Creditor protection and life insurance

A life insurance policy and an insurance death benefit may be protected from a policyowner's creditors in certain conditions under provincial insurance legislation. This creditor protection is a special feature of life insurance, but it has limits and can't be guaranteed.

In the life insurance context, creditor protection is seen in two ways. Firstly, protecting the policy, including its cash value, from the policyowner's creditors. Secondly, protecting the insurance death benefit from the policyowner's creditors. Provincial insurance legislation may provide creditor protection in these two contexts as described in more detail below.

For the purposes of this discussion, a life insurance policy means:

1. An individual life insurance policy
2. An annuity
3. A segregated fund

Protecting the life insurance policy from creditors

Generally, a life insurance policy, including its cash value, may be protected from a policyowner's creditors in two situations:

- where a member within a certain class of family members is designated as beneficiary, or
- an irrevocable beneficiary is designated.

Designating a beneficiary from a certain class of family members

- **All provinces, excluding Quebec**: Where a beneficiary designation is made in favour of a spouse, child, grandchild, or parent *of* the *life insured* (or of the annuitant, in the case of an annuity or a segregated fund), then as long as that designation remains in effect the rights and interests of the policyowner in the life insurance contract are exempt from execution or seizure. The legislative definition of "spouse" varies by province and may not include certain common-law partners. Under Nova Scotia and Alberta law, there is also the possibility of securing protection by designating, as beneficiary, a "domestic partner" or an "adult interdependent partner", respectively.

- **Quebec**: The Civil Code of Quebec provides that protection may be available if the beneficiary is the spouse or any direct relation (ascendant or descendant) of the *policyowner*. A great-grandparent, parent, child, and grandchild are examples of a direct relation. The relationship of the beneficiary to the policyowner is the determining factor under the Civil Code, and not the relationship to the life insured as is the case in the other provinces. There are other notable differences in Quebec:

    - Quebec's definition of spouse does not include common-law partners ('*de facto*' spouses), but does include civil union spouses.
    - The class of beneficiaries, whose designation can provide protection, is wider as it includes all ascendants and descendants (direct relations) of the policyowner.

- The designation, as beneficiary, of the policyowner's married or civil union spouse is automatically irrevocable, unless, at the time of designation, the policyowner states otherwise.
- A divorce, nullity of marriage or dissolution of a civil union causes any designation of the spouse as beneficiary to lapse.

By irrevocable beneficiary designation

Insurance legislation in all provinces state that a policyowner may irrevocably designate a beneficiary. The legislation also states that an irrevocable designation, while in effect, can place a policy beyond the reach of the policyowner's creditors. An irrevocable beneficiary doesn't have to be in the "family class" described above for protection to apply. Neither the policyowner nor the policyowner's estate can qualify as an irrevocable beneficiary.[i] Note that while the irrevocable beneficiary is living, the policyowner may not alter or revoke the designation without the consent of the beneficiary or a court order. Other restrictions on the policyowner's ability to deal with the policy may apply, due to the irrevocable designation.

Additional protections for a policy

- **Pension legislation:** Provincial pension legislation generally contains provisions that prohibit the garnishment of pension money. For example, in Ontario, the *Pension Benefits Act* provides that money payable from a pension plan or transferred to a prescribed retirement savings arrangement (such as a LIRA or LIF) and an annuity purchased with pension money are exempt from execution, seizure and attachment.

- **Quebec Code of Civil Procedure (Quebec only):** The Quebec Code of Civil Procedure also prohibits the garnishment of a retirement or pension benefit (or an income replacement indemnity, in the hands of the payer, even when no retirement or pension money is involved), whether or not the benefit is provided by life insurance. And once paid to the client, only a certain portion of any such benefit is subject to seizure, based on a prescribed formula.

Protecting the death benefit (once payable) from creditors

The law in all provinces provides that once the life insured dies and proceeds are payable to a designated beneficiary (excluding the policyowner or the policyowner's estate), the death benefit proceeds belong to the beneficiary and are generally beyond the reach of the policyowner's creditors. This protection does not extend, however, to protect the proceeds against the *beneficiary's* own creditors.

Limits of creditor protection

Creditor protection in the context of life insurance has limits and it can't be guaranteed. The existence and availability of creditor protection is dependent on the particular facts and circumstances of each policyowner and the legislative and judicial framework in place at the applicable time. The following discussion considers the limits of creditor protection, but not exhaustively. Clients should consult their legal advisors for advice on how creditor protection may apply to their situations.

Corporate-owned insurance

Where the policyowner is a corporation, creditor protection under the provincial insurance legislation is largely unavailable, practically speaking, since the corporate policyowner is typically designated as the beneficiary of the policy for tax purposes.

For situations where a corporation wants a policy to be protected from its creditors, using a holding company to own the policy could be considered. In this structure, the holding company's assets (i.e., insurance policy) may be protected from the creditors of a subsidiary operating company. However, if either the holding company or its shareholder(s) guarantees loans or other transactions entered into by the operating company, then the assets of the holding company or shareholder(s), as the case may be, could be exposed to satisfying claims of the operating company's creditors.

Fraudulent conveyances

All provinces have fraudulent conveyance legislation which may allow a court to set aside a debtor's transactions that are intended to defeat their creditors.[ii] Generally, a fraudulent conveyance is a disposition of property made with the intent to delay, hinder, or defraud creditors or others of their just and lawful remedies. Considering life insurance, a last minute, on the eve of insolvency change of the beneficiary to a family class member, 'dumping' a significant and not required premium amount into a creditor protected policy, and purchasing a life insurance product where the beneficiary designation is one made in the hope of securing creditor protection (e.g., an irrevocable designation), are all examples of transactions which a court may set aside.[iii] There is a difference between seeking to evade payment to those entitled to it and planning ahead to protect assets against future liabilities.

