

## **INCOME TAX CONSIDERATIONS IN LONG TERM DISABILITY CASES**

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### **I. INTRODUCTION**

This paper will examine some of the income tax implications to be taken into account in advising disability insurance clients. It will not attempt to provide an in-depth analysis of the provisions of the *Income Tax Act*<sup>1</sup> but, rather, an overview of various tax provisions, interpretation bulletins and case law relevant to counsel involved in long term disability insurance disputes.

As a result of the growth of the market share of disability policies, disability insurance litigation, which was far less common twenty years ago, is now common place. The tax treatment of amounts paid either as a result of a court order or as a result of settlement in a disability insurance dispute is an area that, until recently, has been widely ignored. Academic legal literature and practitioner papers that treat the legal aspects of long term disability insurance resist the need to address income tax implications in a way other than peripherally.<sup>2</sup> Many lawyers who now represent claimants in disability insurance disputes have little knowledge of the income tax implications on the advice they are giving.

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<sup>1</sup> *Canada Income Tax Act*, R.S.C. 1985, c. 1 (5<sup>th</sup> Supp.) [hereinafter referred to as ITA].

<sup>2</sup> See W.E. Crawford, "Life and Disability Insurance Products" Tax Planning For Executive And Employee Compensation And Retirement (Toronto: Canadian Tax Foundation 1985).

At the conclusion of the litigation, the tax treatment of whatever outcome arises from the disability insurance dispute will have a significant impact on the claimant. Claimants in a disability insurance dispute need to know at a minimum when there might be a tax problem. As such, counsel who represent claimants in disability insurance disputes need to appreciate the tax consequences of the various proposals and alternatives they are suggesting to their clients.

## **II. JUDICIAL AND LEGISLATIVE CONSIDERATIONS**

The jurisprudence on the taxation of disability insurance benefits and disability insurance settlements can primarily be found in cases before the Tax Court of Canada.

The Tax Court of Canada has no general equitable jurisdiction. The court is purely a statutory creation and its jurisdiction is confined to what is expressly conferred on it by Parliament. The court will not consider whether the assessment produces an “unfair” result for an appellant but; rather, the correctness of the assessment in law.<sup>3</sup>

While taxing statutes are interpreted by the court in the same manner as other statutes, the court has moved away from a strict and literal approach of statutory interpretation. The strict and literal approach has been set aside in favour of the plain meaning rule which is applied purposively. The court will now look at the purpose of a provision and try to determine the plain meaning of the provision in light of that purpose. The court will look at the ITA in terms of its object, spirit and structural context.<sup>4</sup>

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<sup>3</sup> Nelson v. R., [1996] 2 C.T.C. 2665D (T.C.C.).

<sup>4</sup> See Stubar Investment Ltd. v. The Queen, [1984] 1 S.C.R. 536; Jastrebski v. R., [1994] 3 F.C. 466 (Fed. C.A.); V. Krishna, “The Scope of Employment Benefits” (1994) 4 Can. Curr. Tax C 55 at C57.

## Relevant Statutory Provisions

Disability insurance policies are classified either under Part V, Life Insurance, or Part VII, Accident and Sickness Insurance, of the *Insurance Act, R.S.O. 1990, c. I.8*. For taxation purposes paragraphs 6(1)(a) and 6(1)(f) of the ITA, treat these forms of policies.<sup>5</sup>

According to paragraphs 6(1)(a) and 6(1)(f) of the ITA:

6(1) There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable:

- (a) the value of board, lodging and other benefits of any kind whatever received or enjoyed by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment, except any benefit
  - (i) derived from the contribution of the taxpayer's employer to or under a registered pension plan, group sickness or accident insurance plan, private health services plan, supplementary unemployment benefit plan, deferred profit sharing plan or group term life insurance policy,
  - (ii) under a retirement compensation arrangement, an employee benefit plan or an employee trust,
  - (iii) that was a benefit in respect of the use of an automobile,
  - (iv) derived from counselling services in respect of
    - (A) the mental or physical health of the taxpayer or an individual related to the taxpayer, other than a benefit attributable to an outlay or expense to which paragraph 18(1)(l) applies, or
    - (B) the re-employment or retirement of the taxpayer, or
  - (v) under a salary deferral arrangement, except to the extent that the benefit is included under this paragraph because of subsection (11);
- ...
- (f) the aggregate of amounts received by him in the year that were payable to him on a periodic basis in respect of the loss of all or any part of his income from an office or employment, pursuant to
  - (i) a sickness or accident insurance plan,
  - (ii) a disability insurance plan, or
  - (iii) an income maintenance insurance plan to or under which his employer has made a contribution, not exceeding the amount, if any, by which
  - (iv) the aggregate of all such amounts received by him pursuant to the plan before the end of the year and
    - (A) where there was a preceding taxation year ending after 1971 in which any such amount was, by virtue of this paragraph, included in computing his income, after the last such year, and
    - (B) in any other case, after 1971,

<sup>5</sup> Paragraph 148 of the *Canada Income Tax Act, R.S.C. 1985, c. 1 (5<sup>th</sup> Supp.)* addresses life insurance policies under the Act. Disposition under paragraph 148 does not include a payment under a policy as a disability benefit or as an accident death benefit.

- (v) the aggregate of the contributions made by the taxpayer under the plan before the end of the year and
  - (A) where there was a preceding taxation year described in subparagraph (iv), after the last such year, and
  - (B) in any other case, after 1967;

The case law on taxation of disability insurance benefits and disability insurance settlements primarily consider the meaning and scope of paragraphs 6(1)(a) and 6(1)(f) of the ITA.

### **Interpretation Bulletins**

Interpretation Bulletins represent the opinion of Canada Customs and Revenue Agency and do not bind the Minister, the taxpayer or the courts.<sup>6</sup> As well, the Minister is not bound by his previous assessments, by his previous policy statements, by the representations of his officers and employees, or by the treatment which he may have accorded other taxpayers.<sup>7</sup> Nevertheless, the Interpretation Bulletins can be used as evidence by the appellant to establish that the interpretation in question is correct where there is some doubt that exists in the Court's mind as to the interpretation of legislation.

