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Creditor Protection of Life Insurance Products

Things change. You need to know.

Creditor protection is a benefit that makes life insurance products particularly valuable for clients. Originally created to protect a debtor's dependants from financial destitution and becoming a burden on society, the notion has changed with Insurance Act revisions and Court rulings. It's important to refresh your knowledge of the facts and how to maximize the chances that it will be effective for your client.

It's equally important to make sure your clients understand the limitations of creditor protection, lest you expose yourself to client claims of negligence. There are circumstances under which it will not apply to savings products issued by life insurance companies, and even where protected under Common Law jurisdiction legislation could be denied under the Quebec Civil Code.

General rules in Common Law jurisdictions

Insurance Acts for each Canadian province and territory and the Quebec Civil Code stipulate that creditors of the life insurance policy owner cannot seize the proceeds on the death of the life insured, so long as a designated beneficiary is in place. When this beneficiary is an eligible family member or irrevocable, the entire contract including cash value is protected both on death and during the lifetime of the insured.

In general, the law protects the beneficiary's interest from creditors of both policy owner and insured, but not from the beneficiary's own creditors, who can seize the proceeds at the moment they are paid out to the beneficiary on death of the life insured.

Eligible products — In addition to traditional life insurance, products eligible for creditor protection also include any annuity issued by a life insurance company, including registered and non-registered accumulating annuities such as segregated funds (variable annuity), term annuities and life annuities.

Protected beneficiaries — The policy owner's creditors cannot seize the proceeds or any cash values if the insurance policy has a proper and valid designation of an irrevocable beneficiary of any class (other than the policyholder), or a family-class member beneficiary including spouse (plus common law spouse and same-sex partner in Ontario), parent, child or grandchild of the person whose life is insured. In Quebec the relationship is extended to any ascendant, descendant or spouse of the policy owner.

In trust or trustee designation — This type of beneficiary designation when properly drafted for the benefit of a family-class member, may provide creditor protection against creditors of policy owners' beneficiaries. *Note that in Quebec Civil Law, only setting up an inter-vivos trust will create this creditor protection, but this trust will never retain the tax advantages of a testamentary trust created through a Will.*

Conflict with Family Law — If a deceased had an insurance policy on his own life and did not make adequate provision to support his dependants, the dependants' rights could supersede those of the policy's designated beneficiaries. The proceeds will then be included in the value of the estate and made available to meet this obligation. In addition, in Ontario, court ordered support payments can supersede the creditor protection.

Creditor protection in bankruptcy

The federal Bankruptcy and Insolvency Act recognizes the creditor protection of life insurance products set by provincial law. If a policy is exempt from creditors at the moment bankruptcy occurred, the trustee in bankruptcy (representing the creditors) cannot surrender it to/or divide it among the creditors unless the protection ends before the assets are given back to the bankrupt — such as when a family-class beneficiary dies and the policy has not designated a contingent protected class beneficiary. *Note that a bankrupt policyholder cannot access any assets, including those that are exempted, until they are discharged.*

Transferring money into an exempt life insurance contract or changing the beneficiary does not automatically protect it. The settled property can be surrendered and the proceeds given to creditors if the bankruptcy trustee can prove it was conveyed only to avoid paying creditors. Any such fraudulent conveyances or assignments and preferences are attackable by creditors under provincial legislation (this applies whether or not the policy owner is bankrupt).

Creditor protection against CCRA

As a federal agency enforcing federal law, the Canada Customs and Revenue Agency (CCRA) is generally immune to the application of provincial legislation that exempts assets from seizure. If the policy owner owes tax money, the life insurance company may be required to provide money to the CCRA which would otherwise be payable to the policy owner.

However, the CCRA is bound by provincial statute provisions when they are incorporated in the *Income Tax Act* or other federal statutes. So if a policyholder becomes bankrupt, the life insurance contract could become exempt because CCRA is bound by the federal Bankruptcy and Insolvency Act.

Creditor protection of various holding methods

As life insurance planning may involve more than designating family-class or irrevocable beneficiaries, advisors have developed other ways to hold these products.

Life insurance held in "nominee account" (IDA) — Unlike a traditional insurance agent where the life insurance contract is issued in the client's name, an investment dealer (member of IDA, Investment Dealers Association of Canada) may purchase the contract in its own "nominee name". The client pays the dealer, the dealer buys the product and pays the insurer. The dealer holds the product for the client, and the client receives a consolidated statement.

