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# PAYING FOR CRITICAL ILLNESS AND LONG-TERM CARE INSURANCE USING LIFE ANNUITIES

Sean and Julia are married, both aged 45. Their children have grown up and are establishing their own careers. Sean and Julia are relieved to finally have their children's educations behind them so they can focus on getting in better financial shape for retirement. Since neither of them has a defined benefit pension plan, they need to maximize contributions to their registered retirement savings plans and tax-free savings accounts. Fortunately, Sean and Julia now have more free cash flow for that purpose.

Recently though, their friends relayed some disturbing news. The mother of one of Julia's friends just entered a long-term care facility, and the father of one of Sean's friends had a serious heart attack. Sean and Julia were surprised at the cost of long-term care and recovery from a serious health event. They're concerned that a critical illness could disrupt their retirement savings plans, and long-term care may be unaffordable as they age.[1]

## ADDRESSING SEAN AND JULIA'S CONCERNS

Sean and Julia meet with their financial advisor. Although they both worry about the financial risks a critical illness and the need for long-term care present, Sean and Julia don't know which risk they should insure against. Sean thinks buying critical illness insurance (CII) policies is a good idea. If they lose their retirement assets because of a critical illness, there won't be enough money for them to retire on, let alone pay for long-term care. Julia thinks that instead they should be concerned about the long-term care risk. Without long-term care insurance (LTCI), they may not have enough money to care for themselves in advanced old age.

[1] We discuss how a couple could protect their retirement savings from the financial consequences of a critical illness in our case study, "Asset protection using critical illness insurance with the return of premium on cancellation or expiry benefit".

Their advisor suggests they cover both risks, but not at the same time. Their advisor suggests Sean and Julia are more likely to have a critical illness before retiring than they are at risk of needing long-term care. After retirement though, and as they grow older, the likelihood that one or both of them could need long-term care increases.

### THEIR ADVISOR SUGGESTS THE FOLLOWING STRATEGY:

- Buy CII policies with the return of premium on cancellation or expiry (ROPC/E) benefit and with the long-term care conversion option (LTCCO).
- After 15 years, convert part of each CII policy to LTCI, and discontinue the LTCCO benefit. Partial conversions are treated as partial cancellations, triggering payment of some of the ROPC/E benefit:[2]
    - LTCI coverage continues for life, premiums continue for life, or stop while the insured person is on claim.
    - CII premium payments decline, in line with reduced CII coverage and the discontinued LTCCO benefit
- Invest the ROPC/E benefits or buy life annuities to help pay LTCI and reduced CII premiums (this case study assumes the purchase of life annuities).
- When each CII policy expires (at the policy anniversaries nearest to Sean and Julia's 75th birthdays), a final ROPC/E benefit is paid.
- Invest the final ROPC/E benefit, buy life annuities to help pay LTCI premiums and supplement retirement income, or use the ROPC/E benefit to supplement LTCI benefits if necessary.

Sean and Julia could also add the return of premium on death (ROPD) benefit to their CII policies, but this case study does not discuss using this benefit.

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[2] The ROPC/E benefit equals all premiums paid to the date of cancellation or expiry minus any return of premium amount previously paid to the policy owner, any premiums paid for the LTCCO benefit, and any unpaid premiums, including interest.

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## IMPLEMENTING THE STRATEGY

Sean and Julia each buy term to age 75 (T75) CII policies with the LTCCO and ROPC/E benefits. Each policy pays a $250,000 CII benefit if Sean or Julia has a covered critical illness and survives the required survival period.[3] A T75 policy provides CII coverage with guaranteed level premiums until the policy anniversary nearest the insured person's 75th birthday. Coverage expires at that point and cannot be renewed. Sean's premiums are $6,167.50 per year, while Julia's are $5,817.50.[4] Their total premiums are $11,985.00.