As Judge Decary noted in *Vaillancourt v. R.*:

It is well settled that the Interpretation Bulletins only represent the opinion of the Department of National Revenue, do not bind either the Minister, the taxpayer or the courts...

Having said that, I note that the courts are having increasing recourse to such Bulletins and they appear quite willing to see an ambiguity in the statute—as a reason for using them—when the interpretation given in a Bulletin squarely contradicts the interpretation suggested by the Department in a given case or allows the interpretation put forward by the taxpayer. When the taxpayer engages in business activity in response to an expressed inducement by the Government and the legality of that activity is confirmed in an Interpretation

<sup>6</sup> *Knox (J.N.) v. Canada*, [1994] 2 C.T.C. 2125 (T.C.C.); *Ludcoe Enterprises Ltd. v. Canada*, [1994] 1 C.T.C. 368, (F.C.T.D.) at par. 21-24.

<sup>7</sup> *Ludcoe*, *supra*, footnote 6.

Bulletin, it is only fair to seek the meaning of the legislation in question in that bulletin also.<sup>8</sup>

In April 1979, Revenue Canada issued Interpretation Bulletin IT-428, which provides a detailed explanation and interpretation of paragraphs 6(1)(a) and 6(1)(f) of the ITA. Other relevant IT Bulletin's are: IT-54 Wage Loss Replacement Plans, IT-85R2 Health and Welfare Trusts For Employees, IT-99R5 Legal and Accounting Fees, IT-223 Overhead Expense Insurance vs. Income Insurance, IT-502 Employee Benefit Plans and Employee Trusts, IT-502SR Employee Benefit Plans and Employee Trusts, and IT-529 Flexible Employee Benefit Programs.<sup>9</sup>

### **III. TAXATION OF DISABILITY INSURANCE BENEFITS**

Where an individual policy is purchased by an insured, benefits under the individual policy are not generally subject to tax. When paid by the individual, disability income premiums are not tax deductible. Furthermore, in a group policy where the employer collects premiums out of the employee's wages and remits them to the insurer, benefits are not considered income and are not subject to tax since the entire cost is borne by the employee.

Amounts received as disability income by an employee under a typical long term disability plan to which the employer contributed are taxable as income provided two criteria are met.

<sup>8</sup> *Vaillancourt v. R., (sub nom. Vaillancourt v. The Queen)(sub nom. Vaillancourt v. Canada)*, [1991] 2 C.T.C. 42, 91 D.T.C. 5352 (Fr) at 48 and also referred to in *Ludco, supra*, footnote 6.

<sup>9</sup> These bulletins can be found on the Canada Customs and Revenue Agency web site at [www.ccr-aadrc.gc.ca/menu/EmenuKLA.html](http://www.ccr-aadrc.gc.ca/menu/EmenuKLA.html).

Firstly, where the taxpayer's employer has paid all or part of the premiums, the full amount of any benefit is taxable. Since the premiums are split between the employer and the employee, the employee is entitled to get a deduction on the monies received up to the total amount of premiums that he or she may have paid.<sup>10</sup> In *Schuett v. Minister of National Revenue*,<sup>11</sup> the appellant contended that because he had paid 50% of the premiums, only 50% of the benefits should be included in income. The court held it was the intention of Parliament that any contribution by the employer had the effect of "contaminating" the plan. As such once it is found that the employer has made a contribution, the portion in which contributions are made by the employer and employee cease to have relevance. All benefits from it are to be included in income, subject to the limitation provided in subparagraphs 6(1) (f)(iv) and (v) of the ITA.<sup>12</sup>

Payments made by an employer pursuant to a collective agreement might be regarded as having been, in fact, paid by the employee if the latter had foregone higher wages or other benefits. There must be evidence that there were trade-offs in the collective bargaining process and that higher wages or other benefits were forgone in favour of the disability benefits so that the payments would not fall within the provisions of paragraph 6(1)(f) of the ITA.<sup>13</sup> In *Dagenais v. R.*,<sup>14</sup> Judge Rosuleau of the Federal Court considered the reasoning outlined in *Schuett v. Minister of National Revenue* and held that it was incumbent on the plaintiffs, employees of Boise Cascade Canada Ltd. and all

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<sup>10</sup> *Desjardines v. R.* 1998 CarswellNat 1785, [1998] 4 C.T.C. 2688 (T.C.C.) at par. 7.

<sup>11</sup> *Schuett v. Minister of National Revenue*, [1980] C.T.C. 2185, 80 D.T.C. 1168

<sup>12</sup> *Ibid.* at par. 4.

<sup>13</sup> *Cunningham v. Wheeler* (1994), 113 D.L.R. (4<sup>th</sup>) 1 (S.C.C.) at 15.

<sup>14</sup> *Dagenais v. R.*, [1995] 2 C.T.C. 100, 95 D.T.C. (F.C. T.D.)

members of a trade union, to establish that the benefit package in question was an employee-pay-all and that they paid for the entire cost.<sup>15</sup>

Secondly, in order for the disability insurance benefits to be treated as taxable the amount must be payable on a periodic basis as compensation for loss of employment income and it must be paid pursuant to a “plan” toward which an employer has made contributions. So long as the contract or agreement calls for payments to be made on a periodic basis, the periodic character of the payments is not changed by the fact that the payment were not paid on time.<sup>16</sup> Where disability benefits are to be paid monthly but in fact are paid on irregular intervals and for varying amounts, the amount will be treated as “on a periodic basis” as required by paragraph 6(1)(f) of the ITA. The court will treat the question not when or how the disability benefits were paid but rather when or how they were payable.<sup>17</sup> It is the year in which the claimant receives the amount and not in the year that the amounts became payable that such amount must be included in the calculation of income.<sup>18</sup>

### **Characterization Of The Payments**

Payments made under a sickness, disability and rehabilitation plan to employees who become disabled will not be treated as pension payments or pension benefits for the purposes of entitlement to a credit against tax in respect of pension income.<sup>19</sup> Moreover, where a government employer pays the wage loss insurance benefits and the disability insurer administers the plan, the wage loss insurance benefits are not compensation

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<sup>15</sup> *Ibid.* at par. 20-23. See also *Pugh v. R.*, [2000] 4 C.T.C. 2391 (T.C.C.); *Leonard v. R.*, [1996] 3 C.T.C. (F.C.T.D.).

