



Taxation of Disability Insurance

What is Disability insurance?

A disability insurance policy generally provides a benefit on a periodic basis to an individual if they become disabled and their ability to earn income is compromised. The common element of the various definitions of "disability" is an incapacity or inability, as a result of an impairment, to pursue an occupation or to perform certain duties.

Disability insurance features and benefits are generally based on a number of factors. An important factor is the occupation class, which would determine the available plans, benefit periods, maximum benefit amounts and the premiums that will be paid. Similar to life insurance, the medical history of the client is important which may influence the premium rating, elimination period and benefit period. As well as the individual's financial information is reviewed to support the amount of insurance.

A return of premium feature may be offered as a "rider" under a disability insurance policy as a separate coverage for which a specified premium is charged. The feature provides premium refunds if there are few or no claims. Any claims may be subtracted from the total premium refund. Maximum refund amounts vary by insurer and contract. For example, a policyholder may choose a plan that returns 50% or 62.5% of all premiums paid less 100% of any disability benefits received.

A common application of disability insurance is in the employer/employee context. An employer purchases disability insurance to provide compensation for loss of employment income for an employee, as a consequence of the employee becoming disabled. The disability insurance may also be portable where upon the termination of employment the employer transfers the ownership of the policy to the employee. This Tax Topic will discuss the nature of disability insurance and its taxation in the individually owned and corporate owned contexts. It will not deal with disability coverage offered as a feature or rider under a life insurance contract.

How are Disability Insurance Policies Taxed?

Where disability insurance is not part of a contract of life insurance, it is considered to be classified as accident or sickness insurance under provincial insurance legislation. When determining the common tax considerations for disability insurance in various applications, such as deductibility of premiums and whether the benefits are taxable, we must first look at the structure of the plan, that is, the owner of the plan, the payor of the premiums, the payee of the benefits and any special insurance features.

Individually Owned Disability Policies

Disability insurance products are generally designed to help individuals meet their income requirements so they can concentrate on recovering from their disability and return to their normal lives. As with most insurance contracts, premiums for disability insurance policies would generally not be deductible from an individual's income as they are a personal living expenses paid with after-tax dollars. In addition, the insurance benefits are ordinarily not of an "income" nature for tax purposes and thus the benefits received by the taxpayer are not subject to tax.

This is supported by the discussion in IT 223 "Overhead Expense Insurance", dated May 26, 1975 dealing with the payment of premiums and receipt of benefits in respect of loss of income insurance. Also, interpretation letter #9720015 comes to a similar conclusion in respect of personally owned and paid-for disability insurance benefits.

Premium Refund Rider

CRA interpretations have confirmed that if a return of premiums were paid to the policyholder when the disability insurance expires or is discontinued, the refund would not be required to be included in the policyholder's income unless the policyholder previously deducted such premiums in computing income. CRA interpretation #2002-00117495 dated March 4, 2002 addressed refund amounts that were less than the premiums paid minus any benefits received on an individually owned disability insurance policy. Although this interpretation applied to a very specific set of facts it could have broader application. The return of premium is simply a return of a personal living expense.

Corporate Owned Disability Policies

There are a number of situations in which disability coverage is considered in the corporate setting. It is possible to categorize these situations into two different needs, corporate protection and employee benefits. These two broad categories will be dealt with below.

Corporate Protection

A corporation may need disability coverage to protect against the loss associated with a key person or shareholder that is disabled and the corporate owner receives the benefits under a disability insurance policy. Other examples of corporate coverage include overhead expense and buy/sell needs.

Key Person

If a key person (for example, a business owner or executive) becomes disabled, the corporation may require funds to meet immediate cash needs and to find a replacement during the period of sickness. The company will experience the loss of that person's knowledge, experience, judgment, reputation, relationships and skills for a period of time. Key person disability protection provides cash to buy time and to fund the hiring of a replacement for the key executive during his or her illness.

Where the corporation owns and pays the premiums and receives the benefits under a disability insurance policy, the premiums are considered to be capital outlays and not an outlay or expense made or incurred by a taxpayer for the purpose of gaining or producing income from a business or property. Therefore, a deduction is generally prohibited under the general limitation for payments on account of capital in paragraph 18(1)(b) of the Act. The benefits are not subject to tax.

This ownership structure may also be used to provide disability benefits when the insured is a shareholder. The business receives the benefits and in turn pays out the benefit in the form of a dividend. That dividend, of course, is subject to regular taxation of a dividend to a shareholder.

Office Overhead

If a key employee whose service is essential to the continuation of the business becomes disabled such that the revenue of the business will cease while expenses continue, disability insurance can reimburse the share of ongoing business expenses like employees' salary and benefits, rent, utilities, furniture, equipment costs and many more. This coverage is generally available to professionals in private practice and self-employed business people and trades people who have a successful business.

