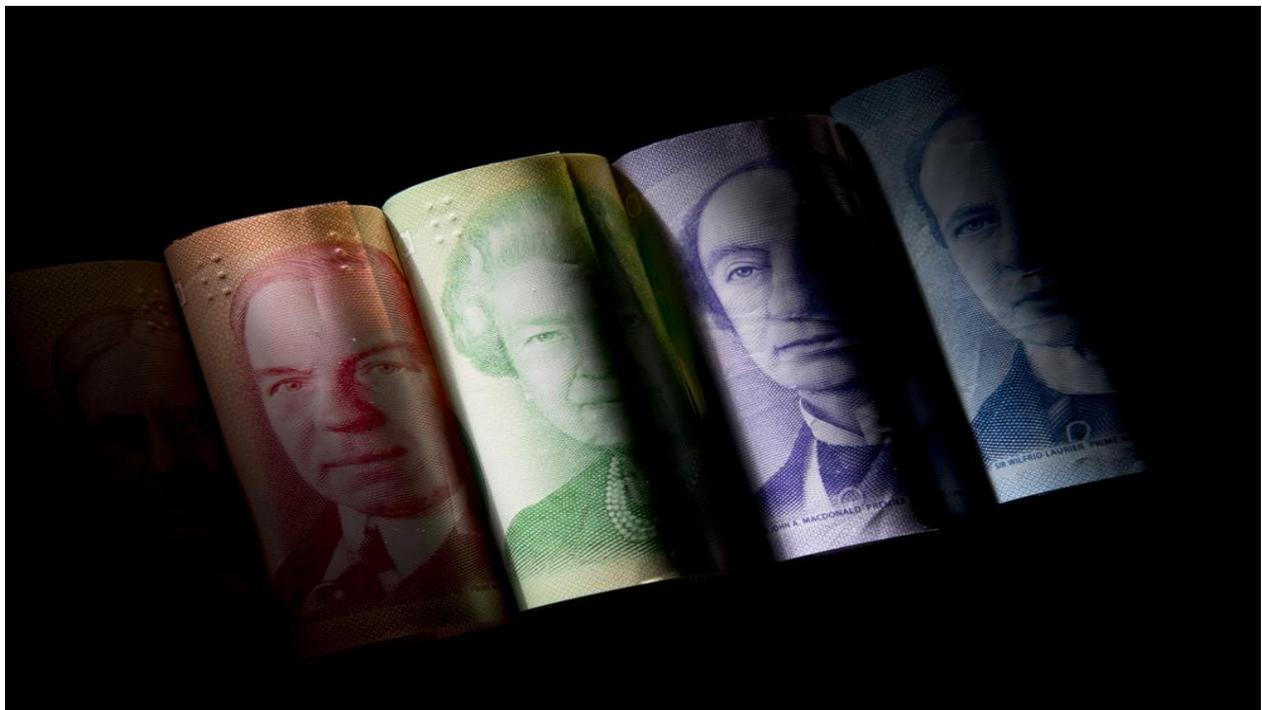


When disability insurance payouts are not actually tax-free

When it comes to benefits received under a disability insurance policy, the tax rules can get a bit murky



The general tax rule is that if you paid the premiums under the disability insurance policy, any periodic disability payments will be tax-free. But, if your employer pays the premiums under the DI policy and does not report them as a taxable employment benefit to you, any benefits received in the future will be fully taxable. *Brent Lewin/Bloomberg Files*



[JAMIE GOLOMBEK](#)

July 6, 2018

1:26 PM EDT

Filed under

[Personal Finance Taxes](#)

One of biggest benefits of life insurance is that the proceeds received by a beneficiary of a life insurance policy upon the death of the life-insured person can

be received by that beneficiary completely tax-free. But when it comes to benefits received under a disability insurance policy, the tax rules can get a bit murky.

Disability insurance (“DI”) is form of insurance coverage that gives you protection to replace income if you become disabled and unable to work. It’s often provided to employees through a group plan, but it can also be bought on its own, which is typically the case with self-employed business owners or professionals.