If Sean or Julia has a covered critical illness while their CII policy is in force, coverage ends and the base benefit is paid in a tax-free lump sum. A CII policy pays only one benefit, a base benefit if the insured person has a covered critical illness while the policy is in force (and survives the required survival period), or an ROPC/E benefit if the policy owner cancels coverage after 15 years or if coverage expires. The policy will not pay both a CII and an ROPC/E benefit.

## AT THE 15TH POLICY ANNIVERSARY

When Sean and Julia reach their policy anniversaries nearest their 60th birthdays, and as long as they haven't had a covered critical illness (or if only one of them has) they can revisit their strategy. Assuming that they have both remained healthy, and depending on their state of health and retirement assets, they have at least three options:

- **Cancel CII coverage for a return of all returnable premiums**. They may supplement their retirement incomes by investing the ROPC/E benefits for income and growth or by purchasing life annuities with their ROPC/E benefits.

Sean and Julia could choose this option if they hadn't saved enough for retirement or if their investments hadn't performed well. Under this scenario, looking after their basic income needs would

[3] $250,000 is the maximum amount of CII coverage that can be converted to LTCI.

[4] Based on rates in effect on November 15, 2021, for male and female non-smokers, both age 45.

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be more important than protecting their finances from a critical illness or long-term care. While not the most attractive scenario, this option is available if needed.

- **Convert all their CII coverage to LTCI coverage**. Sean and Julia could supplement their retirement incomes and pay their LTCI premium payments by investing the ROPC/E benefits for income and growth or by purchasing life annuities with their ROPC/E benefits.

Sean and Julia could choose this option if their financial circumstances were better than in the first option. Because LTCI premiums after conversion would be lower than CII premiums (based on current rates), this option could still leave them with some retirement income even after paying their LTCI premiums, though they would give up all their CII coverage.

Sean and Julia may convert their CII policies to LTCI in whole or in part, starting from the policy anniversary dates nearest their 60th birthdays, until the policy anniversary dates nearest their 65th birthdays.[5] Full or partial conversions of CII policies are treated as cancellations. Therefore, if the ROPC/E benefit has been added to the policy, a conversion triggers a return of all returnable premiums paid to that date to the extent of the cancellation.

The strategy discussed in this case study assumes that Sean and Julia buy life annuities with their ROPC/E benefits. Under current tax law, their annuities will qualify for prescribed annuity contract (PAC) tax treatment. Part of each annuity payment will be taxable. The taxable amounts won't change throughout their lifetimes. Their annuity incomes will continue even if they claim LTCI benefits.

- **Convert some of their CII coverage to LTCI coverage**. Sean and Julia could pay some of the CII and LTCI premium payments by investing the ROPC/E benefits for income and growth or by purchasing life annuities with the ROPC/E benefits.

[5] The conversion benefit allows the policy owner to convert from CII to LTCI at rates applicable on the date of conversion, without having to provide evidence of insurability, using the insured person's age as of the date of the conversion. The weekly LTCI benefit equals the amount of CII coverage converted divided by 200. The maximum CII benefit that may be converted to LTCI is $250,000.

If Sean and Julia didn't need the ROPC/E benefits to supplement their retirement incomes, they could use those benefits to help pay their CII and LTCI premiums. Under this option, they cover some of the risk of needing long-term care as they grow older, and preserve some of their CII coverage.

## MOVING FORWARD WITH PARTIAL CONVERSIONS & LIFE ANNUITIES

### SEAN AND JULIA CHOOSE THE THIRD OPTION. HERE'S HOW IT LOOKS:

- Sean and Julia receive partial ROPC/E benefits of $41,475.00 (Sean) and $39,506.25 (Julia).[6]
- Their CII coverage falls from $250,000 each to $125,000, while their annual CII premiums fall from $6,167.50 per year to $3,182.50 (Sean), and from $5,817.50 per year to $2,881.25 (Julia).[7] Their total CII premiums are now $6,063.75.
- They each buy a Sun Retirement Health Assist (Sun RHA) LTCI policy with a $625 weekly benefit (the $125,000 CII coverage being cancelled, divided by 200). Coverage takes effect on the latter of five consecutive years from the policy issue date or the fifth policy anniversary following the insured person's 65th birthday. If the insured person meets the requirements for claiming benefits, and after a 365-day survival period, weekly benefits continue for life or for as long as the insured person meets the requirements for claiming benefits. The right to convert from a CII policy to a Sun RHA policy is guaranteed regardless of health, though Sean and Julia's Sun RHA premiums would be set using rates in effect for someone of their age and sex on the conversion date. Annual Sun RHA premiums for policies offering comprehensive benefits would be $1,503.75