Dependent's relief legislation

Provincial dependant relief legislation is also a potential limitation on the creditor protection found in provincial insurance legislation. Dependents relief legislation gives courts broad powers to enforce a person's obligations to support a dependent. In Ontario, for example, the *Succession Law Reform Act* can deem certain assets that otherwise fall outside of the estate of person, found to have provided inadequate support for a dependant, to be included back into the estate and from there be used to satisfy a dependant support order or obligation. One of these assets could be the proceeds payable under a life insurance policy owned by the deceased on their own life.

For a dependant's relief claim to succeed, the person applying to court must: 1) qualify as a type of dependant under the legislation, and 2) satisfy the court that the deceased did not adequately provide for the dependant's proper support and maintenance. Who qualifies as a dependant and the test for whether the dependant is adequately provided for varies by province.

Fortunately, when determining whether the dependant had been adequately provided for in a dependant's relief claim, courts will typically look at insurance payouts the dependant received from designations made by the person claimed not to have provided adequate support. Clients can help protect their estate from dependant's relief claims by adequately providing for their dependants with life insurance.[iv]

Presumption of resulting trust (excluding Quebec)

A more recent potential challenge to creditor protection for insurance policies, in the common law provinces, arose in 2020, from the Ontario Superior Court's decision in *Calmusky* v. *Calmusky*.[v] In that case, the entitlement of a named beneficiary to receive the proceeds of a Registered Income Fund (RIF) was challenged. The designation had been made in favour of an adult child, one of the sons of the deceased RIF owner. The court decided, in those circumstances, there was a legal presumption that the beneficiary received the death benefit on the basis of a "resulting trust", to be held for the benefit of the estate (and therefore, the payment could be exposed to claims by creditors of the deceased or his estate). In other words, it was not money for the son to keep personally, but rather it was to be handed over to the estate, unless he could prove to the court that his father intended for him to have the money as his own. He was unable to do so. Accordingly, the court ruled that the death benefit was estate property. The approach taken by the court in *Calmusky* would seem to apply, in principle, to more than just RIF designations, and so could include life insurance.

This decision has been widely criticized, and it wasn't followed in the subsequent decisions of *Mak Estate* v. *Mak*[vi] and *Fitzgerald Estate* v. *Fitzgerald*[vii]. Despite the criticism and these later decisions, there remains some uncertainty – at least for now – on the application of the presumption of resulting trust to beneficiary designations in favour of an adult where the designation was made 'freely' (meaning not 'paid for' by, or in some sense owed to, the beneficiary). In such cases, there's a risk a court might consider an insurance death benefit to be included in the policyowner's estate and thereby exposed to creditors of the deceased policyowner or of the estate. Preventative measures advisors could take include:

- Properly document your clients' intentions to make a gift, if such is the case, when designating a beneficiary, especially when designating an adult beneficiary, even if that beneficiary is the designator's spouse. The rules around gifts to spouses and whether any presumptions apply can be complex and can vary by jurisdiction – it's safer to treat a spouse like any other adult beneficiary.
- This documentation may provide sufficient evidence to overcome a presumption the beneficiary was intended to hold the death benefit for an estate, or for someone other than the beneficiary personally.
- Provide a copy of the documentation to your client and recommend that they keep it with their policy.
- Encourage clients to make their family members aware of their estate plans and how they intend to distribute their assets.
- During regular reviews with clients remember to review their designations, have them make any necessary changes, and properly document client files.

Bankruptcy and Insolvency Act

The federal *Bankruptcy and Insolvency Act* (BIA) applies provincial protections for policies against a policyowner's creditors (according to the policyowner's province), thereby exempting certain policies from being available for distribution to a policyowner's creditors in bankruptcy. That said, even though a life insurance policy may be beyond the reach of creditors under the BIA, courts can determine conditions under which they'll discharge bankrupts. There have been cases where courts required bankrupts to voluntarily surrender to their creditors all or part of exempt property before they would grant a discharge from bankruptcy. In theory, this requirement of voluntary surrender could extend to a life insurance policy that's otherwise beyond the reach of creditors.

Canada Revenue Agency

The Canada Revenue Agency (CRA) (and Revenu Quebec in Quebec) has considerable legislative powers to collect taxes owing. The federal *Income Tax Act* (ITA) has provisions allowing the CRA to garnish or seize taxpayer property to collect on amounts owing by a taxpayer. The CRA also has collection rights, as a creditor, under provincial law. In certain cases, these powers could allow the CRA to access an insurance policy, if the policy or payments under it are not protected by an applicable federal or provincial exemption. Even if a provincial exemption would appear to apply in a particular case, it's possible that a court may 'ignore' the exemption if there is compelling reason to do so – for example, where a taxpayer has been seeking to flagrantly escape the payment of taxes.[viii] The CRA is a privileged creditor, and the law is ever evolving when it comes to the CRA's powers. In this area, as in others, it is important that concerned clients seek their own legal advice.

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[i] Technically, under insurance legislation, neither can be a beneficiary of any kind, whether revocable or irrevocable; rather, they can be designated as payees.

[ii] That is, creditors existing at or around the actual time of a fraudulent conveyance; it is not wrong, for example, for a solvent policyowner to consider that bankruptcy may happen well into the future and to take proactive measures to protect his or her property.

[iii] *Royal Bank of Canada* v. *North American Life Assurance Co*., [1996] 1 S.C.R. 325, para 60.

[iv] For example, see *Wong* v. *Cheung Estate,* 2015 BCSC 1741.

[v] 2020 ONSC 1506

[vi] 2021 ONSC 4415

[vii] 2021 NSSC 355

[viii] For example, see *Minister of National Revenue* v. *Moss*, [1998] 1 C.T.C. 283 (FCTD).