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Tax Topics

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Limitations on Creditor Protection and Life Insurance

One of the attractive features of life insurance policies is the element of creditor protection. In recent years however, this protection has been challenged on many fronts. The good news is that creditor protection still exists in certain circumstances. However, careful review of the limitations on this protection should be considered. This Tax Topic will discuss how life insurance creditor protection has been interpreted in recent years. Reference should also be made to the Tax Topic "Creditor Protection and Life Insurance".

Creditor Protection on Bankruptcy

The status of creditor protection for life insurance and annuity products was uncertain where the insured had made an assignment in bankruptcy, until the Supreme Court of Canada's decision in Ramogtra. (Royal Bank of Canada v. North American Life Assurance Company and Balvir Singh Ramgotra, (1996), 1 S.C.R. 325). Prior to that time, a series of cases starting with the Klassan, (Klassan (Trustee of) v. Great West Life Assurance Co. (1990), 1 C.B.R., (3d) 263 (Sask. Q.B.) decision brought into question the effect of creditor protection afforded by provincial legislation where a "settlement" was found to exist under the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 (BIA).

When an individual becomes insolvent, the rights of the bankrupt and his/her creditors are governed by the BIA. The BIA includes a specific provision that exempts from the control of the trustee in bankruptcy, property that is granted creditor protection under provincial law. Where there is a family beneficiary designation or an irrevocable beneficiary designation in place, or funds are locked in and protected under provincial legislation, the trustee in bankruptcy cannot force the surrender of a life insurance or annuity contract in order to satisfy the claims of the bankrupt's creditors.

The issue of "settlement" in the trustee arose in Ramgotra. A settlement includes a designation of a beneficiary in an insurance contract, to the extent that the designation is gratuitous or made for merely nominal consideration. Section 91(2) of the BIA declares that "settlements" made within one to five years prior to bankruptcy are void against a trustee in bankruptcy, if the interest of the settlor does not pass upon settlement.

In Ramgotra, the trustee in bankruptcy applied for a declaration that the transfer of the RRSP funds into the RRIF, was void relying on the provisions found in s. 91(2) of the BIA. The transfer occurred in June of 1990 and in February of 1992 Dr. Ramgotra made an assignment in bankruptcy. The court determined that the RRIF issued by the insurer was an annuity and a life insurance contract. The court held that a transfer of RRSP funds from a non-protected contract to a creditor protected life insurance RRSP (or RRIF) is not a settlement as defined by the legislation. The court came to this conclusion on the basis that a person cannot settle property upon him or herself and must involve a transfer of the property to be held for the enjoyment of another person.

The court distinguished between s. 91 and s. 67(1)(b) of the BIA. These sections were applied at different stages of the bankruptcy and were not to be considered pre-conditions of one another. The court found that the designation of the policyholder's spouse as a beneficiary was a settlement within five years prior to bankruptcy, and was void as against the trustee under s. 91(2). Therefore, the court invalidated the family beneficiary designation made within 5 years before the bankruptcy at least as against the trustee in bankruptcy. Notwithstanding this finding, the court then considered the provision contained within s. 67(1)(b) of the BIA. While the asset passed into the possession of the trustee at the time of the bankruptcy, the asset was deemed exempt under provincial law, thus barring the trustee from dividing the asset among creditors. The trustee was then obligated to return the asset to the bankrupt prior to the application for discharge.

The Ramgotra decision therefore has upheld creditor protection provided under provincial legislation to life insurance annuities where bankruptcy has occurred. The trustee in bankruptcy cannot force the surrender of a creditor protected life insurance or annuity contract in order to satisfy the claims of the bankrupt's creditors. However, each set of circumstances may present a different scenario that may or may not enjoy this same protection. Advisors should at least be familiar with the findings of the court, to determine if there is an issue that needs to be addressed by a legal advisor.

