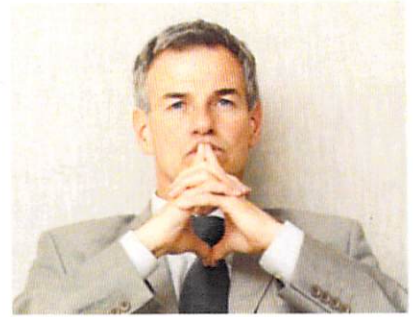


Summary of the legal and tax bases



1. Qualification of critical illness insurance as accident and sickness insurance

To determine whether critical illness insurance qualifies as sickness and accident insurance, we must turn to the applicable legislation in the province where the contract is executed.

As such, the critical illness insurance products currently available on the market, including Desjardins Financial Security (DFS)'s Executive Harmony plan, generally meet the requirements of provincial legislation to be considered accident and sickness insurance.

In Quebec, the Civil Code and the Act Respecting Insurance (R.S.Q., A-32) define certain classes of insurance. Thus, by virtue of section 14 of the Regulation Respecting the Application of the Act Respecting Insurance (R.R.Q. 1981, A-32, r.1), "accident and sickness insurance" is the class of insurance whereby the insurer offers one or more of the following protections:

- 1- payment of an indemnity in the event of bodily injury, including death, resulting from an accident sustained by an insured;
- 2- payment of an indemnity in the event of sickness or disability of an insured;
- 3- reimbursement for expenses incurred as a result of the sickness of or an accident sustained by an insured;
- 4- reimbursement for expenses incurred for the health care of an insured.

In the context of critical illness insurance, the principal benefit is payable in the event that the insured suffers from a critical illness, independently of whether or not the policy includes a return of premiums endorsement. The benefits payable under the additional provisions at the time of the insured's death or during his/her lifetime are more characteristic of life insurance. We can therefore see that critical illness insurance has some characteristics in common with both accident and sickness insurance and life insurance.

The Quebec Civil Code provides for the treatment of clauses which are accessory to the principal contract and stipulates in section 2394 that:

"Clauses of accident and sickness insurance which are accessory to a contract of life insurance and clauses of life insurance which are accessory to a contract of accident and sickness insurance are governed by the rules governing the principal contract."

DFS has concluded that the death benefit and the health benefit are clearly accessory to the insurance covering the critical illness risk. On this basis, in Quebec, it can be concluded that critical illness insurance, including the optional provisions related thereto, is sickness and accident insurance.

For the other provinces, although there are no legal provisions that place the accessory benefit in the same class as the principal benefit, certain arguments can be made in favour of qualifying critical illness contracts with life insurance as belonging to the "sickness and accident" class of insurance. Consequently, DFS has concluded that critical illness insurance, including the optional provisions related thereto, is sickness and accident insurance in all provinces.

2. Tax treatment of a critical illness insurance contract

The tax treatment of a critical illness insurance policy depends on its qualification as sickness and accident insurance. The term "sickness and accident insurance" is not defined in the Income Tax Act (ITA). Therefore, the terms and conditions of the policy and the provincial insurance legislation (and the Civil Code in Quebec) that governs the policy are relevant. The Canada Revenue Agency (CRA) has not expressed an opinion on the status of a critical illness contract, but it has published technical interpretations to provide guidance to taxpayers.

In the **2005-0112781E5 technical interpretation** (February 2, 2005), the CRA indicates that it will not express an opinion on the status of a critical illness contract issued in British Columbia, and instead refers taxpayers to the Deputy Superintendent of Insurance of that province. In the **technical interpretation 2003-0026385** (December 10, 2003), the CRA states the following:

"Where the terms and conditions of a critical illness policy provide benefits only in the event of critical illness and the provision of that insurance is clearly the purpose of the contract, the policy in our view would likely be a sickness policy for purposes of the Act."

In the **2004-0090181E5 technical interpretation** (November 30, 2004), the CRA assumes that the critical illness policy that includes a return of premiums endorsement is subject to the rules and requirements of Quebec's Act Respecting Insurance and Civil Code. The CRA also considers that this policy constitutes a

sickness and accident insurance policy as defined in section 5 of the Regulation Respecting the Application of the Act Respecting Insurance and consequently, it does not constitute life insurance. The CRA then concluded that the benefits received under a critical illness insurance policy and the return of premiums are not taxable.

3. Each party assumes their fair share of the premium based on the benefits to which they are entitled

In the 2004-0090181E5 technical interpretation (November 30, 2004) cited above, the CRA indicates the following:

"So when a company holds a critical illness insurance policy for which it is the beneficiary, we find that the payment of premiums by the company will not generally constitute a taxable benefit provided to the shareholder in accordance with subsection 15(1). However, if the shareholder is the beneficiary of the benefit or of the return of premiums under the policy, the payment of the applicable premiums by the company will constitute a benefit, the amount of which the shareholder must include in computing his/her income for the year in which the premiums were paid, in accordance with subsection 15(1)."

For pragmatic reasons, the company often assumes the payment of the entire premium payable to DFS, while it should pay its part of the premium and let the shareholder or key employee pay the other part. If the company chooses this arrangement, it should simply attribute a dividend to the shareholder or a taxable benefit to the key employee for his/her share. Another option would be to ask the shareholder or key employee to write a personal cheque to the company in reimbursement of the portion it paid on his/her behalf.