<sup>16</sup> *Sills v. Minister of National Revenue*, [1985] 1 C.T.C. 49, (Fed. C.A.).

<sup>17</sup> *Ouimet v. Minister of National Revenue*, [1979] C.T.C. 2172, 79 D.T.C. 16. See also *Marchand c. Ministre due Revenu national*, [1987] 2 C.T.C. 2309, 87 D.T.C. 630 (T.C.C.)

<sup>18</sup> *R.D. Jesshope v. Canada*, [1995] 1 C.T.C. 2833 (T.C.C.).

<sup>19</sup> *Morin v. R.* 1991 CarswellNat 640 [1991] 2 CTC 2645, 92 DTC 1069 at par. 6&7.

paid under a federal or provincial worker's compensation law. One court has held that the appellant in these circumstances must include the wage loss insurance benefits in calculating the appellant's income under paragraph 6(1)(f) of the ITA.<sup>20</sup> More recently, another court has held that disability payments received directly from an employer constitute income from employment pursuant to paragraph 6(1)(a) of the ITA.<sup>21</sup>

### **Charter Considerations**

The ITA has provisions that make distinctions and differences among people subject to it. The Tax Court of Canada has consistently held that the taxpayers Charter rights are not violated by paragraph 6(1)(f) of the ITA. In *Morin v. R.*, the appellant's main contention was that disability payments received from Sun Life Assurance Company are not taxable because other types of compensation benefits are not taxable. The appellant argued that the taxation under paragraph 6(1)(f) of the ITA would constitute unequal treatment and would thereby contravene the Charter. Judge Bowman did not accept the argument and held that the ITA deals with a multiplicity of types of income and accords different types of treatment to them. He stated:

The fact that the recipient of one type of income is treated differently from the recipient of another type of income that may bear some resemblance to the former does not in itself give rise to a remedy under the Charter. I do not imply that the Charter may not possibly have some application if, for example, a particular class of taxpayers were unfairly discriminated against. This is not however this case.<sup>22</sup>

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<sup>20</sup> *Gingras v. R.* 1996 CarswellNat 2752, 16 C.C.P.B. 69, (sub nom. *Gingras v. R.*) [1998] 2 C.T.C. 2557 (T.C.C.) at par. 10 & 16.

<sup>21</sup> *Suchon v. R.* 2001 CarswellNat 2261 (T.C.C.).

<sup>22</sup> *Morin v. R.* 1991 CarswellNat 640 (T.C.C.) at par. 9.

As such, for there to be a Charter violation the provisions in the ITA must have the effect of treating an individual, or group of individuals, to their disadvantage on the basis of one or more of the personal characteristics enumerated in section 15 of the Charter.<sup>23</sup>

### **Benefits Received By Way Of Lump Sum Damages**

A lump sum award will be treated as taxable where the taxable disability benefits are received pursuant to a court order. In *Desjardines v. R.*,<sup>24</sup> the appellant sued Great West Life Assurance Company and after a trial the court awarded judgment to the appellant against Great West Life Assurance Company in the amount of \$96,637.46 inclusive of interest. The court also ordered that the appellant have a declaration that he suffered total disability within the meaning of the Group Long Term Disability Income Assurance Policy and that Great West Life Assurance Company forthwith resume paying the monthly benefit amount to the appellant in accordance with the provisions of the policy. Judge Teskey of the Tax Court of Canada concluded that the \$98,859.06 was a calculation of the legitimate claim that the appellant had from the date that Great West Life Assurance Company stopped paying to the date of trial. As he stated:

General damages or damages out of a lawsuit have to be looked at as to how they are calculated and what is the purpose. Obviously general damages for pain and suffering are not taxable. But where the reasons of the trial judge the lump sum general damages are calculated to exactly recompense the Plaintiff therein for what should have been paid to him previously and which would have been income, then the lump sum damages do not magically take on the veil of being non taxable income. So that herein the lump sum damages are income.<sup>25</sup>

Moreover, where the claimant sues the disability insurer for an income stream, the legal expenses are deductible.<sup>26</sup>

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<sup>23</sup> *Getty v. R.* 1999 CarswellNat 2624, 2000 D.T.C. 1597 (T.C.C.) at par. 11.

<sup>24</sup> *Desjardines v. R.* 1998 CarswellNat 1785, [1998] 4 C.T.C. 2688 (T.C.C.).

<sup>25</sup> *Ibid.* at par. 6.

<sup>26</sup> *Ibid.* at par. 17.

## **Withholdings**

Paragraph 6(1)(f) benefits are within the meaning of “salary or wages” as defined in paragraph 248(1) of the ITA. Such benefits are also within the meaning of “remuneration”, by specific definition, under section 100(1) of the Income Tax Regulations and thus subject to withholdings under paragraph 153(1) of the ITA.<sup>27</sup>

## **Cases Affected By ITAR s. 19(1)**

Special provisions apply to benefits which are paid pursuant to plans created before 1971 so long as the event giving rise to the disability occurred before January 1, 1974.

Subsection 19(1) of the Income Tax Application Rules (ITAR) reads as follows:

19. Income maintenance payments.

(1) Notwithstanding section 9, paragraph 6(1)(f) of the amended Act is not applicable in respect of amounts received by a taxpayer in a taxation year that were payable to him in respect of the loss, in consequence of an event occurring before 1974, of all or any part of his income from an office or employment, pursuant to a plan described in that paragraph that was established before June 19, 1971.