Where the disability insurance provides for amounts of overhead expenses actually incurred or paid by the insured during the disability period the premium will be allowable as a business expense and any benefits, including refunded premiums, received under the plan will be included in income. Of course the expenses actually incurred in respect of the overhead continue to be deductible in calculating the taxpayer's income. IT-223 confirms this treatment.

Disability Buyout (Buy-Sell Plus)

A shareholders' agreement may provide for the purchase and sale of shares of a company in the event a shareholder becomes disabled. It should be noted that a mandatory buy-out might not be the desired plan of action. An individual may fully recover from a disability and shareholders may not wish to trigger a mandatory purchase of their shares if they are disabled. It is for this reason that the shareholders should think about whether or not they wish a disability to be a triggering event at all and if so, whether or not that event triggers a mandatory or optional buy-sell.

If a disability is chosen as a triggering event or when a buy-sell trigger date is reached, there are numerous ways of structuring such a buyout. The active shareholders could purchase the shares directly (referred to as a cross purchase). Disability insurance to fund such an obligation may be personally owned by the active shareholders. Alternatively, the corporation could redeem the shares from the disabled shareholder (resulting in a deemed dividend to the disabled shareholder). Disability insurance to fund such an obligation may be owned by the corporation to fund the redemption.

CRA confirmed in interpretation letter #9208045 that when a corporation purchases disability insurance pursuant to a shareholders' agreement, the premiums are not deductible even though the corporation is the beneficiary of the policy. Consequently, any amount received by the corporation under the policy because of the disability of a shareholder is not taxable income of the corporation nor would it be added to the corporation's capital dividend account. Although the insurance benefits are tax-free, the sale of the business or the redemption of shares in these cases is a taxable event.

Transferring a Disability Insurance policy from the Corporation to an Employee or Shareholder

Often, the need for corporate coverage can change – a key person leaves the company, a buyout between shareholders occurs or some other reason. In such a circumstance the corporation may wish to transfer ownership in the policy to the insured person under the policy.

There are no policyholder tax consequences to the corporation for a transfer of ownership of a disability insurance policy, however, there still may be an employee or shareholder benefit conferred on the transfer pursuant to either paragraph 6(1)(a) or 15(1) of the Act for the value of the policy.

In Information Circular IC 89-3 "Policy Statement on Business Equity Valuations" dated August 25, 1989 CRA provided commentary regarding the factors to consider in the determination of the fair market value of corporate-owned life insurance in the context of business equity valuations. Some of these factors may be viewed as directory in looking at what the fair market value of a disability insurance policy could be in a similar context. The factors listed at paragraph 40 of the circular include: cash surrender value, the policy's loan value, face value, the state of health of the insured and his/her life expectancy, conversion privileges, other policy terms and replacement value.

Employee Benefits

A corporation may provide, sponsor or otherwise support the provision of disability coverage to employees. In these situations, the benefits are payable directly to the employee.

The payment of disability insurance premiums by a corporation does not give rise to any employee or shareholder taxable benefit. This exemption in 6(1)(a) for an employer's contribution to a disability plan on behalf of its employees applies only to a plan which is a group sickness or accident insurance plan.

Under 6(1)(f), employment insurance plan benefits such as disability insurance are exempt from tax if the employee paid *all* the premiums, and taxable if the employer paid *any* premiums (with a reduction for any premiums paid by the employee). Note that premiums deducted by payroll deduction are considered paid by the employee.

Corporate Payor (not grouped)

The corporation may pay for the premium on a disability policy on behalf of an employee but not as part of a group employee benefit plan or wage loss replacement plan. In this situation,

the corporation or the employee owns the policy and any benefits on disability are payable to the employee.

If the plan is not considered a group plan, any payment of premiums by the employer is considered to be a payment of a personal expense on behalf of the employee and the value of the premium is added to the employee's income as a taxable benefit in the year the payment is made.

Paragraph 6(1)(f) specifies that amounts received by an employee on a periodic basis because of the loss of income from an office or employment that are payable pursuant to a sickness, accident, disability or income maintenance insurance plan and where the employer has made contributions to the plan are taxable. However, IT-428 Wage Loss Replacement Plans paragraph 20 states that if the payment of the premium is regarded as a taxable benefit to the employee under a non-group plan that is a sickness or accident insurance plan, a disability insurance plan or income maintenance insurance plan, the payment by the employer is not viewed as a "contribution" by the employer under the plan. Therefore paragraph 6(1)(f) does not apply and any benefits received by in the employee's hands pursuant to the plan is not subject to tax.