Note should be taken of amendments to the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 proclaimed in 2008. These amendments leave the provincial exemption intact for life insurance products with appropriate beneficiary designations while introducing creditor protection for registered products that are not subject to protection under provincial law. Most RRSPS and RRIFS issued by insurance companies take the form of an undertaking to provide an annuity and as such come under the definition of life insurance in provincial insurance legislation. The amendments provide creditor protection to all RRSPS and RRIFS of any issuer, without the need for any particular beneficiary designation but are subject to certain limitations (e.g. a 12 month claw back of contributions). This means that if a life insurance RRSP has an appropriate beneficiary designation it receives creditor protection under provincial law and consequently the provincial exemption in the BIA also applies.Where registered insurance products do not fall under provincial exemption (for instance, where a family class beneficiary is not named) and where certain provinces have not yet enacted specific legislation that provides provincial protection to all RRSPs (like Saskatchewan, PEI, Manitoba and Newfoundland and similar proposed legislation in Ontario) then protection can now be found under the BIA. The protection is still subject to certain limitations as set out above (i.e. the clawback).

Deferred Annuities

Deferred annuities have found the same favour with the court. A trilogy of cases at the B.C. Court of Appeal, the cases of Re Sykes, Robson and A.R. Thompson, In the matter of the Bankruptcy of Russell Boyd Sykes v. Smythe McMahon Inc., Trustee in Bankruptcy for the Estate of Russell Boyd, the "Bankrupt" and Russell Boyd Sykes and Shirly Anne Sykes, Edison Robson and Daniel Robson v. Seaboard Life Insurance Company and Royal Life Insurance Company Limited, A.R. Thomson Ltd. v. Dennis Stock and Coast Seal Co. Ltd. and Cameron Waddall, 156 D.L.R. (4th) 105, (sub nom. Sykes (Bankrupt), Re) 103 B.C. A. 81, (sub nom. Sykes (Bankrupt, Re), 169 W.A.C. 2 C.B.R. (4th) 79, 1 C.C.I. (3d) 1, 48 B.C.L.R. (3d) 169, [1998] 8 W.W.R. 120, C.C.P.C. 219 (B.C.C.A.) overturned earlier lower court decisions determining that segregated fund and deferred annuity RRSPs were not entitled to the creditor protection afforded to life insurance contracts. The contracts in question contained language which would allow the policyholder to "annuitize" their contract at maturity or any time prior to that. So unlike the Ramgotra case, the contract was not yet in the pay-out mode.

The court in its reasoning considered in addition to s. 147(2) of the B.C. Insurance Act R.S.B.C. 1996, c. 226, which set out the rules relating to creditor protection where a family beneficiary is named, (see the Tax Topic Creditor Protection and Life Insurance) that the amending legislation had expanded the definition of "life insurance" to include annuities. The court determined that the purpose of the amending bill must be a legislative intent to extend the protection afforded to beneficiaries and dependants with respect to life insurance to annuities issued by an insurer. These cases determined that RRSP funds in the form of a deferred annuity including segregated fund contracts issued by a life insurer, are eligible for creditor protection except in the case of a fraudulent conveyance.

Other provinces have confirmed that the purpose of the amendments to the definition is to protect retirement savings in the form of annuities (whether they are deferred life annuities or segregated fund annuities) from seizure by creditors, in the same manner as life insurance. We can find comfort in these decisions at least to the extent that the court has provided a dialogue on the issue and judicial confirmation that creditor protection continues to exist for these types of products.

In Quebec, most case law has brought about discussion as to whether annuity products are subject to the claims of creditors. The Supreme Court of Canada in Scotia Capitol Inc. v. Bank of Nova Scotia and Guy Thibault [2004] S.C.R. 758 determined that the self-directed plan cannot be characterized before maturity as an annuity contract within the meaning of the Quebec Civil Code S.Q. 1980, c. 39 since there is no alienation of funds, which is one of the central elements of an annuity contract. Therefore a contract that reserves the investor's ownership and control of his or her capital does not reflect the idea that creditor protection exists for family members, which is the underlying reason for creditor protection.

Consequently, the Quebec National Assembly passed amendments in 2002 to Quebec's legislation. The amendments contain a declaratory provision that states that contracts are considered annuity contracts, even if they provide for a total or partial withdrawal of capital. The provisions apply to all future annuity contracts previously issued (except those pending litigation as of December 16, 2002 or any previously litigated and closed to that date). It was hoped that the amendments would result in the Thibault case having no effect. However the amendments did not change the rule requiring that capital be alienated and as a result did not address one of the key conditions to determine whether a contract qualifies as an annuity contract. While the case is based on Quebec legislation and may not apply outside of the province of Quebec, if the legislative requirements for defining an annuity or trust are similar in other provinces the case may have an impact.