[6] Sean's ROPC/E benefit is calculated as the ROPC/E benefit times 1 minus the ratio of the new CII premiums without the LTCCO benefit to the old CII premiums, also without the LTCCO benefit. The new premiums without the LTCCO benefit are $3,182.50, and the old premiums without the LTCCO benefit are $5,947.50. The ratio is calculated as 1 – ($3,182.50/$5,947.50) = 0.46490122. If Sean had completely surrendered his policy the ROPC/E benefit would be $89,212.50. Applying the ratio gives us a partial ROPC/E benefit of $41,475.00 ($89,212.50 X 0.46490122). The same calculation for Julia gives a ratio of 0.4775612 (1 – ($2,881.25/$5,817.50)). Julia's full ROPC/E benefit is $82,725. Applying the ratio to her full benefit gives us a partial ROPC/E benefit of $39,506.25 ($82,725.00 X 0.4775612).

[7] Sean and Julia's continuing CII premiums would be calculated using the same day that their CII policies were issued, but with only a $125,000 CII benefit, not $250,000. The premiums would include a charge for the ROPC/E benefit, but not for the LTCCO benefit, which will have been eliminated.

for Sean and $2,401.25 for Julia.[8] Their total LTCI premium cost is $3,905.00. Combined with their CII premium cost, their total premium payments are $9,968.75.

- Sean and Julia use their ROPC/E benefits to buy life annuities to help pay the Sun RHA and reduced CII premium payments:[9]
    - $1,892.75 per year for Sean ($272.63 is taxable), $1,715.93 per year after tax.
    - $1,703.71 per year for Julia ($267.12 is taxable), $1,556.55 per year after tax.
    - Their total after-tax annuity income is $3,353.57. Their annuity income can be used to offset their total premium payments, bringing their total commitment down from $9,968.75 to $6,615.18.
- After 20 years both annuities are guaranteed to have paid $67,071.45 after tax (assuming a 45% tax bracket), about 80% of the combined initial premiums used to buy both annuities.

To summarize, Sean and Julia add Sun RHA coverage, keep half their CII coverage, and reduce their combined annual out-of-pocket expenditure from $11,985.00 to $6,615.18, just when they need to reduce it most: in retirement.

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[8] Based on rates in effect on November 15, 2021 for male and female non-smokers both age 60, $625 weekly benefit amount is payable for life with a 365-day survival period. The illustrations use current rates, but assume that Sean and Julia are both age 60, and convert part of their CII coverage to LTCI 15 years after they first purchased their CII policies (between the policy anniversaries nearest their 60th and 65th birthdays).

[9] Based on rates in effect on November 15, 2021, for a male and female, both age 60. Annuity payments are payable for life, guaranteed for 20 years. The illustrations use current rates, but assume that Sean and Julia are both age 60, and convert part of their CII coverage to LTCI 15 years after they first purchased their CII policies (between the policy anniversaries nearest their 60th and 65th birthdays).

## AT POLICY ANNIVERSARIES NEAREST SEAN & JULIA'S 75TH BIRTHDAYS

When Sean and Julia reach their policy anniversaries nearest their 75th birthdays, CII coverage will expire. Sean's ROPC/E benefit will be $95,475.00, Julia's will be $86,437.50, for a grand total of $181,912.50.[10]

Sean and Julia could use the ROPC/E benefit to further supplement their retirement incomes or provide additional protection against the financial consequences of needing long-term care. The annuity income they purchased when they were 60, and their Sun RHA premiums and coverage, will continue for the rest of their lives (subject to Sun RHA premiums stopping for the duration of a claim).

