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Accessing corporate-owned critical illness insurance benefits

How can a shareholder access a critical illness insurance benefit for personal use when it's received by a corporation? This article discusses the tax consequences of various methods of transferring a critical illness benefit from a corporation to a shareholder.

Premiums for personally owned critical illness insurance ("CI") policies are personal expenses and therefore, aren't deductible for tax purposes. Consequently, business owners may find it more attractive to have their corporation own the CI policy so that cheaper after-tax corporate dollars are used to pay the premiums[i]. To avoid taxable shareholder benefit issues with corporate-owned CI policies, the corporation should be named as beneficiary of the CI benefit.

A CI benefit received by a corporation doesn't increase its capital dividend account because the payment isn't proceeds of a life insurance policy[ii]. Consequently, a CI benefit can't be paid out as a tax-free capital dividend to a shareholder. Therefore, how can a shareholder access the CI benefit in a tax-efficient manner? The corporation paying the CI benefit to the shareholder as a salary or dividend and having it taxed at their personal tax rate may not be the most tax effective method of distributing it to the critically ill shareholder. This article explores other ways of distributing a CI benefit out of a corporation.

Income splitting with dividends

One method for shareholders to access a CI benefit from a corporation is to pay a dividend. To take advantage of lower personal tax rates, the dividend could be paid to a spouse or other family members who are shareholders. The tax on split income rules ("TOSI") are a major consideration when paying out dividends to family members. By way of background, the original TOSI rules generally targeted dividends from privately held corporations paid to minor children[iii] by taxing them at the highest marginal rate. Additional TOSI rules were introduced in 2017 that apply to adult family members as well unless specific exemptions were met. These exemptions include:

- The recipient works 20 hours per week in the business (or has been in any five prior taxation years).
- The business owner's spouse is the recipient and the business owner is 65+ and works 20 hours per week in the business (or has in any five prior taxation years).
- The recipient is 25+ and directly owns shares that represent at least 10% of the votes and value of the company (and the corporation isn't a service company, like a professional corporation).
- Limited to safe harbour returns on capital (where the recipient is 18 – 24 years of age).
- The recipient is under 25 and received shares from a parent as a result of death.
- Potentially income on retained earnings (second generation income) within a standalone investment holding company (on basis that the corporation has no "business").

If an exemption to TOSI is available, a dividend to a spouse or another family member with a lower marginal tax rate than the principal shareholder may allow for a more tax -efficient distribution of the CI benefit from the corporation.

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Unreasonable salary or bonus

The corporation paying an unreasonable salary or bonus to a spouse or family member is another way to distribute the CI benefit from the corporation. An unreasonable salary is one that is excessive in relation to the services that were actually performed for the corporation.

Business expenses are generally deductible for tax purposes if they are reasonable. If all or a portion of the salary is unreasonable then that portion is not deductible, but still fully taxable to the recipient, resulting in both the corporation and the recipient paying tax on the same amount[iv]. Even though this results in double taxation, this strategy may be effective if the net tax cost from the payment of the unreasonable salary and denied deduction is less than net tax cost from the payment of the salary to the critically ill shareholder and the permitted corporate deduction.

For example, suppose a critically ill shareholder, at the top marginal tax rate, requires the $100,000 CI benefit paid to her corporation for various personal expenses. If the benefit is paid as a bonus to the shareholder, the corporation is entitled to a deduction, resulting in a tax savings $9,000[v] and the shareholder incurs a personal tax liability of $54,000[vi]. The net tax cost is $45,000. Alternatively, an unreasonable salary paid to a spouse triggers a personal tax liability of $24,000[vii] and a tax cost of $9,000 associated with the denied corporate deduction[viii], resulting in a net tax cost of $33,000. Therefore, there's a tax savings of $21,000 by paying the CI benefit as an unreasonable salary to a spouse taxed at a lower marginal tax rate.

	Salary paid to principal shareholder	Unreasonable salary paid to inactive family member
CI Benefit	$100,000	$100,000
Salary	$100,000	$100,000
Deduction	$100,000	$0
Corporate tax savings	$9,000	$0
Personal tax	$54,000	$24,000
Net tax costs	**$45,000**	**$33,000**

There's a risk that a payment of an unreasonable salary could attract other anti-avoidance rules so clients must consult with their professional tax advisor prior to implementing this strategy[ix].

Shareholder loans

A shareholder loan is another method for a shareholder to access a CI benefit from a corporation. There are several tax consequences that should be considered prior to a corporation extending a loan to a shareholder. These tax consequences include:

- A loan to a shareholder is generally included in the shareholder's income for tax purposes.
- No income inclusion to the recipient of the shareholder loan, if among other exceptions, the loan is repaid by the end of the following taxation year in which loan is made[x].
- A taxable imputed interest benefit is levied unless interest is charged on the shareholder loan at the prescribed rate (currently 1%)[xi].
- If a loan is made to a shareholder's family member, TOSI may apply to tax the shareholder loan at the top marginal tax rate unless an exemption is available.