For a plan to qualify to pay non-taxable benefits, IT-428 paragraph 16 states that the employees must be legally obligated to pay all the premiums. One or more employees must pay the entire premium cost and therefore the plan is not a plan within the meaning of paragraph 6(1)(f). Where the employer is paying the premiums it must be done on the employees' behalf and must account for them in the manner of wages or salary, for example, through payroll deductions.

Grouped Individual Plans - Income Loss Replacement Plan (ILRP)

An ILRP is an arrangement that allows a business to group together, by means of a board resolution, individual disability insurance policies for income replacement for their employees. The individual policies are owned and paid for by the business but the benefit is payable to the employee. Such arrangements are referred to by the CRA as wage loss replacement plans and provide coverage for employment income only. Owners of a small corporation can be included to the extent that they are employees of the business. At least two individuals are required to qualify the disability policies as a group sickness or accident insurance plan. Partners and sole proprietors are not eligible for coverage under such a group plan but may be suitable for individual disability insurance.

Determining whether the premium is deductible depends on whether individual policies grouped together qualify as a group sickness or accident insurance plan. According to IT-428, a "wage loss replacement plan" means "a plan which paragraph 6(1)(f) applies is any arrangement, however it is styled, between an employer and employees, or between an employer and a group or association of employees, under which provision is made for indemnification of an employee, by means of benefits payable on a periodic basis, if an employee suffers a loss of employment income as a consequence of sickness, maternity or accident."

A "group" means a plan under which a number of employees are insured either under a single contract between the insurer and an employer contracting with the insurer, or under individual contracts but pursuant to a common plan. In interpretation letter #9126876, dated December 11, 1991 CRA clarifies that the phrase, "pursuant to a common plan" simply means that the individual contracts are bought in respect of employees covered by one plan. Each individual contract forms part of the plan of the employer. The insurance plan includes an undertaking by the employer to insure a certain class or group of employees against sickness or accident and disability or for income maintenance. The agreement of such a plan could be

formal (a contract between employer and employee) or informal (stated in the corporate minutes) in nature. Where the arrangement involves a contract of insurance with an insurance company, the insurance contract becomes part of the plan but does not constitute the plan itself. It is a question of fact as to whether a collection of individual contracts are considered to be issued pursuant to a common plan established by the employer to insure its employees.

Paragraph 2 of IT-85R2 (Health and Welfare Trusts for employees) states that the Department generally accepts that an employer's contribution to a sickness, accident, disability or income maintenance plan qualifies as a contribution to a "group sickness or accident insurance plan" as described in subparagraph 6(1)(a)(i), provided that the particular plan is both a group plan and an insured plan.

By structuring the individual disability policies as a group plan and qualifying as a "group sickness or accident insurance plan", the employer can provide employees with disability coverage and deduct the premiums as a business expense under paragraph 18(1)(a) but subject to the limitation in 18(9) for prepaid amounts. The premiums are not a taxable benefit for the employee. The benefits received by the employee are taxable under paragraph 6(1)(f), however, usually under these types of plans the insurer allows a higher benefit than if the policy were issued on a non-taxable basis (i.e. employee paid premium) to compensate the employee for the tax payable.

There may also be a return of premium feature that is payable to the owner of the disability insurance. A refund of a premium under an individual disability insurance contract would not be required to be included in a policyholder's income unless the policyholder in computing income previously deducted such premiums [2002-0117495]. Since the corporation deducts the premiums under the ILRP, the return of premium benefit is taxable to the corporation. Since it is taxable, consideration to purchase this feature should be weighed against the premium savings typically seen under this concept.

Where a member of the plan is both an employee and a shareholder, the premium may not be deductible by the corporation and the payment of the premium may be treated as a taxable shareholder benefit. It is a question of fact whether a benefit has been conferred on the individual in the capacity of a shareholder or in the capacity of an employee. The benefit is presumed to be conferred upon the individual in the capacity as a shareholder unless it can be shown that the benefit is comparable in nature, quantum and cost-sharing ratio to benefits generally offered to employees who perform similar services and have similar responsibilities for other employers of a comparable size. These guidelines were provided at the 1999 CALU AGM Question 6 (#9908430) regarding wage loss replacement plans as well as in interpretation #2000-0055145 in the context for a professional corporation employee/shareholder. Therefore, the employer cannot deduct the costs of premiums if the coverage is provided to shareholder/employee in his capacity as a shareholder. The premium amounts would be included in the shareholders' income as a benefit under subsection 15(1). Benefits received by the shareholder from the policies would not be included in their income.