Cases affected by Income Tax Application Rules, s. 19(1) commonly deal with the interpretation and scope of the exception. The Federal Court of Appeal in *Jastresbski v. R.*,<sup>28</sup> found that the disability and the loss of income must both occur before 1974 in order for the exemption provided in ITAR section 19 to apply.<sup>29</sup>

The Tax Court of Canada has also held that a medical condition does not apply to ITAR section 19 as opposed to an occurrence which adversely affects health and/or physical capacity for work, to the degree that loss of employment results. The court was of the

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<sup>27</sup> See Canada Customs and Revenue Agency, Technical Interpretation, Business and Publications Division, “6232 Withholding-Wage Loss Replacement Plan” (22 February 2000).

<sup>28</sup> *Jastresbski v. R.*, [1994] 3 F.C. 466 (Fed. C.A.).

<sup>29</sup> *Ibid.*; see also *Getty v. R.*, [2000] D.T.C. 1597 (T.C.C.).

view that to interpret s. 19(1) as encompassing a medical condition would result in an unacceptable width of the meaning of Subsection 19(1).<sup>30</sup>

### **The Effect Of Off-Sets**

Disability insurance contracts usually include clauses providing for the deduction from a claimant's benefits of any payment received under plans such as government disability programs. Insurers commonly request their claimants to apply for Canada Pension Plan disability benefits.<sup>31</sup> Where a claimant receives Canada Pension Plan disability benefits by way of a lump sum and periodic benefits, they are required to reimburse the insurer for amounts paid in lieu of Canada Pension Plan disability benefits. Where the claimant becomes entitled to Canada Pension Plan disability benefits, the monthly periodic disability insurance benefit will be reduced.<sup>32</sup>

Paragraph 56(1) of the ITA requires the taxpayer to include in income his or her benefits under the Canada Pension Plan Act. Where the claimant receives a Canada Pension Plan lump sum disability payment to compensate for Canada Pension Plan disability benefits not received earlier, the claimant is entitled to a special tax calculation which takes into account sections 120.3 and 56(8) of the ITA. As such, even though the disability insurance plan may not be subject to tax, the Canada Pension Plan disability benefit off set will reduce the disability insurers liability and will be treated as subject to tax.<sup>33</sup>

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<sup>30</sup> *Gabrielle v. Minister of National Revenue*, [1984] C.T.C. 2722, 84 D.T.C. 1635.

<sup>31</sup> Canada Pension Plan R.S.C. 1985 L.C-8 as amended.

<sup>32</sup> See D. Schulze, "The Industry Of The Living Dead: A Critical Look at Disability Insurance" (1993) 9 *Journal of Law and Social Policy* 192.

<sup>33</sup> See *Plan v. R.*, [1998] 3 C.T.C. 2353 (T.C.C.) and *Reimann v. R.*, [1995] 1 C.T.C. 2334, 95 D.T.C. 649 (T.C.C.).

#### **IV. TAXATION OF A DISABILITY INSURANCE SETTLEMENT**

Where the claimant has paid all of the premiums and as such the disability benefit is non taxable, any lump sum settlement will not be subject to tax. Where the disability benefit is a taxable benefit, the insurer may or may not issue a T-4A for the lump sum settlement. Where the insurer issues a T-4A, retroactive lump settlement funds may be distributed over the past and present benefit years at issue in order to reduce the tax payable. In order to distribute the lump sum settlement over the past and present benefit years at issue, the cooperation of the insurer is required. As such, as a condition of settlement, counsel for the claimant can insist that the insurer complete, on behalf of the claimant, the Statement Of Qualifying Retroactive Lump-Sum Payment form called a T1198.

#### **Reinstatement Of Benefits**

Where a lump sum settlement represents the total amount payable, on a periodic basis, with respect to loss of income from employment pursuant to an insurance plan to or under which the employer made a contribution, the disability benefits will be taxable pursuant to paragraph 6(1)(f) of the ITA. In *Dragovich v. R.*,<sup>34</sup> the appellant commenced an action on August 11, 1989, against Sun Life Assurance Company for an order directing payment to him of disability payments owing, past, present and future; general and special damages; damages for breach of contract; punitive damages and costs. Sun Life Assurance Company settled the lawsuit by agreeing to pay \$15,561.46 to the appellant. This amount represented the reinstatement of benefits from June 1, 1988, through May 31, 1989. Sun Life Assurance Company also granted a waiver to the appellant of all its subrogation rights against him. The Minister assessed the appellant

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<sup>34</sup> *Dragovich v. R.* 1993 CarswellNat 1031, [1993] 2 C.T.C. 2396.

for the 1989 taxation year on the basis that the amount of \$15,561.46 should have been included in the appellant's income in accordance with the provisions of paragraph 6(1)(f) of the ITA. The appellant submitted to the court that the payments of \$15,561.46 was not merely income replacement but included the other heads of damage claimed and particularly reflected the waiver of subrogation.

Judge Sarchuk dismissed the appeal and concluded that the payment must be categorized as a reinstatement of benefits. As it was not a lump sum payment for impairment of the appellants earning capacity or compensation for loss of expected future income, the payment represented the total amounts that were payable to him on a periodic basis. The characterization as a disability benefit payment did not change because it was paid in a lump sum form. Furthermore, the fact that the insurer released its subrogation rights did not change the nature or characterization of the payment.<sup>35</sup>

### **Lump Sum Settlement Of Past And Future Benefits**

The tax treatment of amounts paid in a lump sum disability insurance settlement requires clarity by the Federal Court of Canada. There are now several conflicting cases in the Tax Court of Canada on this subject. Judge Taylor, as early as 1987 in a decision called *Peel v. Minister of National Revenue*,<sup>36</sup> first addressed the tax treatment of a disability lump sum settlement. At that time, he noted that there was no clearly defined pathway in either the legislation or the case law for one to follow in search of a solution.<sup>37</sup> Since Judge Taylor made those comments, there have been several cases in the Tax Court of Canada on this subject but the law still remains unclear.

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<sup>35</sup> *Dragovich v. R.* 1993 CarswellNat 1031, [1993] 2 C.T.C. 2396 at par. 11.

<sup>36</sup> *Peel v. Minister of National Revenue* 1987 CarswellNat 415, [1987] 1 C.T.C. 2373 (T.C.C.).

<sup>37</sup> *Ibid.* at par. 19.

