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Tax Topics

THE TAX AND ESTATE PLANNING GROUP

Life insurance and property issues on marriage breakdown

Estate plans that include life insurance can be significantly impacted as a result of marriage breakdown. Life insurance that has been put in place to benefit the family unit becomes part of the assets in dispute. This Tax Topic will consider some of the property and insurance related issues on marriage breakdown. Reference to the Tax Topic “Life insurance and support obligations on marriage breakdown” should also be reviewed.

Generally this Tax Topic will cover provincial legislation across the common law provinces and will not discuss the Quebec Civil Code. The Tax Topic will primarily discuss Ontario legislation.

Who can make a property claim?

At one time provincial legislation narrowly defined “spouses” to be members of the opposite sex who have entered into a legally valid marriage. Today, depending upon the applicable provincial law and court decisions, the scope of potential spouses for matrimonial purposes can also include common law and same-sex partners.

Not only is it possible for each province’s definition of spouse to vary, but also that definition may not necessarily apply within a province to all legislation affording rights to “spouses”. Determining who may potentially bring a claim under family law, and how to plan accordingly for that claim, becomes challenging given the variations between the provinces and within specific provincial legislation.

For purposes of discussion in this Tax Topic, a reference to “spouse” will be defined in the context of married heterosexual couples unless noted otherwise.

Provincial Legislation and Property Rights (separation and divorce)

Custody, access, support and property rights are governed by provincial legislation. The right to assert a property claim will therefore depend upon court decisions and legislation in the particular province where the spouses reside. It should be noted that common law spouses may not be provided property right claims under provincial legislation. However, case law has evolved to allow common law spouses to make property right claims via trust law.

In order to consider how property rights work in the various provinces an initial overview of the legislation will assist in setting the groundwork for comparisons and help define the planning issues as they relate to property right claims and insurance considerations.

Ontario, Manitoba, Newfoundland, Prince Edward Island and Saskatchewan permit a division of property when a relationship has ended by separation or divorce. These provinces also allow a surviving spouse to make a property claim at death which will be discussed later. Under Ontario legislation, a spouse may seek an “equalization” of net family property (NFP) meaning upon separation, divorce or death. This allows the spouse with the lower “net family property” to make a claim against the other spouse for an amount equal to one-half the difference in net family property value. For example, if at the time of separation one spouse has a net family property of $400,000, and the other spouse has net family property of $1 million, the first spouse can bring an equalization claim for $300,000.

In other provinces, such as British Columbia, property is considered separate as to each spouse until a triggering event occurs. While the BC legislation does not deal with the concept of equalization, it has a somewhat similar mechanism for property division. From the date of the triggering event (separation or divorce), each spouse is deemed to own a 50% interest in each family asset as defined under s. 58(2) of the B.C. Family Relations Act, R.S.B.C. 1996, c. 128. What differs with the BC legislation is that the triggering event does not include death.

While the Alberta Matrimonial Property Act, R.S.A. 2000, c. M-8, contemplates an equalization scheme similar to Ontario, like the BC legislation, it does not permit a spouse to assert a property right claim on death. The equalization of assets happens at the time of trial.

In Nova Scotia, the division of family assets is made in equal shares notwithstanding ownership. In New Brunswick, under the Marital Property Act, S.N.B. 1980, c. M-1.1 the fulfillment of joint responsibilities will entitle each spouse to an equal share of marital property.

Provincial Legislation and Property Rights (on death)

Upon death, a surviving spouse in Ontario may seek equalization by way of election under s. 5(2) of the Ontario Family Law Act, R.S.O. 1990 c. F.3 (FLA). The election must occur within six months after the death of a spouse. The spouse in making the election either seeks equalization under the FLA or under the provisions of the deceased spouse's will or where a will does not exist under the provincial rules of intestacy. If this election is made the spouse cannot take any gifts or bequests under the provisions of the deceased spouse's will unless the will expressly states that the gifts are in addition to the spouse's entitlement under section 5 and section 6(8) of the FLA. The provision applies to spouses who are married at the time of death or those that are in the midst of separation.

One way to reduce the possibility of an equalization claim in Ontario is to use life insurance as a remedial instrument. Under subsection 6(6) of the Ontario FLA, where a spouse owns a life insurance policy or was a member of a group policy and designates the other spouse as the beneficiary, the proceeds from the policy can be credited against the surviving spouse's equalization claim. Note should be made that where life insurance proceeds are received by a surviving spouse, the proceeds will not be a credit against the NFP if the deceased spouse provided in writing that the surviving spouse shall receive the insurance proceeds in addition to the entitlement under the FLA.