Should you become disabled, the general tax rule is that if you paid the premiums under the DI policy, any periodic disability payments received from the insurer will be tax-free. On the other hand, if your employer pays the premiums under the DI policy and does not report them as a taxable employment benefit to you, any benefits received in the future under the DI policy will be fully taxable.

A recent tax case, however, shows that what appeared to be tax-free DI benefits to the purchaser of the policy was not seen as tax-free by the Canada Revenue Agency.

The case involved a Sherbrooke, Que., dental surgeon who was reassessed by the taxman for her 2009, 2010 and 2011 taxation years. The CRA added \$88,150 to her 2009 income, \$249,417 to her income in 2010 and \$114,116 to her 2011 income to reflect insurance benefits she received under two disability professional overhead protection policies issued by Great-West Life (GWL) insurance company.

The taxpayer testified that she purchased three separate DI policies from GWL. The first policy, entitled “Professional Overhead Protection,” was issued in 1991 and provided monthly protection of \$3,000 at a monthly premium cost of \$57. The second policy, entitled “Professional Overhead,” was issued in 2007 and provided monthly protection of \$15,000 in exchange for a monthly premium of

\$408. The third policy, entitled “Disability Insurance Plan — Professional,” was issued in 2008 for a monthly premium of \$883 and provided monthly protection of \$8,000.

In court, the taxpayer provided evidence that she had paid the premiums for these three policies out of her personal bank account and that, in all the years, she never deducted the premiums she paid as an expense from her taxable income.

In May 2009, the taxpayer became disabled due to illness, but nevertheless continued to operate her clinic from then through July 2011, using other dentists and paying them 50 per cent of their billed revenues.

She began receiving benefits under her three policies, all of which were deposited into a personal bank account (vs. her clinic’s business account). She did not include them in her professional income for the years in question, believing they were tax-free disability payments.

Following a tax audit, however, the CRA reassessed her and included the disability benefits she received under the two overhead policies in her business income. It did not reassess her for the benefits she received under the third policy since it was a personal DI product whose benefits were not taxable.

The taxpayer’s main argument was that DI premiums are considered personal expenses that cannot be deducted in computing the insured’s income under the Tax Act and therefore any benefits paid under a DI policy cannot be taxable.

At trial, the dentist testified that she believed that the three DI policies purchased from GWL should all be treated similarly as tax-free policies and put into evidence e-mails and letters exchanged with GWL regarding the tax treatment of

its insurance policies, confirming that the benefits paid under these policies are not taxable.

In court, the CRA called a product expert from GWL to testify about the nature of the three policies purchased by the dentist. Unfortunately, the expert testified that GWL had provided the dentist with incorrect information about the tax treatment of the DI benefits.

The CRA's position was that the benefits paid under the two overhead policies were a reimbursement of business expenses that were intended to maintain the operation of the practice for 24 months to allow the dentist to reorganize her business if the disability persisted.

In order for benefits to be paid under the two overhead policies, the practice had to continue to be operated by the insured during the disability period and evidence of overhead costs relating to the operation of the clinic had to be presented to GWL monthly. These benefits are intended to replace the dental clinic's operating expenses that were included in the calculation of the net operating income of the clinic and deducted for tax purposes.

This can be contrasted with the third policy where the benefits were non-taxable because the only condition required for payment was that the insured was disabled. Benefits would continue to be paid as long as the insured's disability lasts, whether or not her practice continued.

The judge referred to the principle of substitution (the "surrogatum principle") in which the Supreme Court, in a seminal 2005 decision, concluded that the tax consequences of DI benefits are established on the basis of what the amount was intended to replace. Under this principle, the tax treatment of DI benefits were intended to replace the general operating expenses of a dental clinic. The

judge concluded that since the source of the insurance benefits is the taxpayer's dental business, the insurance benefits paid to the taxpayer must be included in the calculation of her business income.

As for GWL's role in providing incorrect information, a company spokesperson acknowledged being "aware of the decision.... While we have acknowledged that we provided incorrect information regarding the taxability of the benefits, this information was not provided to the claimant until after she had already made her tax filings. The benefits under the Office Overhead Expense policies are taxable."

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Financial Planning & Advice Group in Toronto.