If the shareholder loan can navigate through the tax consequences listed above, the CI benefit could be paid out to the shareholder in a tax-efficient manner. For example, taking a shareholder loan may be a good option if the shareholder knows that he or she will contribute capital to the corporation in the following year which may be characterized as a repayment of the shareholder loan.

Capital gains planning

Another method for a shareholder to access a CI benefit from a corporation is through a capital gains planning strategy. This strategy allows for the extraction of corporate assets at capital gains tax rates instead of dividend or regular income tax rates. It involves complex transactions and a professional tax advisor must be involved in its implementation. The high implementation costs result in the strategy being reserved only for large cases.

There are several options to implement this strategy and the following is an example of one of those options. Ms. A wholly owns common shares of ACo with a nominal adjusted cost base ("ACB"). Ms. A becomes critically ill and a CI benefit of $1,000,000 is paid to ACo. Ms. A requires the CI benefit for medical and household expenses. To implement this strategy, Ms. A will exchange a portion of her shares of ACo equal to the amount of the CI benefit of $1,000,000 for a new class of common shares of Aco. Ms. A and ACo will jointly elect under subsection 85(1) of the *Income Tax Act* (Canada) (the "Act") for proceeds of disposition of $1,000,000, which will result in a capital gain of the same amount. Half of this gain is included in income, resulting in a $500,000 taxable capital gain.

Ms. A will then exchange her shares of ACo to an existing or newly created Holdco and take back a promissory note equal to the ACB of the shares, being $1,000,000. Opco then pays an inter-corporate dividend to Holdco, equal to Opco's safe income[xii], so that Holdco can repay the promissory note held by Ms. A. Ms. A now has the CI benefit and is taxed at capital gains rates (26.76%) rather than dividend rates (47.74%) or fully taxable remuneration (53.53%).

It is worth noting that the Department of Finance ("Finance"), on July 18, 2017, introduced proposed legislation that would eliminate corporate surplus stripping. However, after public consultation, Finance decided not to proceed with this legislation in its current form but to continue discussions with affected parties to appropriately target this type of planning.

Private health services plan

A private health services plan ("PHSP") is another possible way to extract all or a portion of a CI benefit in a tax-efficient manner. A PHSP is a contract or plan of insurance generally covering costs incurred by employees for health and medical expenses that qualify for the medical expense tax credit ("METC")[xiii]. A CI contract wouldn't be the PHSP, rather it could provide the employer corporation with cash to fund a self-insured PHSP.

PHSPs offer the following benefits:

- Employer contributions / premiums are generally tax deductible as well as, administrative fees.
- Employer's PHSP contributions are not a taxable benefit to an employee.
- Benefits received from the PHSP aren't taxable to the employee.
- Employee contributions to a PHSP generally qualifies as a medical expense for the METC.

If a shareholder becomes critically ill, the PHSP could provide funds to cover eligible medical expenses. The corporation would fund the PHSP with all or a portion of the CI benefit which could then be used to cover the employee's qualified METC expenses.

In the business owner context, a PHSP is for shareholders who are actively engaged as employees of the company and the PHSP forms part of a reasonable remuneration package. For small businesses, there's a risk that the CRA would consider a PHSP benefit received by an owner-manager to be a taxable shareholder benefit on the basis that the benefit

isn't received as an employee. The CRA has stated that it would accept that PHSP benefits are received as an employee (rather than a shareholder), where all of the employees are shareholders or individuals related to a shareholder if the benefit is comparable (in nature and amount) to benefits generally offered to non-shareholder employees of "similar-sized businesses, who perform similar services and have similar responsibilities"[xiv].

Conclusion

There are several methods for a shareholder to access a CI benefit received by their corporation, but these methods require careful planning and may require the engagement of a professional tax advisor.

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[i] There are non-tax considerations that should be addressed in the decision to own the critical illness policy in a corporation, such as retirement, sale of the business, and creditor protection.
[ii] Definition of capital dividend account in the Income Tax Act (Canada) (the "ITA") refers to proceeds from a life insurance policy.
[iii] 17 years old and younger in the year.
[iv] Paragraph 18(1)(a) and Section 67 of the Act.
[v] $100,000 x 9% (Ontario small business deduction rate).
[vi] $100,000 x 54% (Ontario top marginal tax rate).
[vii] $100,000 x 24% (Ontario graduated personal tax rate).
[viii] $100,000 x 9% (Ontario small business deduction rate).
[ix] Subsections 56(2) and 246(1) of the Act.
[x] Subsection 15(2.6) of the Income Tax Act (Canada) (the "Act").
[xi] Subsections 80.4(2) and (3) of the Act.
[xii] Safe income avoids the possible application of subsection 55(2) of the Act.
[xiii] Refer to the Canada Revenue Agency's website for a list of expenses that qualify for the METC.
[xiv] CRA TI 2016-0635351E5, dated January 11, 2017.

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