If they purchase additional life annuities, Sean and Julia's income pictures will look like this: Sean will receive additional annuity income of $6,366.11 per year, of which $614.60 will be taxable – $6,089.54 after tax. Julia will receive additional annuity income of $5,363.73 per year, of which $338.29 will be taxable - $5,211.50 after tax. Their annuities will also come with 15-year guarantee periods.[11] Their total after tax annuity income will be $11,301.04, plus $3,353.57 from their annuities purchased at age 60, for a total after-tax annuity income of $14,654.61. Their combined LTCI premiums are $3,905.00, for a net after-tax income of $10,749.61. Further, if they need LTC, their annuity income will continue, and their LTCI premiums will stop for the time they are on claim (though LTCI benefits will not start until after a one-year survival period).

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[10] Amounts are equal to the ROPC/E value that remained in the original CII policy (for Sean, $89,212.50-$41,475.00 = $47,737.50) plus returnable premiums paid after conversion ($47,737.50) for a $95,475.00 ROPC/E benefit in total. For Julia the calculation is $82,725.00 - $39,506.25 = $43,218.75, plus returnable premiums after conversion, $43,218.75, for an $86,437.50 ROPC/E benefit. Total ROPC/E benefits equal $181,912.50.

[11] Based on rates in effect on November 15, 2021 for a male and female, each age 75. Annuity payments are payable for life, guaranteed for 15 years. The guarantee period is only 15 years because a non-registered prescribed annuity contract cannot have a guarantee period that extends past the annuitant's age 90.

## HOW IT WORKS

Sean → Premiums → CII policy → ROP benefit → Sean → Premium → Life annuity → Annuity income → Sean

Sean → Premiums → Reduced CII policy → ROP benefit paid at age 75 → Sean

Sean → Premiums → Sun RHA policy

Sean → Tax → CRA

For clarity, only Sean's policies are shown. Julia's experience with this case study will parallel Sean's.

Sean pays premiums for CII policies with the LOIE, LTCCO and ROPC/E benefit.

At the 15th policy anniversary, partial ROPC/E benefit is paid, half of Sean's CII policy is converted to LTCI.

ROPC/E benefit used to buy a life annuity.

After-tax life annuity income helps pay CII and Sun RHA premium payments.

At the policy anniversary nearest to Sean's 75th birthday, CII coverage ends and CII ROPC/E benefit is paid. Sean's annuity income continues for life.

Sean pays Sun RHA premiums for the rest of his life (or until he needs Sun RHA and begins receiving Sun RHA policy benefits).

## AN ALTERNATE, COST SAVINGS STRATEGY:

## BUY CII & SUN RHA TODAY WITH NO OPTIONAL BENEFITS

Sean and Julia have only one concern with their advisor's strategy: it's expensive during the years leading up to retirement. What if they bought the same coverage they intend to have from age 60, but buy it now, minus the optional benefits? Sean's annual CII and Sun RHA premiums would be $2,150.00 and $567.50, while Julia's would be $1,883.75 and $874.38.[12] For the first 15 years of this strategy, their premium expenses would fall from $11,985.00 to $5,475.63. They'd save $97,640.55 in premiums over 15 years.

During the 15 years from their ages 45 to 60 this alternate strategy would provide only half the CII coverage that Sean and Julia would have had, but they would gain Sun RHA coverage not previously included.

The premium savings would continue for the next 15 years after age 60. Sean will save $2,980.25 over that time period, while Julia will save $14,112.96, $17,093.21 combined over that 15-year period, and $114,733.76 in total savings from the time they first started coverage at age 45 until they reach aged 75 and their CII policies expired.

