same principle as in the previous example. Again, as in the case of Mrs. Tremblay, the parties involved may enquire on several insurer quotes and apply the same split calculation as above, considering that Opco is paying a higher premium for an extra 10 year coverage that it will not need, or obtain an actuarial calculation.



- For Opco:

1. The premiums paid by Opco for the CI benefit and the ROPD 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 CI benefit and the ROPD, when received, as not taxable to the company.
3. The grossed up salary would 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 CI benefit and the ROPD 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 ROP will receive the total of the premiums paid. On the other hand if the insured does become critically ill, the owner and beneficiary of the ROP will have paid additional premiums for absolutely nothing.

Many issues must be considered before going ahead with this Strategy, well considering the upside and downside risks.

This document is not a legal or tax opinion.

Current formal tax policy on this strategy has not been established by the CRA. As such an individual application of this strategy and resulting tax implications will be based on the facts presented to CRA at the time of a review or assessment, recognizing that tax policies can change. It is a general commentary of some of the considerations and issues involved in a shared ownership/beneficiary strategy of a CI policy with ROP benefit.

This document and its contents do not purport to bind Empire Life, nor any individual, corporation or agency, and specifically is not a representation on behalf of any tax authority. Empire Life and its employees, agents and registered representatives do not provide specific legal, accounting or tax advice, and the provision of the above information and any oral or written communication regarding the same should not, nor is intended to be construed as such. Each situation will be judged by CRA based on the facts and according to law and regulations in force at the time of a review or assessment. As such, the commentary provided here may not be the most current available. Additionally, tax policies change over time so every client should seek independent legal and tax advice before going ahead on any transaction. The use of an independent third party is not only proper and common business practice, but would enhance the objectivity of any recommendation that is made and removes any potential concerns over conflicts of interests.