Manulife

TAX TOPICS

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. Therefore any potential planning in Quebec will not be discussed. 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, recent changes in family law legislation in British Columbia , provides property rights to common law spouses who have lived in a relationship of permanence or with a child, for two years. In the other common law provinces, case law has evolved to allow common law spouses to make property right claims via trust law or on the basis of an equity argument. The Supreme Court of Canada in Kerr v. Baranow 2011 SCC 10 (CanLII) and the companion case of Vanasse v. Seguin 2011 SCC 10 (CanLII) has recently opened the door for common law spouses to further arguments on the basis of unjust enrichment by recognizing the relationship as a "joint family venture".

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) 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 British Columbia, the new Family Law Act, does not deal with the concept of equalization but all property is divisible, regardless of use by one or both spouses unless it is "excluded" property. The British Columbia Wills, Estates and Succession Act states that an appointment of or a gift to the surviving spouse is revoked if the spouses cease to be spouses. A spouse ceases to be a spouse where they live separate and apart for at least two years with one or both having an intention to live separate and apart or where a division of assets occurs under the B.C. Family Law Act.

While the Alberta Matrimonial Property Act, 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. However, proposals still being considered with the passing of Alberta's modernized Wills and Succession Act legislation (proclaimed as of February 1, 2012) would have a surviving spouse under the Matrimonial Property Act, be entitled to make a claim against the estate for a division of matrimonial property accumulated during the marriage. Such a claim would be in addition to any property or other benefit received by the surviving spouse under a will or on an intestacy of the deceased spouse, where the spouses have been separated for less than two years. Under Alberta's Wills and Succession Act, a former spouse or adult interdependent partner is deemed to predecease the testator for the purposes of gifts or appointments. These provisions however do not apply to designations relating to RRSPs, RRIFs, investment or insurance products.

In Nova Scotia, the division of family assets is made in equal shares notwithstanding ownership. In New Brunswick, under the Marital Property Act, 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 ("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. Excluded property deposited into a joint account loses its exclusionary character to the extent of the one-half interest that is presumed to be gifted to the spouse. (see Coletta v. Coletta, 50 R.F.L. (3d) 1 (Ont. C.A.)

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 (ONCA) and Cohen v. Zagdanski [2006] O.J. No. 3729 151 A.C.W.S. (3d) 398 Ont. S.C.J.).

Where insurance planning has been done in contemplation of an intergenerational transfer of a life insurance policy (for example, where dad owns a policy, son is the life insured and the policy will be transferred to the son at a future date on a tax-free rollover basis) the policy may be subject to equalization or division claims by a former spouse where there is cash value in the policy unless at the time of transfer there is evidence that the policy is intended to be transferred as a gift. However even with the evidence of a gift there may be the ability to argue that the life insurance policy should be included for NFP purposes. The FLA defines property to include "vested or contingent rights" in property. Therefore the son in the scenario above arguably could be treated as an actual owner. However, the son could argue that he did not have access or control of the life insurance policy at the time of the marriage and that ownership started after the date of marriage but as a gift or inheritance where death of the parent occurs.

Failing a pre-nuptial agreement that addresses the issue the best mechanism is to have the parents expressly state in writing that the policy is intended to be a gift and should be excluded from NFP. This way there is at least evidence in writing for a court to consider which is considerably better than no evidence at all. However, if the cash value is used to purchase a matrimonial home then the "gift" argument will be jeopardized.

Estate freezes and gifting for matrimonial purposes has been reviewed by the court in Ontario. Generally, it is always 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.

In McNamee v. McNamee, 2011 ONCA 533 (CanLII) the estate freeze was atypical in the sense that the growth shares were transferred to the adult children and the freeze shares had a discretionary dividend feature that gave the father the ability to strip the value of the company. The lower court considered the nature of the gift and found that the father had not truly gifted the shares. Despite the father taking measures to document the gift the court found that the elements to make a gift did not exist due to the dividend feature and the father's ability to implement the control and realize on the value of the company. The Ontario Court of Appeal reversed the decision. The Court of Appeal found that the donor could affect the

value of the shares at any time reflecting the nature of the estate freeze and it did not affect the existence of the gift. However, the Court of Appeal indicated that there may be other arguments available by way of unjust enrichment and sent the matter back down to the lower court for reconsideration.

Two other cases have dealt with estate planning using a freeze. In Reisman v. Reisman, 2014 ONCA 108, the Ontario Court of Appeal did not accept the argument that an estate freeze could cause the assets to be included for equalization purposes on the basis of fraudulent conveyance. First the court did not find that the freeze was done when the Applicant would have been a creditor as the parties were still married at the time. Second no fraudulent intent existed at the time the freeze was implemented.