From age 75 on, the situation changes. Under their advisor's strategy Sean and Julia's after-tax annuity incomes total $14,654.61 per year. Subtracting their LTCI premiums ($3,905.00 combined), they have net annuity income of $10,749.61 per year after tax. Under the alternate strategy, their LTCI premiums continue ($1,441.88 combined). This puts their advisor's strategy $12,191.49 per year ahead of the alternate strategy from age 75 on.

Their advisor's strategy costs more than the alternate strategy until age 75, and only produces more money in total for Sean and Julia if they each live to age 85 without having a covered critical illness or needing long-term care, and then only if they don't consider the time value of their money. From this

[12] Based on rates effective November 15, 2021 for male and female non-smokers age 45. Each would have a $125,000 T75 CII policy with no optional benefits, and a Sun RHA policy with a $625 weekly benefit, payable for life with a 365-day survival period.

perspective, their advisor's strategy seems expensive. But there are other issues that Sean and Julia should consider when deciding which strategy to pursue:

- **The ROPC/E benefit provides a recovery of premiums**. Using the alternate strategy, Sean and Julia save $165,037.35 in total premiums, but under their advisor's strategy they get back $353,850 in total when they convert half their CII policies to LTCI, and when their CII policies expire.
- **The ROPC/E benefits can provide cash when Sean and Julia need it**. Sean and Julia receive their final ROPC/E benefits near their 75th birthdays, and can use those benefits to help pay for long-term care or supplement their retirement incomes. If they need long-term care before their 75th birthdays (and if their CII policies have been in force for at least 15 years), they may cancel their CII coverage for a reduced ROPC/E benefit. In contrast, the $116,037.35 saved under the alternate strategy will be realized over an almost 30-year period, and won't be paid to them: it represents only the premium difference between two strategies.
- **Annuity income continues**. Under their advisor's strategy, if Sean and Julia reach age 75 without having a critical illness, or if they cancel CII coverage between age 60 and 75, their CII coverage will end but their Sun RHA coverage and premiums will continue. Under their advisor's strategy they could use their ROPC/E benefits to buy life annuities that will help pay those premiums. What's more, if they need long-term care, their annuity income could supplement their Sun RHA benefits.

## TAX AND LEGAL ISSUES

The Income Tax Act[13] (ITA) does not specifically discuss health insurance policies, and the Canada Revenue Agency (CRA) has offered little guidance on their taxation. What follows is a general discussion. Further details on the tax treatment of health insurance policies are available in the Canadian Health Insurance Tax Guide:[14]

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[13] Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.
[14] Available at www.sunlife.ca/advisor/HealthTaxGuide.

- **Premiums paid by individuals for their own or their family's coverage are not deductible**. The ITA defines insurance premiums as "personal or living expenses" if the proceeds of the policy or contract are paid to or for the benefit of the taxpayer or to a person connected with the taxpayer by blood relationship, marriage or common-law partnership, or adoption.[15] Personal or living expenses are not deductible.[16]
- **The CII and LTCI base benefits are paid tax-free**. If a CII or LTCI policy meets the definition of health insurance under provincial or territorial law, the CRA treats it as a sickness or accident insurance policy (SAIP). Most CII and income style LTCI policies sold in Canada meet the provincial and territorial definitions of health insurance. Reimbursement LTCI policies (policies that reimburse the policy owner for covered long-term care costs) may also meet the definition of a private health services plan (PHSP). PHSP benefits are paid tax-free. According to CRA guidance, the base benefits from a CII or LTCI policy (income or reimbursement) are paid tax-free.[17]
- **The ROPC/E benefit is paid tax-free**. The CRA has said that a return of premium at cancellation or expiry (ROPC/E) benefit from a CII policy is tax-free when none of the premiums paid (including the premiums paid for the ROPC/E benefit) have been deducted, and represent no more than the total premiums paid.[18] The CRA's guidance considered policies owned by one person or entity.
- **Medical expenses may be claimed even if paid from tax-free insurance benefits**. If the insured person has a covered critical illness or needs long-term care, and uses the CII or income style LTCI benefit to pay hospital, medical, and/or nursing home expenses, the policy owner may