In *Peel v. Minister of National Revenue*, the appellant settled a litigated claim against their disability insurer, Constellation Life Assurance Company of Canada. The insurer paid a lump sum payment of \$90,000.00 to the appellant as the insurer's final and full liability under the insurance policy plus \$8000.00 on account of the appellant's legal costs. The Minister assessed the lump-sum payment as income received in the 1983 tax year.<sup>38</sup>

Judge Taylor allowed the appeal. He contended that the issue was not governed by paragraph 6(1)(f) of the ITA because the benefit was not payable "on a periodic basis" and was not paid "pursuant to" the insurance plan. Secondly, it was exempt from inclusion under paragraph 6(1)(a) of the ITA as there was no connection with a contract of employment. The court was not prepared to find that the fact that the appellant could sue to obtain his "rights" under the insurance contract constituted a "benefit" which should be included "in respect of" his employment contract. The court held that the fact that the former employer allowed the appellant to exercise his rights to sue the insurer should not be considered a "taxable benefit" emanating from that employer.<sup>39</sup>

Judge Taylor revisited the tax treatment of a lump sum disability settlement in *Cook v. R.*<sup>40</sup> The appellant in *Cook v. R.* had been refused benefits under a policy of insurance with Great-West Life Insurance Company. The appellant launched a legal action against the insurer for a declaration that the insurer was in breach of the policy of insurance, a declaration that a valid policy or insurance existed covering the appellant, and damages

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<sup>38</sup> Ibid. par. 1-4.

<sup>39</sup> Ibid. at par. 19-23. While Judge Taylor was correct in his analysis that the insurer has rights under the insurance contract, the former employer under the Insurance Act, R.S.O. 1990, c. I.8 has no discretion to allow or disallow the appellant to exercise his rights. See also S. Muller "Avoiding The Statutory And The Contractual Limitation Defence In Disability Insurance Disputes" (2002) Advocate Quarterly.

<sup>40</sup> *Cook v. R.* 1994 CarswellNat 1181, [1995] 1 C.T.C. 2251 (T.C.C.).

for long term disability benefits from August 17, 1989 to the date of trial. The appellant also sought against the insurer general damages in the sum of \$100,000.00, aggravated damages in the sum of \$50,000.00 and punitive and exemplary damages in the sum of \$50,000.00. A settlement was reached whereby the appellant received \$15,000.00 inclusive and released the insurer from claims past and future for disability benefits pursuant to the policy of insurance.

The Minister took the position that the amount was received by the appellant in 1991 pursuant to a disability plan. According to the Minister, the amount was payable to the appellant on a periodic basis in respect of the loss of all or part of her income from an office of employment. As such the \$12,000.00 payment was to be included in the appellant's income.<sup>41</sup>

Judge Taylor, on facts that closely parallel *Peel v. Minister of National Revenue* reversed, himself and held that paragraph 6(1)(a) applied. Judge Taylor was of the view that his comments in *Peel v. Minister of National Revenue* that "Paragraph 6(1)(a) does not serve the Minister's Purpose" cannot withstand the logic of *R. v. Savage* which Judge Taylor felt was the standard in analyzing such cases.<sup>42</sup> As he explained:

It is not for this Court to examine the view of Great-West, that she was not qualified for disability payments sought. Nor is it for this Court to question whether the payment of \$12,000 (net after legal fees) at issue was an award for damages and therefore—as argued by counsel for the appellant—non-taxable. That appears to me to be aside from the main point of issue, irrespective of whether "damages" as such are now taxable or non taxable. The significant and

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<sup>41</sup> *Ibid.* at par. 1-6.

<sup>42</sup> The court also noted that reference to *R. v. Savage* was made by the Federal Court of Appeal judgment of *Phillips v. Minister of National Revenue*, [1994] 1 C.T.C. 383, 94 D.T.C. 6177. In *R. v. Savage* [1983] 2 S.C.R. 428, the Supreme Court of Canada held that a monetary award paid to the taxpayer by an employer for passing employment related courses was taxable under paragraph 6(1)(a) and stated that the words "in respect of" were words of widest possible scope.

the simple point is whether the amount is found in the appellant's rights under an employment contract, and it is so found.<sup>43</sup>

The appeal was dismissed and the amount was held to be taxable because of the provisions of paragraph 6(1)(a) of the ITA.

The Tax Court of Canada considered the taxation of a lump sum disability insurance settlement in *Landry v. R.*<sup>44</sup> The appellant in *Landry v. R.* was a member of a group long term disability insurance policy with London Life Insurance Company. Premiums were paid by her employer and included in the appellant's income as taxable benefits from her employment. The insurer refused to pay disability benefits and, as a result, the appellant sued. The insurer accepted settlement of a lump sum payment to the appellant of \$30,000.00. The insurer issued a T-4A for \$25,000.00 being the settlement net of the appellant's legal fees. The Minister included the amount of \$25,000.00 in the appellant's income on the basis of paragraph 6(1)(a) of the ITA.<sup>45</sup>

Judge Bowman concluded that Judge Taylor was correct in *Peel v. Minister of National Revenue* and that neither *R. v. Savage* nor paragraph 6(1)(a) had any application. The court noted that the respondent declined to rely upon paragraph 6(1)(f) which considers disability benefits payable on a periodic basis. According to Judge Bowman: "Paragraph 6(1)(a) is a general provision and it was not intended to fill in all the gaps left by paragraph 6(1)(f)- *expressio unius est exclusio alterius*." Moreover, the lump sum payment received by the appellant did not represent the aggregate of periodic payments that she might have received over her lifetime.<sup>46</sup>

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<sup>43</sup> *Cook, supra*, footnote 40 at par. 11.

<sup>44</sup> *Landry v. R.* 1998 CarsewellNat 101, 98 D.T.C. 1416 (T.C.C.).

<sup>45</sup> *Ibid.* at par. 2-4.

<sup>46</sup> *Ibid.* at par. 8-10.

