Last updated: April 2019

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

When an individual becomes insolvent, the rights of the bankrupt and his/her creditors are governed by the Bankruptcy and Insolvency Act (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 beneficiary designation in favour of a member of the preferred or family class (spouse, child, grandchild or parent to the life insured in the common law provinces) 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 to satisfy the claims of the bankrupt's creditors. The case of Royal Bank of Canada v. North American Life Assurance Company and Balvir Singh Ramgotra, (1996), S.C.R. 325 upheld creditor protection provided under provincial legislation to life insurance annuities when a bankruptcy occurred. The trustee in bankruptcy could not force the surrender of a creditor protected life insurance or annuity contract to satisfy the claims of the bankrupt's creditors.

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 exemption under the BIA extends to all RRSPS and RRIFS of any issuer not just an insurer, subject to certain limitations (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 applies. Where a registered insurance product does not meet the exemption under the provincial exemption (for instance, where a family class beneficiary is not named) and there is no protection available under provincial law for RRSPS (like there is in Saskatchewan, PEI, B.C., Alberta, Manitoba, Newfoundland and Labrador) protection will exist under the BIA.

Annuities

A series of cases has 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. There is some 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, case law has challenged creditor protection to annuity products. 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. 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.

The Quebec National Assembly passed legislation that deals with this issue. 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 this would mean that the Thibault case would have 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.

Non-Insurance RRSP/RRIF contracts

Traditionally, non-insurance contracts and annuities issued have not enjoyed creditor protection. However, case law and legislation in this area is evolving.

In CIBC v. Beshara, (1989), 68 O.R. (2d) 443 (Ont. H.C.J.) The court determined 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 subject to the annuitants' creditors. Here the court went on to say that no statutory exemptions existed for RRSPs that would be like insurance plans.

However, in Curley v. MacDonald, 2000 CanLII 22836 (ONSC) and Banting v. Saunders Estate, 2000 CanLII 22834 (ON SC) 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 do not form part of the estate; such funds are available to satisfy creditors of the estate, but only after other assets of the estate were exhausted.

In 2004 the Ontario Court of Appeal in Amherst Crane Rentals Ltd. V. Perring, 2004 CanLII 18104 (ON CA) 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 Ontario 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.

Fraudulent Conveyances

Provincial legislation dealing with fraudulent conveyance provides an argument for creditors when seeking to satisfy outstanding debt. 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 is to place the insurance for this purpose, then it may be a fraudulent conveyance.

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. 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, in Duca Financial Services Credit Union Ltd. v. Bozzo, 2010 ONSC 3104 (CanLII) the court indicated that a person can isolate his or her assets from future creditors as opposed to present creditors. But series of transactions including creating entities and backdating documents for self-serving purposes will not be looked at favorably by the court. (See Bayerische Landesbank v. Sieber, 2015 ONSC (CanLII).

Great caution therefore needs to be exercised when dealing with this issue. It should be noted that the more knowledge the consumer has regarding arguments to support creditor protection, the more likely creditor protection will not be available. Life insurance advisors should not encourage the purchase of insurance "to provide" creditor protection where it appears that the purchaser could have a fraudulent intent or where it is apparent that the purchaser is in financial difficulty. If there is any doubt, a recommendation to seek legal advice should be made.

Amounts Available to the Owner

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 and in Quebec the relationship is to the owner and not the life 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 *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. In Bormans v. Estate of Bormans et al., 2016 ONSC (CanLII) the court found that insurance proceeds were deemed to be part of the deceased's estate for the purposes of the dependant support claim made under the Succession Law Reform Act.

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?".

Marriage Breakdown and Arguments in Equity

Creditor protection may not always be extended in marriage breakdown. An insurance policy may become subject to property claims relating to marriage breakdown and equity arguments. See the Tax Topic on Life insurance and property issues on marriage breakdown.

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 Income Tax Act (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 Act. 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. Note should be taken of S. 160 2(l) of the Income Tax Act, 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 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 Saskatchewan Pension Benefits Act. Sun Life tried to argue that s. 224(1) of the Act could not be employed by the Minister because of the provisions in s. 19 of the Saskatchewan Pension Benefits Act. However, this argument was not successful.

Under the Saskatchewan Pension Benefits Act, the 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 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. CRA appears to have 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

In the Newfoundland Court of Appeal case of M.N.R. v. Anthony, 1995 CanLII 5595 (NL CA) 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. The Minister was attempting to obtain a garnishment remedy under s. 224 of the Act. The court disagreed with this argument and indicated that the insurer's undertaking to provide an annuity fell within the ambit of the Act. 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 Act 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) on appeal [1997] F.C.J. 1765, 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 in allowing 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 Act regardless of the provisions contained within s. 173 of the Manitoba Insurance Act. 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 CanLII 2699 (MB CA)). Like the previous Sun Life case cited above, the remarks of the Court of Appeal judge indicated that the purpose of the Act was not only to levy tax but also to collect it.

Collection and enforcement under the ITA are 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 Act exempting property from seizure under provincial law. The lower court decision was appealed but the appeal was unsuccessful.

The decision in the Ross case appears somewhat unusual and inconsistent. 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.

Time limitations set out in provincial legislation appears to have no application against CRA's claim for seizure and garnishment. In MNR v. Ruh et. al, 2017 CF 272 (Federal Court) the taxpayer could not rely on the limitation period found in the Quebec Civil Code. The limitation period in the Civil Code was not applied even though the orders for garnishment dated back several years they were not realizable until the taxpayer demanded the cash value of the policies. Therefore, the garnishment orders remained outstanding.

One further case to consider is Higgins v. The Queen, 2013 TCC 194 (CanLII). In that case an appeal was launched because of an assessment. The CRA relied on s. 160(1) of the ITA as the enforcement mechanism. It argued that a transfer of a non-registered insurance segregated fund had occurred and therefore tax was owed. However, the court disagreed with this argument finding that the asset had been distributed by way of a beneficiary designation in the contract. The court found that the B.C Insurance Act applied and therefore the segregated fund contract was protected under the preferred class provisions of the B.C. Insurance Act.

Summary

While creditor protection continues to exist for life insurance contracts, there appears as of late to be some erosion of that protection. In certain instances, competing claims may supersede the provincial insurance acts. Fraudulent conveyance, dependant relief claims, property claims in marriage breakdown as well as CRA claims are instances where creditor protection may be impacted. 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.