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[15] ITA subsection 248(1). See paragraph (b) of the definition, "personal or living expenses".
[16] ITA paragraph 18(1)(h).
[17] There are no sections in the ITA that tax CII benefits. The CRA has said that a CII policy should be viewed as a "sickness" policy, and that the disposition (i.e. payment of the base benefit) from a CII policy is not taxable: CRA Document 2003-0004265, June 18, 2003. See also CRA Document 2003-0054571E5, December 24, 2004. Regarding LTCI, see CRA Document 2003-0048461E5, March 5, 2004. The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the Income Tax Act and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.
[18] CRA Documents 2002-0117495 and 2003-0054571E5, March 4, 2002 and December 24, 2004. CRA Document 2002-00117495 discussed a disability income insurance plan, but the CRA's comments should also apply to CII policies.

be able to count those expenses towards a claim for the Medical Expense Tax Credit (METC). It will not matter that the source of the money used to pay those expenses was a tax-free insurance benefit. Note: any expenses for which the policy owner received benefits from a reimbursement style LTCI policy may not be used as part of a claim for the METC (except any unreimbursed part of the expense, such as deductibles, co-payments, and claims over the policy limits.

- **You may not count CII or income style LTCI premiums towards a claim for the METC.** According to CRA guidance, one of the requirements for counting insurance premiums towards a claim for the METC under ITA paragraph 118.2(2)(q) is that all or substantially all of the benefits paid under the policy relate to medical expenses that are eligible for the METC (the CRA defines "all or substantially all" to mean at least 90%).[19] Because CII policies pay benefits with no restriction on how you may use them, the benefits do not relate to medical expenses, and the premiums do not count towards a claim for the METC.[20] See our article, "The Medical Expense Tax Credit" for more details.
- **It's not certain whether converting a CII policy to LTCI is tax-free.** The issue is not discussed in the ITA, and the CRA has not provided any guidance. In guidance dealing with the fair market value (FMV) of life insurance policies, the CRA said that "conversion privileges" were among the elements that contributed to a life insurance policy's FMV, but did not say whether the exercise of such a privilege produced any tax consequences.[21]
- **Non-registered PAC annuity payments are partly taxable.** Under ITA paragraph 56(1)(d) non-registered annuity payments are included in income (subject to certain exceptions that do not apply to this case study), but the capital element of each annuity payment is deducted from income under ITA paragraph 60(a)(i). The capital element is calculated under Income Tax Regulation (ITR) section 300 as the amount of each annuity payment representing a return of the policy owner's capital over the term of the contract (life expectancy in the case of life annuities).

[19] CRA Document 2015-0610751C6, November 24, 2015. See additional CRA commentary at www.cra-arc.gc.ca/whtsnw/tms/phsp-rpam-eng.html.
[20] CRA Document 9711505, June 2, 1997.
[21] Information Circular IC 89-3, August 25, 1989.

## CONCLUSION

Sean and Julia each decide to buy CII policies with the LTCCO and ROPC/E benefits. They are optimistic that in 15 years their personal and financial health will be good. If so, they intend to convert part of their CII policies to Sun RHA policies and use the ROPC/E benefits to buy life annuities. The after-tax life annuity income could help pay their CII and Sun RHA premiums, and would continue even if they needed to claim against their insurance policies. CII coverage lasts only until the policy anniversaries nearest to Sean and Julia's 75th birthdays. But after15 years, and if there have been no CII claims, each policy pays an ROPC/E benefit on expiry of coverage that can further help with retirement or long-term care expenses.

Even if their financial health were poor in 15 years, Sean and Julia could still use their ROPC/E benefits to augment their retirement incomes. They would however, have to limit or give up their insurance coverage. Regardless of how Sean and Julia reach retirement, the main benefit from this strategy is the flexibility that's gained to meet the couple's needs for retirement income and health insurance protection according to their financial circumstances at different stages in life.

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