Judge Taylor for a third time revisited the issue of the taxability of a disability settlement in *Cave v. R.*<sup>47</sup> The appellant in that case had paid premiums personally with his group disability insurer. The appellant employer had been acquired by another company and the appellant continued to pay premiums personally to a new group disability insurer. The appellant suffered from a terminal disability which pre-existed the current employer. Since benefits were now not payable because of a pre-existing limitation exclusion clause, the appellant had reached a settlement with his employer. Because of the employers mishandling of the group insurance, it was agreed between the appellant and his employer that the appellant would received an amount of \$500.00 per month until death or age 65. The Minister included the \$6000.00 as income. Judge Taylor dismissed the appeal and held that the facts fell within paragraph 6(1)(a) of the ITA and the decision of *R. v. Savage* which the Minister relied upon.<sup>48</sup> The fact that the employer was the payor and that a settlement was reached due to the breach of the employment contract distinguished *Cave v. R.* from the previous cases mentioned thus far in this section.

As in *Peel v. Minister of National Revenue*, *Cook v. R.* and *Landry v. R.*, the appellant in *Whitehouse v. R.*<sup>49</sup> brought an action against his disability insurer, Great-West Life Assurance Company, claiming monthly benefits from June, 1991, to June, 2004, when the appellant would reach age 65 years. A settlement was reached whereby Great-West Life Assurance Company agreed to pay \$138,000.00 in exchange for a full and final release of all claims past present and future arising directly or indirectly from the facts alleged in the proceedings. The appellant received an amount of \$69,000.00 in each of

<sup>47</sup> *Cave v. R.* 1999 CarswellNat 2199, [2000] 1 C.T.C. 2259 (T.C.C.).

<sup>48</sup> *Ibid.* at par. 6.

<sup>49</sup> *Whitehouse v. R.* 1999 CarswellNat 2298, [2000] 1 C.T.C. 2714 (T.C.C.).

1995 and 1996 taxation years. The issue that the court addressed was whether the amount of \$69,000.00 received by the appellant in the 1995 taxation year was to be included in income pursuant to paragraph 6(1)(a) or 6(1)(f) of the ITA.<sup>50</sup>

Judge Lamarre allowed the appeal and agreed with Judge Bowman that paragraph 6(1)(a) is a general provision and is not intended to fill in the gaps left by paragraph 6(1)(f). Judge Lamarre applied the reasoning of the Supreme Court of Canada in *Schwartz v. R.*<sup>51</sup> In that case, the Minister argued that even if a lump sum received by the taxpayer could not be characterized as a retiring allowance and was thus not taxable under paragraph 56(1)(a)(ii) of the ITA, it nevertheless constituted income from an unenumerated source taxable under the general provisions of paragraph 3(a) of the ITA. The Supreme Court of Canada in *Schwartz v. R.* concluded that:

To find that the damages received by Mr. Schwartz are taxable under the general provision of paragraph 3(a) of the ITA would disregard the fact that Parliament has chosen to deal with the taxability of such payments in the provisions of the ITA relating to retirement allowances.<sup>52</sup>

*Dumas v. R.*<sup>53</sup> is the most recent and most thoroughly reasoned decision by the Tax Court of Canada in favour of taxation of a lump sum disability insurance settlement. The court held that the underlying nature of the claim will determine taxability and the courts are free to examine pleadings in relevant court proceedings. The appellant in *Dumas v. R.* had settled with Great-West Life Assurance Company for an all inclusive amount of \$105,000.00 for “arrears in disability payments, future disability payments, interest and legal costs”. Judge Morgan held that the amount recovered compensatory in nature will not determine the character as being income or capital. The court must determine why

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<sup>50</sup> Ibid. at par. 1 & 2.

<sup>51</sup> *Schwartz v. R.*, [1996] 1 S.C.R. 254.

<sup>52</sup> *Whitehouse*, *supra*, footnote 49 at par. 6, 8 & 9.

<sup>53</sup> *Dumas v. R.* 2000 CarswellNat 2358, 2000 D.T.C. 2603, [2001] 1C.T.C. 2490 (T.C.C.).

the compensatory amount is paid. The character of an amount received as damages or to settle a claim will be influenced by the nature of the claim made by the person receiving the amount. Since the appellant claimed “monthly payments in the amount of \$1,210 per month...”, the court held that the settlement amount was income to the appellant. Because the settlement amount was not paid or received on a periodic basis, it was not taxable under paragraph 6(1)(f) but was found to be taxable pursuant to *R. v. Savage* under paragraph 6(1)(a) as a benefit received “in respect of, in the course of, or by virtue of an office or employment.”<sup>54</sup>

In the year 2001, the Tax Court of Canada made three decisions on the issue of taxability of a lump sum disability insurance settlement. These decisions are *Fry v. R.*, *Siftar v. R.* and *Tsiaprailis v. R.* All three decisions held that lump sum disability insurance settlements are non taxable and that neither paragraph 6(1)(f) nor paragraph 6(1)(a) were applicable. Currently, should a tax payer request from the Canada Customs and Revenue Agency rulings directorate in Ottawa their current position, Canada Customs and Revenue Agency will advise that long-term disability insurance payments including settlement payments are either paragraph 6(1)(a) or paragraph 6(1)(f) taxable benefits despite the case law in the year 2001 to the contrary.

The most significant case in the year 2001 was *Fry v. R.*<sup>55</sup> In *Fry v. R.*, the appellant had sued The Manufacturer’s Life Insurance Company for a declaration that she was entitled to long term disability insurance benefits. The claim settled for the amount of \$82,500.00 and the settlement represented approximately 6.5 years of future long term disability insurance benefits plus \$15000.00 as a contribution to legal expenses. Judge Bell

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<sup>54</sup> Ibid. par. 25 & 26.