If the company does not attribute a dividend to the shareholder or if the shareholder does not reimburse the company, the shareholder must add a taxable benefit to his/her income equal to his/her portion of the premium, in accordance with subsection 15(1) of the ITA.

Please note that at DFS, it is possible to send two cheques for the annual payment method. For the monthly payment method, only one pre-authorized bank withdrawal is possible.

4. Impoverishment of the company and shareholder benefit

In the 2004-0090181E5 technical interpretation (November 30, 2004) cited earlier, the CRA mentions that, in accordance with subsection 15(1) of the ITA, the shareholder must include a benefit in the calculation of his/her income when the company pays the critical illness insurance premiums and that the shareholder pays the premiums for the return of premiums if the company is impoverished as a result of these transactions. CRA also indicates that:

"The value of the benefit could correspond to the amount that the shareholder should pay in similar circumstances to obtain the same benefit resulting from the transactions in question from a person who deals at arms length."

In the 2006-0178561E5 technical interpretation (November 3, 2006), the CRA updated certain information and added the following statement:

"More specifically, we are unable to find that there will be no benefit for the shareholder under subsection 15(1) if an insurance company determines the premium amount payable for a policy with or without a return of premiums endorsement, and, in the context of a shared agreement¹, a company pays the annual premiums for a critical illness insurance policy of which it is the beneficiary while the sole shareholder pays the additional annual premiums for the endorsement of which he/she is the beneficiary."

To ensure the company is not impoverished, it is important that it assumes the payment for the critical illness and death benefits based on the duration of the coverage it needs. The amount it pays must correspond to the amount it would pay for term coverage of the same duration.

- For example, if the company needs coverage until the individual reaches age 65, it will be the beneficiary of the critical illness and death benefits and pay the portion of the premium associated with these benefits, that is, the premium for a term-to-65 critical illness insurance that includes the same benefits.

The individual assumes the payment for the health benefit and the critical illness and death benefits that continue once the company's coverage terminates.

- He/she is the beneficiary of the health benefit.
- When the company's coverage terminates, that is, at age 65 in this example, the health benefit may be claimed or the contract may be transferred so he/she can maintain all of the coverages personally.

¹ The CRA refers to a "shared agreement", but we interpret it as a "shared ownership agreement".

In the 2006-0178561E5 technical interpretation (November 3, 2006) cited earlier, the CRA indicates that the company must experience a detriment or impoverishment in order for a benefit to be conferred on a shareholder in accordance with subsection 15(1) of the ITA. In **Del Grande v. The Queen** (decision rendered December 11, 1992 in the Tax Court of Canada), the court stated:

"Paragraph 15(1)(c) contemplates the conferral of a genuine economic benefit upon the shareholder. The word "confer" implies the bestowal of bounty or largesse, to the economic benefit of the conferee and a corresponding economic detriment of the corporation."

As such, if the company transfers its shared ownership rights in a critical illness policy to its shareholder or a key employee or if the latter makes a claim for the health benefit that inevitably leads to the termination of the contract, the following aspects must be taken into consideration:

- *At the end of the coverage period* needed by the company, no taxable benefit will be conferred to the individual as each party assumed their fair share of the premium.
- *Before the end of the coverage period* needed by the company, no taxable benefit will be conferred to the individual if the company no longer needs this coverage.

5. Capital Dividend Account (CDA)

The company receiving the death benefit cannot include it in its CDA because this benefit is payable under a sickness and accident insurance contract. Only a benefit received under a life insurance contract can generate a CDA.

6. Shared Ownership Agreement

It is important to draw up an agreement outlining the rights and obligations of each party to the insurance contract. This document will serve to show, at the appropriate time, that the parties decided in a private contract to share the rights and obligations of a critical illness insurance policy.

Here are the guidelines for the agreement:

- The policy is purchased jointly by the company and the individual (shareholder or key employee).
- The co-ownership of the policy is treated as undivided property (assets). (It cannot be asserted that one party owns the critical and death portions while the other owns the health portion.)
- The signature of both policyowners is required for any contract amendment.
- Both policyowners are responsible for paying the premium.
- The parties agree to specify the beneficiary(ies) of all three benefits and make the necessary designations in the application.
- It is established for a period of time equal to the coverage period needed by the company. It indicates the portion of the premium assumed by the company and the portion assumed by the individual.
 - Upon the expiration of this period:
 - The individual may become the sole owner of the contract and change the beneficiary(ies) so that he/she may benefit from the coverages personally.
OR
 - A claim may be submitted so that he/she may obtain the health benefit.

7. Designation of beneficiaries

At DFS, we have made a point of structuring our contract so that the return of premiums option constitutes a benefit because only a benefit can have a designated beneficiary.

Consequently, in DFS's application, it is possible to designate a beneficiary for each of the following benefits:

- Critical illness benefit
- Death benefit
- Health benefit

Note: While Desjardins Financial Security cannot guarantee the EHSP, the Harmony Executive product was designed to meet all the legal and tax requirements identified by the company's law and tax experts and a reputable external firm. However, all clients should consult their legal and tax advisors before setting up an EHSP.