Using life insurance is an especially attractive proposition in the second marriage scenario, where the individual has children from a first marriage and wishes to preserve the assets of his or her estate for those children. However, such a tool is limited to those provinces that permit such an offset mechanism.

Excluded property

Excluded property provisions in provincial legislation may permit further planning with life insurance. Under subsection 4(2) of the Ontario FLA, and similarly in other provincial legislation such as in PEI, the value of excluded property that a spouse owns on the date of separation (the "valuation date") will not form part of that spouse's NFP. A list of excluded property is provided in the Ontario FLA and includes proceeds or a right to proceeds of a policy of life insurance, that are payable on the death of the life insured. This permits a parent to designate a married son or daughter as a beneficiary under a life insurance policy, and upon marriage breakdown of that child, those proceeds or right to proceeds will not be included in the net family property calculation. However, should the proceeds be used to acquire or make improvements to the matrimonial home, or included (or mixed) with other property that might be considered marital property, the excluded status of that property may be lost.

Therefore, from a planning perspective, a beneficiary who receives proceeds under a life insurance policy may want to consider keeping these proceeds separate from any other matrimonial property. Provincial legislation may also permit the purchase of substituted property provided that the substituted property is owned in the beneficiary's name alone. The excluded status of this property may be lost if the beneficiary shares ownership with his or her spouse. This would allow the beneficiary of the insurance proceeds to purchase assets, such as shares of a corporation owned by the deceased parent, from the estate and such property would continue to qualify as excluded property. A related issue is whether any income derived from such property would remain separate, given that the property is traceable back to what is considered excluded property. There is no case law directly on point in relation to this issue.

The Ontario FLA also excludes the value of assets gifted to a child after the date of his or her marriage as long as the gift remains separate or is not co-mingled with other matrimonial assets and is not co-owned with a spouse. Evidence as to the intention of that gift should be properly documented. If there is a lack of documented evidence or an intent to cheat a spouse the case law supports that the transaction will be set aside. (See Stone v. Stone, 2001 CanLII 24110 (On. C.A.) and Cohen v. Zagdanski [2006] O.J. No. 3729 151 A.C.W.S. (3d) 398 Ont. S.C.J.).

One area that may pose more questions than an answer is planning that occurs using an estate freeze. Case law as it stands today indicates that the shares would not be excluded property. (See Karakatsanis v. Georgiou [1991] O.J. No. 1298, 33 R.F.L. (3d) 263 and Dalgleish v. Dalgleish [2003] O.J. No. 2918 124 A.C.W.S. (3d) 322). However this reasoning is based on the sale of shares. In the Karakatsanis case a share sale arrangement occurred to circumvent the Gift Tax Act and Succession Duty Act that existed at the time. While this legislation has been repealed the case law does not reflect this change. The current case law provides that a gift of shares under a corporate reorganization is not excluded where there is no family trust. A family trust will allow for the gift to be recognized as such after marriage. (See Armstrong v. Armstrong [1997] O.J. No. 4137, 46 O.T.C. 274, 34 R.F.L. (4th (38). It is recommended that the donor of the gift make a declaration that excludes capital and income and the child not use his or her own money to purchase the new common shares nor should a promissory note be used.

When a trust is set up prior to marriage or during cohabitation, the frozen shares may not form part of net family property. (See Sagl v. Sagl (1997) CanLII 12448 (On. S.C.)). Whether frozen shares are included will depend upon timing (is marital breakdown imminent?) and the context and true intention of the arrangement – that being for income tax planning purposes.

Since insurance planning often is used in the estate freeze context and where planning occurs using a trust, these potential matrimonial issues are important to understand.

Not all-provincial legislation contains "excluded property" provisions. For example, the B.C. Family Relations Act does not have provisions that would exclude certain property from division on a matrimonial breakdown. Therefore, insurance proceeds or any property purchased with such proceeds would be included as family assets and be subject to the provisions of that Act.

Life insurance as "property"
What is considered "property" for division or equalization purposes varies based on the definition found in provincial legislation. Property is referred to as a "family asset", "matrimonial property" or "matrimonial assets". This different terminology defines what is included or what may be excluded as property. Generally across the provinces the definition of property would include a life insurance policy. A general consideration of provincial legislation in some of the provinces will be provided below.

In B.C. the legislation indicates that each spouse is entitled to an interest in a "family asset" which is defined as property owned by one or both spouses and ordinarily used by a spouse or a minor child of either spouse for a family purpose.

In Nova Scotia, reference is made to "matrimonial assets" which means the matrimonial home and other real property acquired by either or both spouses before or during their marriage is included in the definition.

In Manitoba the family legislation provides provisions addressing and including life insurance and pensions as a family asset.