Fraudulent Conveyances

Provincial legislation dealing with fraudulent conveyance provides another argument for creditors when seeking to satisfy an outstanding debt. While Re Sykes, would have succeeded in providing protection regardless of the provisions of the BIA, it failed under the B.C. Fraudulent Conveyances Act R.S.B.C. 1996, c. 163. Certainly, the decision in Ramgotra, opened the door for challenges under fraudulent conveyance.

Life insurance should not be purchased for the sole purpose of defeating creditors. This issue should be discussed in advance to ensure that this is not the case. If the intent to place the insurance is for this purpose, then it may be seen as a fraudulent conveyance. While there may be fewer claims by trustees in bankruptcy under the BIA in the future, the downside is that there may be more claims under fraudulent conveyance legislation.

Generally, provincial legislation will allow the creditor to set aside transactions where the intent of the transaction is to avoid the claims of creditors. However, the onus in these cases is on the creditor to illustrate that there is an intention to delay, hinder or defraud creditors. The court will also consider whether consideration has flowed from the transferee to transferor and whether the consideration is adequate to illustrate the transaction was made in good faith and not for fraudulent purposes. If a creditor is successful in demonstrating a fraudulent intent, the exemption under the BIA will not be available and no protection will exist.

Note should be taken of cases that have considered the requirement of “intent” in relation to fraudulent conveyance. In Abakhan & Associates Inc. v. Braydon Investment Ltd., 2008 BCSC 1547, 2009 BCCA 521 (leave to appeal to the Supreme Court of Canada denied) the Court of Appeal concluded that improper intent was not required when putting assets outside of the reach of present and future creditors. This reflects to a certain extent the current state of the law in Ontario. However at the Ontario Superior Court, in Duca Financial Services Credit Union Ltd. v. Bozzo, 2010 ONSC 3104 the court indicated that a person can isolate his assets from future creditors as opposed to present creditors.

Great caution therefore needs to be exercised when dealing with this issue. It should be noted that the more knowledgeable the consumer of life insurance is on this point, the more likely creditor protection will not be available. As well, in this instance the policy is more apt to be seized placing the insurer in a difficult position. Life insurance advisors should not encourage the purchase of insurance "to provide" creditor protection where it appears that the purchaser could have fraudulent intent or where it is apparent that the purchaser is in financial difficulty. This is often a difficult determination to make. If there is any doubt, a recommendation to seek legal advice may be made. An advisor may provide information to a client about creditor protection but the limits of that protection should also be discussed.

Amounts Available to the Owner

Where a life insurance policy or an annuity contract is surrendered by the owner for its cash value, creditor protection will not be provided. As well, it was previously thought that there was no statutory protection for payments received under a life insurance or annuity contract by the life insured or annuitant while living. Although the contract itself may not have been subject to seizure and surrender, payments from the policy were thought to be available to the claims of creditors. This however was changed by the decision in Whalley v. Harris Steel, (1997), 46 C.C.L.I. (2d) 250 (Ont. C.A.). The court held that such payments are payments of insurance monies and are therefore creditor protected, even when paid to a life insured or annuitant.

However, the case of the Tennant v. Tennant (2002) 34 R.F.L. (5^{th}) 167 goes well beyond the Whalley reasoning. The issue before the court was whether s.196 of the Ontario Insurance, R.S. O. 1990, c. I.8, Act barred an ex-spouse from enforcing an order for spousal support against the estranged husband’s annuity income. The Court of Appeal considered both subsection 196(1) and (2) of the Ontario Insurance Act. Under s. 196(1) the court concluded that the ex-spouse was a beneficiary under annuity contracts and where a beneficiary is designated, all annuity payments are protected from creditor’s claims. The ex-wife asserted her claim only as a creditor and not in her capacity as beneficiary.