<sup>55</sup> *Fry v. R.* 2001 CarswellNat 1803, [2001] 4 C.T.C. 2388, 2001 D.T.C. 846 (T.C.C.).

reached a conclusion consistent with the decisions in *Whitehouse* and *Landry*. He concluded that the amount of \$300.00 at issue in *Savage* had nothing to do with an insurance claim settlement. According to Judge Bell, paragraph 6(1)(f) of the ITA deals specifically with amounts paid pursuant to an accident insurance plan. As he stated:

That paragraph would have little, if any meaning if, in circumstances where it cannot be applied to a taxpayer, an amount escaping inclusion by virtue of its terms would be includable in another subparagraph. It is noted that paragraph 6(1)(a) is not paramount to paragraph 6(1)(f). Each of the paragraphs contain under subsection 6(1) stand separate and apart from each other. The subject matter of payment under an accident plan having dealt with under paragraph 6(1)(f), the matter is closed.<sup>56</sup>

Similar to *Fry v. R.* in its result, in *Sftar v. R.* Judge Beaubier concluded that the sum of \$44,495.83 constituted general damages paid by Great-West Life Assurance Company to the appellant. The appellant had claimed against Great-West Life Assurance Company for damages in the sum of \$250,000.00. As such, Judge Beaubier held that the lump sum settlement was non-taxable.<sup>57</sup>

The court in *Tsiaprailis v. R.*<sup>58</sup> extended the reasoning in *Fry v. R.* In *Tsiaprailis* the appellant had reached a lump sum disability settlement of \$105,000.00 with The Manufacturers Life Insurance Company. The sum of \$105,000.00 meant that the insurer was paying the appellant's entitlement to past benefits, plus interest, 75% of the present value of the appellant's entitlement to future benefits under the policy, \$6,455.00 for costs, GST and disbursements. The court held that the lump sum disability settlement was non taxable. As Judge Bowman stated:

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<sup>56</sup> Ibid. at par. 14.

<sup>57</sup> *Sftar v R.* 2001 CarswellNat 2305, 2001 D.T.C. 938 (T.C.C.). This case is now being appealed by the Minister to the Federal Court of Canada.

<sup>58</sup> *Tsiaprailis v. R.* 2001 CarswellNat 3029 (T.C.C.). This case is now being appealed by the Minister to the Federal Court of Canada.

I have no difficulty with the idea that where a person received damages or insurance proceeds for the failure to receive business income those damages are themselves income from that business. That is a far cry from the notion that the same principle can justify that a lump sum payment made as the result of a compromise of a law suit brought to recover disability payments that are taxable only if the strict conditions of paragraph 6(1)(f) are met can be swept into income under the broad provisions of paragraphs 6(1)(a). That is a distortion of the logic and common sense of the point that Lord Diplock was making. It is not this court's role to dream up imaginative ways of taxing disabled people on lump sum settlements that they receive from insurance companies. If Parliament thinks that its revenues are in jeopardy because it does not get it tax on such payments it can amend the legislation.<sup>59</sup>

Until the Federal Court of Canada addresses the issue of the taxability of a lump sum disability insurance settlement or Parliament amends paragraph 6(1)(f) of the ITA, counsel will need to advise their client of the possibility of a tax problem.

Counsel should be cognisant that the Tax Court of Canada will scrutinize the underlying pleadings, settlement correspondence and settlement releases. Evidence by the insurer that the amount settled considered by the insurer as non taxable and assurances are provided that no T-4A is to be issued or that the settlement amount represents general damages may be helpful. Moreover, where the Statement Of Qualifying Retroactive Lump-Sum Payment form called a T1198 the appellant lump sum payment received by the appellant may provide unintentionally evidence to the Tax Court of Canada that the settlement represents the aggregate of periodic payments.

### **Lump Sum Settlement That Does Not Represent Loss Of Income From Employment**

Where a lump sum disability insurance settlement is reached but does not represent loss of all or any part of income from employment, the lump sum settlement is not taxable. In

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<sup>59</sup> Ibid. at par. 24 & 25.

Johnson Estate v. R.<sup>60</sup> the appellant sued The Mutual Life Assurance Company of Canada on November 22, 1994, claiming among other things, \$500,000 in damages for breach of contract. The appellant also claimed \$100,000 for aggravated, punitive and exemplary damages and a declaration that the appellant was entitled to disability benefits for loss of income from employment pursuant to the Mutual Life Policy. Despite the appellant's denial of benefits from her insurer in March, 1994, the appellant resumed work in May of 1994 and worked with the school board as a teacher until the end of the 1995 school year. In May, 1995, a lump sum settlement was reached representing arrears of benefits from March 28, 1994 to April 28, 1995, interest and costs. There was no relinquishment of rights under the policy to claim future benefits. Subsequent to the May settlement, The Mutual Life Assurance Company of Canada discovered that the appellant had been working and ceased paying monthly disability insurance benefits. On October 25, 1995, The Mutual Life Assurance Company of Canada obtained an order that the May settlement be rectified to reduce the lump sum payable to the appellant to account for disability insurance benefits paid while the appellant was working. A subsequent December settlement was reached whereby disability insurance benefits were paid from April 29, 1995, to December 28, 1995, and an amount was deducted to account for disability insurance benefits paid while working. The Mutual Life Assurance Company of Canada also agreed to continue paying future benefits. In February, 1996, The Mutual Life Assurance Company of Canada issued a T4A slip stating that the appellant had been paid wage loss replacement plan benefits to the appellant during the 1995 taxation year totalling \$69,018.78.

At issue before the Tax Court of Canada was whether the lump sum payments made by The Mutual Life Assurance Company of Canada to the appellant, less the amount

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<sup>60</sup> Johnson Estate v. R. 2002 CarswellNat 691 (T.C.C.).

ordered by the Ontario court to be repaid to the insurer, was to be included in the appellant's income pursuant to paragraph 6(1)(f) of the ITA. Judge Rip did not accept the position of the appellant that the \$69,018.78 was paid for breach of contract or as punitive damages. Nevertheless, Judge Rip allowed the appeal and concluded that no amount of money received from The Mutual Life Assurance Company of Canada with respect to the period that the appellant was employed with the school board was to be included in her income in 1995. The portion of the lump sum payment attributed to the period of employment of May, 1994, to June, 1995, was not paid in respect of loss of all or any part of income from employment since the appellant did not lose any employment income for the time the appellant worked.<sup>61</sup>

It was Judge Rip's view that the appellant did not resume work as part of a rehabilitation program under the policy. Rather, the appellant returned to work because of financial pressures and Canadian Customs and Revenue Agency should not have "bought" The Mutual Life Assurance Company of Canada's treatment of the payment as rehabilitation earnings.<sup>62</sup> Finally, paragraph 6(1)(a) of the ITA was held to be of no assistance. As Judge Rip stated: "Any amount of money Ms. Johnson received from Mutual Life was as an insured and not as an employee of the School Board, which would be required if paragraph 6(1)(a) were to apply."<sup>63</sup> Once again the court confirmed the proposition that paragraph 6(1)(a) of the ITA is a general provision and it is not intended to fill in all the gaps left by paragraph 6(1)(f) of the ITA.