Health and Welfare Trusts

Individual disability insurance policies may also be used under a health and welfare trust. Health and welfare benefits for employees are sometimes provided through a trust arrangement under which trustees receive contributions from the employer to provide a benefit program as have been agreed to between the employer and the employees. In this structure, the employer may deduct contributions and an employee is not considered to have received or enjoyed a benefit at the time the employer contribution is made. However, the benefit programs are limited to a group sickness or accident insurance plan, a private health services plan, a group term life insurance policy or any combination thereof.

Where the trustees make a payment to an employee out of funds arising from the employer's contributions, then a benefit may arise in respect of, in the course of, or by virtue of the employee's employment. Further discussion of health and welfare trusts is provided in a separate Tax Topic titled "Health and Welfare Trusts".

Transferring a Disability Insurance policy from a Group Plan to an Employee

Where an employee leaves the company, the corporation may wish to transfer ownership in an individual policy that is part of a group plan to the insured person under the policy. There are no policyholder tax consequences to the corporation for a transfer of ownership of a disability insurance policy, however, there still may be an employee benefit conferred on the transfer pursuant to paragraph 6(1)(a) of the Act.

The CRA (#9411015, dated July 12, 1994) provided commentary where a policy was being transferred to an employee after the termination of the individual's employment with the result of the discontinuation of coverage under the employer's plan. The policy was part of "grouped" individual disability income insurance policies. In this case, the CRA confirmed that any future benefits received under the policy would not be included in income under 6(1)(f) provided that such benefits were not conditional on coverage under the policy during the period of participation in the employer's plan. However, the former employee would have to include in income at the time of transfer any benefit arising from the transfer of ownership of the policy to him/her. The CRA stated, "...such a benefit would arise where the level of benefits or amount of premium payable for the policy is favourable in relation to that which the individual could purchase separately."

Typically under an ILRP, the premiums and benefits are set at higher amounts than personally owned policies as a method of compensating for the tax payable on the benefits received by the employee. Where upon a transfer of ownership of the policy, the employee retains those higher amounts; there may be an argument that those amounts are "favourable" inviting a taxable employee benefit assessment on transfer.

Similarly, an earlier interpretation letter #9238025 dated February 8, 1993 dealt with the tax implications of converting an employer-paid wage loss replacement plan to an employee-paid plan by way of transferring ownership of the policies to the employee. CRA stated "...the employees would be required to include in income for that year the value of any policy so assigned to the extent that the employer is not reimbursed by the employee." However, if at the time of assignment the policies required no further premiums, CRA would view the group plan to be still in existence and any benefits received by the employee would still be considered to be received pursuant to a plan to which the employer made contributions. As a result, the benefits remain taxable despite the fact that the policy had been assigned to the employee. IT-428 paragraph 21 also confirms this latter tax treatment.

Sales Tax on Group Plans

In the context of grouped individual accident and sickness insurance plans, the employer should also consider the applicability of provincial sales taxes in relation to premiums paid. Generally, in Ontario and Quebec, the existence of a "master policy" determines whether the premiums are group insurance and are subject to provincial sales tax.

Section 1(1) of the Ontario Retail Sales Tax Act defines "group insurance" as "a policy of insurance that covers, under a master policy, the participants of a specified group or other persons." Section 2.1(8)(c) provides that:

Despite this section, no tax is payable on premiums for....contracts of insurance (other than contracts of group insurance or trip cancellation insurance) for the life, health or physical well-being of insured individuals....

A "master policy" is not specifically defined. Therefore, the legal meaning and industry usages are important determinants.

Where individual disability, critical illness or long term care policies are grouped together to form a group sickness or accident insurance plan, the insurer underwrites for each individual and issues and administers individual insurance plans but has no master contract with the employer. There would be no provincial sales tax payable by the insurer. However, the Board resolution that grouped the policies along with their common ownership may qualify the common plan to be a master policy. The employer has both ownership rights and control of the policies. An employer should consider if it has a sales tax obligation. The same consideration should be given where the employer contributes to a health and welfare trust and the trust holds a group of such policies.

Retirement Savings Protection

If the insured is disabled due to accident or sickness, disability policies may offer to pay the monthly benefits into a non-registered annuity contract. The funds may be locked in until age 65, at which time the client can use the benefits to supplement their retirement income. This arrangement is available either as a standalone plan or as a rider on disability insurance plans. Income earned on the deposits to a non-registered fund will be subject to annual accrual tax reporting. Some plans may allow withdrawals from the fund to pay the corresponding annual tax amount. The tax treatment for these benefits is the same as if the benefits were paid to the insured.

Conclusion

The tax treatment of the premiums and benefits under a disability insurance policy depends upon the purpose of the insurance and whether the policy is individually or corporately owned. Under corporate owned policies the tax treatment is dependant on whether the policies are grouped as a "group accident or sickness plan" or as individual corporate policies.

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