However, under s. 196(2) the ex-husband asserted that all payments under an annuity contract are protected because his former spouse was a beneficiary under both contracts. However, the former-spouse is not included under this section and therefore the ex-husband could not rely on putting forth an argument to protect the annuity contract under this subsection of the Act. The Court therefore concluded that the ex-wife was not barred from making a claim against the income stream arising from the annuities.

Family Beneficiaries

The legislative intent to provide creditor protection to life insurance has been to shield family members who are beneficiaries from creditor claims against the owner of the policy. The exemption exists where there has been a designation of a spouse, child, grandchild or parent of a person whose life is insured. The definition of spouse, may include common law spouses or same-sex spouses, depending upon provincial legislation.

Dependant Relief Claims – Support

Family dependants may sue to recover insurance proceeds where a support obligation exists. A dependant's relief claim may partially or completely override a beneficiary designation resulting in a loss of creditor protection that may have otherwise been allowable. The ability to make a dependant's relief claim will depend upon whether provincial legislation exists or permits an action of this nature. In the case of Harrison *(Litigation Guardian of v. State Farm Mutual Automobile Insurance Co.* (1996) 21 O.T.C. 62, Mr. Harrison by court order was to pay child support of $1,200 a month and to protect the support payment by a life insurance policy on his life in the amount of $150,000 designating his children as irrevocable beneficiaries. At the time of his death, he was in arrears of support and had failed to take out a life insurance policy as ordered. He did however take out a policy for $300,000 designating his common-law spouse as irrevocable beneficiary. The court determined that the estate of Mr. Harrison was charged with the arrears of support. The court also found that the children were entitled to a charge on the life insurance policy to the extent of $150,000 to provide for child support despite the irrevocable beneficiary designation in favour of the common-law spouse.

For a further discussion regarding dependant relief claims see the Tax Topics "Life insurance, support obligations and marriage breakdown" and "Beneficiary Designations: why, when and how".

Testamentary Trusts

The right of a beneficiary to receive money from an estate, may be subject to the claims of that beneficiary's creditors. A separate testamentary trust created in a Will may be one way of protecting beneficiaries from their own creditors. A testamentary trust within a Will must clearly create a separate trust in such a way that insurance proceeds will not flow through the estate. One way to achieve this outcome is by way of a discretionary trust. In a discretionary arrangement, the trustee has control of the trust and the pay outs made from the trust. The trustee can refrain from making payments to the beneficiary until such time as the beneficiary is no longer subject to claims of creditors or make payment to the beneficiary in such a manner that the creditor will not gain the benefit of the distribution.

While a testamentary trust can be an effective vehicle to ensure life insurance proceeds are creditor protected, the Will must be structured in such a manner to ensure that the proceeds flow outside of the estate. Otherwise, the protection that the testator hoped in drafting the Will to create such a trust will fail and the proceeds will be subject to creditor's claims

Inter Vivos Trust

The question of whether creditor protection exists in an inter vivos trust scenario depends upon the relationship of the beneficiary to the life insured rather than the relationship of the trustee to the life insured. If the beneficiary falls within the protected class, then insurance money should be protected from creditors. This is regardless of the fact, that the policy may be payable to a trustee. As long as the benefits are payable in trust for a beneficiary, in the protected class, then creditor protection should exist.

Non-Insurance RRSP/RRIF contracts

Generally, in most provinces the definition of "life insurance" under provincial legislation traditionally includes life insurance, accidental death and disability insurance when part of a life insurance contract and annuities. The British Columbia Court of Appeal confirmed in the case of Robson v. Robson, 1995 CanLII 3197 (3d) 169 (BCC.A.) that an option to annuitize is sufficient to qualify a contract with an insurance company as life insurance. The key component in the definition is that the product take the form of "an undertaking to provide an annuity." This would therefore include RRSPs/RRIFs and segregated funds. As a result, creditor protection exists for these types of insurance products.

Traditionally, non-insurance contracts and annuities issued by non-life insurers have not enjoyed such protection. However, the case law and legislation in this area is evolving. A series of cases in the non-insurance RRSP/RRIF context have examined the issue of whether these types of products should be protected. If the case law continues in the current direction both insurance or non-insurance products will likely enjoy the same type of protection.