The implications on creditor protection depend on the dealer's legal status ("trustee" or "agent") with regard to the policy, and contract arrangements between insurer, dealer and client.

Because the status of an insurance product held in "nominee account" is not set, clients who want creditor protection should instead (for now) deal directly with the insurer.

***Life insurance held in a corporation* —** Shareholders can hold insurance products, but conventional buy-sell agreements usually do not provide total protection against the personal creditors of the shareholder, and individual debt or bankruptcy could leave the business with no insurance. Unless all the company's shareholders are family-class members, only an irrevocable beneficiary designation can provide creditor protection.

Life insurance held in a corporation is protected against personal creditors of the shareholders, but cash values will be company assets and could be seized in the corporation's bankruptcy. Since the company must be the beneficiary to access the capital dividend account and pay tax-free dividends, a preferred beneficiary designation is not possible. Furthermore, the shareholders' creditors could seize the shares themselves, whose value includes the insurance cash value.

Life insurance held in a holding company may be protected against creditors of the operating company, if the holding company does not guarantee loans or other transactions negotiated by the operating company.

***Life insurance held in a partnership* —** The policy becomes part of the partnership assets held by each partner. Personal insolvency of one partner will not compromise the policy as long as the partnership remains economically sound. But the bankruptcy trustee could seize the insolvent partner's interest, and the fate of assets to which he/she has rights will be determined by the agreement between the partners.

***Life insurance held in an asset protection trust* —** This can protect the policy against creditors regardless of beneficiary status, and also allow tax-free transfer of property to beneficiaries. Since a life insurance contract is not defined as capital property, the "21 Year" rule requiring periodic deemed disposition does not apply.

General rules under Quebec Civil Law

Recently the Supreme Court of Canada ruled that all rights conferred by Quebec issued life insurance contract are seizable unless a specific legislative rule governing unseizability is in place.

***Eligible products* —** In Quebec, creditor protection is extended to life insurance and fixed-term annuities sold by insurance companies. The deciding factor is "*alienation of capital*," and recent decisions disqualify RRSPs and RRIFs because the policyholder can withdraw contributions. Unless further legislative changes occur, any accumulation annuities (including fixed-rate and segregated fund policies) exemption from seizure could be challenged in Quebec. However, payout annuities are protected.

***Protected beneficiaries* —** In Quebec, the beneficiary must be of the *policyholder*, not of the insured, and can include a family member, spouse, ascendant or descendant of the policyholder or an irrevocable beneficiary. Spouse, however, is defined as *"married persons of opposite sex"* and does not include common law spouse or same sex partner. The designation of policyholder's spouse is automatically irrevocable unless otherwise stipulated, while the opposite is true for any other person.

Quebec exceptions to creditor protection

***Family law* —** In Quebec, assets included in family patrimony (such as RRSPs, RRIFs, LIFs and supplemental pension plans) can be seized by a spouse or former spouse to satisfy an obligation to pay alimony and child support. On the other hand, insurance policies and non-registered annuities are not included in family patrimony, so they cannot be seized if a protected beneficiary is designated. The insurance proceeds are not included in the estate when there is a designated beneficiary. However, if the insured dies within three years of the beneficiary designation, the proceeds will be clawed back into the estate for the purpose of determining the deceased's obligation to provide for a spouse and children.

***Legal separation* —** In Quebec, legal separation does not affect the rights of a spouse as beneficiary or subrogated policyholder, but the Court may declare the designation revocable or lapsed at the time a separation is granted. If there is no replacement-protected beneficiary, the contract is no longer protected.

***Divorce, annulment* or nullity of marriage —** In Quebec, a court-granted divorce or marriage annulment after December 1, 1982 causes the automatic lapse of the designation of spouse as beneficiary or subrogated policyholder, and the life insurance policy or annuity contract is no longer protected.

In conclusion, life insurance policies including fixed-rate annuities and segregated fund policies can provide fund accumulations exempt from seizure by the policy owner's creditors. But this protection is not complete or available in all cases. It requires proper selection of policy owner, insured and beneficiary. But even then, there are many situations in which creditor protection will not be upheld.

Each person's circumstances are unique. It is wise to review them with the client and his/her legal and tax advisors to determine whether or not creditor protection may be applicable.

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