In Hamm v. Hamm (Estate of), 2014 MBQB 14, the Manitoba Court of Queen's Bench ordered that the assets that were covered by the estate freeze transaction should be included for the purposes of accounting and equalization under the Manitoba Family Property Act. The court found that the transactions resulted in the petitioner having nothing. The court considered whether any one of the legal requirements of dissipation, excessive gift or a transfer of inadequate consideration had occurred. It came to the conclusion that all criteria could be met citing that the transfer of preferred shares to the son which was part of a final transaction after the freeze most closely resembled an excessive gift.

When a trust is set up prior to marriage or during cohabitation, frozen shares may not form part of net family property. However, there are not a lot of cases dealing with valuation but see Sagl v. Sagl (1997) CanLII 12448 (On. S.C.). Whether frozen shares are included will depend upon the timing of the gift and the context and true intention of the arrangement.
Not all provincial legislation contains "excluded property" provisions. Therefore, insurance proceeds or any property purchased with such proceeds could be included as family assets and be subject to the provisions under family law legislation.

Planning using a trust
Planning using a trust may be one way in which to contemplate the second marriage scenario and to avoid the implementation of a marriage contract. In Spencer v. Riesberry 2012 ONCA 418 CanLII, the court was asked to consider whether a property owned by a family trust, where the separated beneficiary had lived with her family, was a matrimonial home for the purposes of the FLA. On appeal, the court followed the finding of the trial judge and concluded that the home was not a matrimonial home as defined under the FLA. The property was therefore exempt from equalization, although the spouse-beneficiary of the trust had to include the value of her interest in the trust for equalization purposes.

There is some concern regarding the reference to "beneficial interest" and property under the British Columbia Family Law Act. It would appear that a beneficial interest in a trust may be found to be family property. However, the legislation does exclude property held in a discretionary trust to which the spouse did not contribute, or settle it and where the spouse is a beneficiary. However, while the Act appears to exclude the interest in a discretionary trust, the growth in the value of the trust would be captured for division purposes. Since the legislation is new, the outcome of this issue may be dealt with at a later date either by the provincial legislature or interpretation by the court.

Trust assets may be considered matrimonial property. The courts have considered whether the value of trust assets should be considered for matrimonial division or equalization in divorce cases. In the case of Sagl v. Sagl, 1997 CanLII 12248 (On SC) the court considered the husband's one-seventh interest in the trust in determining equalization. In Alberta the case of Shopik v. Shopick 2014 ABQB 41, the court was asked to determine the division of their interests in a family trust. It found there was a one-half interest for each spouse. In another Alberta decision, Kachur v. Kachur, 2000 ABQB 709 the court did not find there to be an interest in the trust because there was no expectation that the husband would ever receive an interest in the trust.

In addition to the consideration above in the trust planning context and family law, an interest in a trust and gifts can be the subject of disclosure orders from the court in family law disputes. This issue arose in Clapp v. Clapp 2014 ONSC 4591. There the court had considered whether the gifts received by a spouse and the distributions from a trust should be included in income for purposes of calculating spousal support. The court found that the amounts received had not been included in the spouse's income for tax purposes. The amounts received were commingled with family law property and were not used to generate income. For these reasons the court found no basis for a court order of interim support.

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 common law 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 British Columbia, the Family Law Act excludes money paid or payable under an insurance policy other than a policy respecting property.

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. Presumably insurance is included in this definition.

In Manitoba 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, (the "Act") contains specific provisions that deal with the transfer of life insurance. Like the transfer of capital property, the Act 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))

For tax purposes, spouses are still legally married to one another until divorced. Where an individual is separated from a spouse and not yet divorced and living with a common law spouse, CRA will recognize both spouses for tax purposes in certain circumstances. (see Technical Interpretation # 9425755 dated October 19, 1994). A tax-free rollover pursuant to s. 148(8.1) could therefore still occur with a former spouse where the parties have not yet divorced even though there is a common law spouse.

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 Act 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 Act.

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.

Where a policy must be split and the carrier issues a new policy, such that an actual transfer of an interest in the original policy cannot occur, consideration should be given to a July 23, 2001 Technical Interpretation no. 2001-0073505(E). Subsection 148(8.1) would not apply in the situation where a life insurance contract is split because a transfer of an interest in a life insurance policy cannot be said to have occurred when the result of the proposed transaction is to create a new life insurance policy. As well, the party keeping the original policy may realize taxable income if it is determined that a disposition of the interest in the policy has occurred even if the only change to the policy will be a reduction in the death benefit (where the owner and life insured remain the same). It is a question of fact whether the change in the terms and conditions of the policy will result in the acquisition of a new policy.

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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