The issue first arose in CIBC v. Beshara, (1989), 68 O.R. (2d) 443 (Ont. H.C.J.) The court determined in that case, that notwithstanding that an RRSP was purchased from a trust company under which the annuitant designated his spouse as beneficiary, the proceeds passed through the estate and were therefore subject to the annuitants' creditors. Here the court went on to say that no statutory exemptions existed for RRSPs that would be similar to insurance plans.

In Curley v. MacDonald, 2001 D.T.C. 5141, (2000) 35 E.T.R. (2d) 201 and Banting v. Saunders Estate (2000) 34 E.T.R. (2d) 163 the court questioned the reasoning in the Beshara case and instead followed the Manitoba Court of Appeal decision in Clark Estate v. Clark, (1997), 15 E.T.R. (2d) 113. The decision in Clark concluded that RRSP funds payable to a named beneficiary did not form part of the estate. The Court further concluded that such funds were available to satisfy creditors of the estate, but only after other assets of the estate were exhausted. Note should be taken of S. 160 2(l) of the Income Tax Act, R.S.C. 1985, c. I (5^{th} Suppl) (ITA), relating to tax liability, with respect to amounts received out of an RRSP, under this provision, the taxpayer and the last annuitant under the plan are jointly and severally liable to pay a part of the annuitant's tax for the year of the annuitant's death.

In 2004 the Ontario Court of Appeal in Amherst Crane Rentals Ltd. V. Perring, 187 O.A.C. 336 considered the issue. In Amherst the estate of Mr. Perrin was bankrupt. Amherst Crane was owed $53,000. Mr. Perrin’s widow was a beneficiary of a $107,000 non-insurance RRSP. The Ontario Court of Appeal refused Amherst access to the non-insurance RRSP proceeds. The court considered the reasoning in the Clarke case cited above. The court also relied on s. 53 of the Succession Law Reform Act, R.S.O. 1990. c.S26 (SLRA) and determined that the RRSP did not form part of the deceased’s estate and that the funds were not available to satisfy debtor’s claims. The decision was appealed to the Supreme Court of Canada but leave was denied.

Insurance company products continue to enjoy the greatest level of creditor protection through provincial legislation. Several provinces (P.E.I., Saskatchewan and more recently, Manitoba and Newfoundland) have amended their provincial legislation to extend creditor protection to annuity and RRSP products offered by trust companies and banks, and amendments to the BIA discussed above, afford a certain level of creditor protection for all registered products whether issued by life insurers of not.

Claims by Canada Revenue Agency (CRA)

CRA has two avenues available for collection purposes. It may provide notice to a third party to require payment to the Minister, pursuant to s. 224(1) of the ITA where moneys are immediately payable and where moneys become payable generally within one year. This provides the CRA with a garnishment remedy. The second avenue arises under s. 225(1) of the ITA. It allows the Minster to give written notice to the debtor of the Minister's intention to seize property to collect on any balance owing by the taxpayer. The latter is a seizure remedy.

In the first instance, it was thought that CRA could only exercise its garnishment power if provincial legislation did not prevent such remedy. In Sun Life Assurance Co. of Canada v. M.N.R., [1992], 2 C.T.C. 315 (Sask. Q.B.), however the Saskatchewan Queen's Bench determined that CRA could garnish pension payments regardless of restrictions contained within the Pension Benefits Act. Sun Life argued that s. 224(1) of the Income Tax Act could not be employed by the Minister because of the provisions in s. 19 of the Pension Benefits Act.

Under the Pension Benefits Act S.S. 1992, c.P-6.001, the legislation provided that pension payments were not attachable by garnishment. The question really became one of Federal paramountcy. The court determined that the Federal Crown was not engaging in an act regulated by provincial legislation but rather, it was exercising its proper authority pursuant to s. 91 of the Constitution. The court determined the collection provisions fit within the scope of the federal legislation. The court also found that Sun Life was contractually liable to make payments to the tax debtor and therefore it was properly put on notice of the requirement to remit under s. 224(1) of the Income Tax Act. The court indicated that this was a special debtor-creditor relationship and CRA was a special kind of creditor. In coming to its conclusion that CRA was not an ordinary creditor, the court determined that the intention of the provincial legislation was not applicable to CRA. The court declared that CRA has the right to levy taxes and the right to collect them and therefore this remedy was found appropriate. This decision now indicates that CRA has a special status as a creditor allowing it to garnish payouts under life insurance contracts that are owned by registered pension plans.