## **Legal Fees**

<sup>61</sup> Ibid. at par. 31.

<sup>62</sup> Ibid. at par. 30.

<sup>63</sup> Ibid. at par. 32.

Legal expenses paid to collect or establish the right to reinstatement of disability insurance benefits or the right to a lump sum disability insurance settlement of past and future benefits are deductible for tax purposes. Where a claimant incurred legal expenses, those expenses are deductible from the settlement amount as being reasonable necessary expenses incurred to realize the settlement that was achieved. Without the legal expense, the settlement amount would not have been realized by the claimant. Where the lump sum disability insurance settlement between the claimant and the disability insurer does not specify the amount of legal costs, the Tax Court of Canada will consider the evidence of what legal expenses were incurred.<sup>64</sup>

### **Eligible Annuities**

A lump sum settlement of taxable disability insurance benefits can be converted into an eligible annuity. Provided that certain criteria are met, Canada Customs and Revenue Agency will not tax the lump sum and will tax the payments only when they are actually received by the claimant. The annuity must be of the same duration as the maximum benefit period in the original disability insurance policy. As well, the monthly payments must not exceed the original entitlement at any time during the duration of the payments. Where the disability insurance policy provides for level payments, the annuity must also provide for level payments. An assignee or the disability insurance carrier must own the annuity policy. The annuity must be non-assignable, non-commutable and non-transferable. The claimant has no rights or interest in the annuity other than the irrevocable right to receive payments. Canada Customs and Revenue Agency treats the disability annuity as a novation of the original disability insurance policy entitlement.<sup>65</sup>

<sup>64</sup> *Dumas, supra*, footnote 53 at par. 28 & 29. See also *Fry, supra*, footnote 55 at par. 8.

<sup>65</sup> J. Melnizier, "CCRA approves structure for disability benefits" *Law Times* (15 October 2001) at 13.

When considering the disability annuity as an option, a structured settlement company should be contacted early in the negotiation process between the claimant and the disability insurer. The advantages to the claimant in creating this type of a “structured” settlement is that the claimant is prevented from unwisely spending the disability settlement proceeds. The “structured” settlement provides the claimant with security. As well, should the Federal Court of Canada overturn the current Tax Court of Canada decisions on taxation of lump sum settlements of past and future benefits, a “structured” settlement can save the claimant from paying a higher tax rate resulting from the claimant receiving a large taxable amount in one year.<sup>66</sup>

## **V. CONCLUSION**

Generally the current regime of taxation of disability insurance benefits is straightforward. By contrast, the current regime of taxation of disability insurance settlements is convoluted. The inconsistent treatment for different forms of disability insurance income mirrors the patchwork of rules that make up the current Canadian taxation policy in relation to the disabled in our country.<sup>67</sup> It is important for counsel representing a claimant in a disability insurance dispute to be able to recognize the income tax implications on the advice being given.

Counsel who represent claimants in a disability insurance dispute should be aware of the debate between critics and proponents of the current Tax Court of Canada's treatment of lump sum disability settlements of past and future benefits. Critics argue

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<sup>66</sup> A settlement can also be structured where premiums for a long term disability policy are paid by the claimant and as such benefits payable to the claimant are free from income tax. See B. Baxter, “Structured Settlements Can Be Used In Some Long-Term Disability Cases” *The Lawyers Weekly* (25 February 2000) at 12 for a discussion of the advantages and disadvantages of such financial planning.

<sup>67</sup> D. Schulze, “Obstacles To Equity: An Analysis Of The Taxation Of Disability Income In Canada And Proposals For Reform” (1994) 14 *Windsor Yearbook of Access to Justice* 135.

that the true character of the underlying disability settlement is what should be looked at by the court. They argue that underlying the lump sum disability insurance settlement is the claimant's desire to seek compensation for their loss of disability benefits. As such, a claimant should not be put in a better tax position for making a lump sum disability insurance settlement rather than obtaining the benefits in the normal course through the disability insurer or through the courts. These critics characterize the current decisions on lump sum disability insurance settlements of past and future benefits as a tax loophole that should be rectified by a general provision in the ITA.

Proponents of the courts' reasoning in *Fry*, *Dumas* and *Tsiapraillis* argue that clearly the object, spirit and structural context of paragraph 6(1) must be what guides the court's assessment. The purpose of paragraph 6(1)(a) and paragraph 6(1)(f) was never to include lump sum disability insurance settlements of past and future benefits. They argue that the obvious tax result for taxing a lump sum disability insurance settlement representing both past and future benefits in the year that the settlement is received is that the disability claimant incurs a significant tax burden in the year the claimant receives the amount. As a consequence of taxing lump sum disability settlements that represent future benefits, the claimant loses much of what is bargained for from the private insurer to tax and will likely sooner be dependant upon some government disability program. Finally, they argue that the lump sum settlement of past and future benefits represents an exchange between a claimant who may no longer be employed and the insurer whereby the claimant receives money in exchange for surrendering their rights under an insurance policy. This type of compromise cannot be reproduced by way of a court order and as such it is not evidenced by pleadings.

In negotiating a resolution to a disability insurance dispute, tax issues should be taken into account. The case law should be kept in mind. Court documents and settlement documents should reflect the desired characterization of the payment. Claimants in a disability insurance dispute should be made to understand and appreciate the tax implications on alternative courses of action. In the end, counsel should be mindful that after much battling between the insurer and the claimant and after securing a sizable settlement, what is left in the pocket of the client is what will ultimately matter to them.