Under Part I of the Ontario FLA, net family property is equal to the difference between the value of property owned on the valuation date, and the value of all property, other than the matrimonial home, that the spouse owned on the date of marriage. Financial statements exchanged by the parties for disclosure purposes requires each spouse to list all life insurance policies including the type of policy, the owner, face amount and beneficiary. The cash surrender value of such policies will be included in the net family property calculation.

Term policies are usually considered to have no value and therefore not relevant for the purposes of property division on separation or divorce. However, in Paterson v. Remedios, 1999 SKQB 6 (CanLII) the Saskatchewan Family Court examined whether term insurance has a value for the purpose of the division of property under family law legislation. The court determined that although term policies generally have no value, persons who are terminally ill may in fact receive some or all of the proceeds of the term insurance prior to death, and therefore term insurance policies do have a value. This case opens the door for other courts to examine whether a value should be assigned to a term policy.

Transfer of a life insurance policy between spouses

A life insurance policy may be transferred as a result of a property settlement or court order. The Income Tax Act, R.S.C. 1985 c. I (5th supp) (ITA) contains specific provisions that deal with the transfer of life insurance. Like the transfer of capital property, the ITA permits the transfer during a policyholder's life, to the policyholder's spouse or former spouse in settlement of rights arising out of their marriage as a tax-free rollover. (See s. 148(8.1)) Where the rollover provision applies, the transferor will be deemed to have disposed of the life insurance policy for proceeds of disposition equal to the adjusted cost basis (the "ACB") of the policy. The recipient will be deemed to have acquired the interest in the policy at a cost equal to those proceeds. In order for this subsection to apply, both the policyholder and the recipient spouse or former spouse must be resident in Canada at the time of the transfer.

Subsection 148(8.1) provides an automatic rollover. However, the policyholder can elect out of this rollover by filing an election as part of his or her income tax return for the year of the transfer. If the policyholder elects out of the rollover, then by operation of law subsection 148(7) of the ITA applies. The proceeds of disposition to the transferor and the new ACB to the recipient are deemed to be equal to the "value" of the policy at the time of disposition. The term "value" is defined to be the cash surrender value of the policy in subsection 148(9) of the ITA.

Pursuant to subsection 74.1 where there is a disposition of the life insurance policy after the transfer of the policy to the spouse, the attribution rules will apply and any policy gain will be taxable to the original policyholder. However, where the transfer was made to a former spouse in settlement of rights arising out of their marriage and there is a subsequent disposition resulting in a taxable policy gain, the attribution rules will not apply.

Another automatic rollover provision applies to transfers of the ownership of a life insurance policy to a policyholder's spouse in the event of the policyholder's death. (See s. 148(8.2)). The policyholder and the recipient spouse must be resident in Canada immediately before the policyholder's death in order for the rollover to apply. Although this subsection provides an automatic rollover, the deceased's representative can elect out of the rollover by filing an election as part of the deceased's terminal income tax return.

The rollover provisions allow for a tax effective transfer of life insurance to a spouse during marriage, to a spouse at death or to a former spouse in settlement of rights arising out of their marriage. These provisions are especially important where the life insurance policy transferred has a high cash surrender value.

Policy Splitting

When a multi-life policy with coverage on both spouses is held jointly policy splitting may be considered as one option to deal with this asset. However, whether the policy can be split depends on whether the terms of the contract permit a split of the interest in the policy.

In most instances, carriers will treat a policy split as a disposition of the policy. Where a policy is split due to permissible contract wording, the carrier may allow a new policy to be issued to one of the parties while the other party will take over the original policy. If the original contract is one that is currently sold then that new policy will be the same as the original policy. If the original contract is one that is no longer sold the carrier may be able to provide a similar product offering and if there is no similar offering the client should seek the assistance of their advisor for product selection choices offered by the carrier.

While there is a disposition of the policy, policy splitting would be caught under s. 148(8.1) of the ITA as a transfer to a spouse as a result of settlement of rights; therefore the interest is deemed to have been disposed of by the policyholder for proceeds of disposition equal to the ACB of the policyholder of the interest immediately before the transfer. The transferee acquires the interest at a cost equal to those proceeds. While the carrier may treat the split as a disposition the transferor will report it as a settlement of property rights for their own tax reporting purposes.

Property used to satisfy support obligation

Case law has blended issues of property division and spousal support obligations together, where there is a concern that the support obligation may not be met over time. For a further discussion of the case law on this point see the Tax Topic “Life insurance and support obligations on marriage breakdown”.

Conclusion

While provincial legislation varies as to how property is defined for marriage breakdown purposes generally life insurance would fall under provincial legislation as property. A transfer of a life insurance policy or policy splitting between spouses will result in a neutral tax position for both spouses if the transfer or split of the policy is in settlement of property rights.

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