While a higher court has not tested this decision, it is one in which close attention should be given. The outcome may be analogized and applied to provincial insurance legislation. If provincial pension legislation was not protected in this instance, then the same success may be achieved by creditors in relation to pay outs made under the Insurance Act.

In the Newfoundland Court of Appeal case of M.N.R. v. Anthony,(1995), 32 C.B.R. (3d) 109 (Nfld. C.A.), the court held that the retirement savings plan that a bankrupt dentist held with the Canadian Dental Association under an agreement defined as a "variable annuity contract" was a contract of insurance falling within the legislation and was therefore exempt from execution and seizure. The insurer held and invested the funds of participating members of the association and undertook to pay individual annuities to members of the plan who elected to receive by that mode all or part of his or her value in it. The Minister argued that a contracting insurer makes no undertaking to create an annuity until an election has been exercised by the participating member. On this basis, the Minister argued that it was not eligible to be protected under the definitions contained within the legislation. In essence the Minister was attempting to obtain a garnishment remedy under s. 224 of the ITA. The court disagreed with this argument and indicated that the insurer's undertaking to provide an annuity fell within the ambit of the ITA. The outcome of the case indicates that unless money is payable by operation of a contract or the policy owner requests the money, an argument to garnish should not succeed. Despite this outcome, CRA continues to take the position that a requirement to pay attaches to the policy whether there are moneys payable or not and there is an obligation to collapse the policy.

Subsection 225(5) of the ITA, states provincial exemptions from seizure will apply. CRA however challenged this exemption under the provisions of the Manitoba Insurance Act. In M.N.R. v. Ross, [1997] Fed. Ct. (T.D. No. 1538), the court allowed an order to continue allowing for the seizure of life insurance policies by the Minister of Revenue. The facts indicated that the taxpayer had flagrantly avoided making payment and this ultimately may have brought the court to its conclusion to allow for the seizure.

The taxpayer had three insurance policies described by the court as bank chequing accounts. Funds flowed in and out of the accounts frequently. The court concluded that the insurance policies were not exempt from seizure under the Income Tax Act regardless of the provisions contained within s. 173 of the Manitoba Insurance Act C.C.S.M. c. 140. The court followed the reasoning found in another Manitoba Court of Appeal decision, although that case had dealt with the issue of garnishment and not seizure.(See Red Development Corporation v. Triman Industries Ltd. [1991] 6 W.W.R. 481). Similar to Sun Life, the remarks of the Court of Appeal judge indicated that the purpose of the Income Tax Act was not only to levy tax but also to collect it.

Collection and enforcement under the ITA is part of the subject matter of s. 91(3) of the Constitution Act and is not merely incidental to raising revenue. In Ross, the Federal Court went on to say that the collection provisions fit within the scope of the federal legislation and therefore the policies were not exempt or immune from seizure under provincial statutes. The court determined that unlike 67(1)(b) of the BIA, there is no provision in the ITA exempting property from seizure under provincial law. The decision in this case appears somewhat unusual and inconsistent in its finding with the provisions in the ITA. While this case seems to have provided CRA with broad remedial powers, the facts of this case should be considered. Here the taxpayer debtor continually avoided making payment and garnishment had already been utilized by Revenue to obtain some funds in settlement of the debt. Perhaps, in a scenario where the taxpayer had not gone to such lengths to avoid payment, the court may not have granted such relief in the first instance. However, the case does confirm that CRA may take such steps to obtain payment and that life insurance and annuity contracts will no longer be subject to the same sort of protection in relation to seizure that was once enjoyed.

Summary

While creditor protection continues to exist for life insurance contracts, there appears as of late to be some erosion of that protection. There continues to be many instances, however, where life insurance can provide protection. It is important to understand the restrictions of creditor protection to better determine where it may still exist as an additional feature. Creditor protection should not be the only reason for placing life insurance. It should, however, be viewed as an added feature of the product, if in the future creditor issues do arise.

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Last updated: May 2011