



COMMENT

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Marriage Breakdown and Life Insurance Policies

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When a marriage breakdown occurs, a life insurance policy may form part of the assets of the marriage. Since a life insurance policy is a contract containing a bundle of rights it is not always an easy asset to divide, equalize, or even transfer. The starting point is to always review the contract terms and determine what may be possible in respect of the policy. Various legal and tax issues arise and should always be considered before entering into a separation agreement that addresses what will happen with a life insurance policy. A caveat for all separating parties is to always consider whether insurability will be at issue if they decide to transfer or cancel a policy.

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.

Most provincial financial statement forms include disclosure of the type of life insurance policy, the insurer, the owner, the face amount, and the cash surrender value (CSV) of the policy at the date of

separation. Term policies are usually considered to have no value and therefore are not relevant for the purposes of property division on separation or divorce.¹

Tax Treatment

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 ss. 148(8.1) of the Act.). The requirement for “in settlement of rights” means in writing by court order or by a separation agreement. This provision will allow a tax-free rollover of the policy if this requirement is met.

Spouses are still legally married to one another until divorced, so for tax purposes they are a spouse. Where an individual is separated from a spouse, not yet divorced, and is living with a common-law spouse, CRA will recognize both spouses for tax purposes in certain circumstances.²

A tax-free rollover pursuant to subparagraph 148(8.1)(a)(i) could therefore still occur with a former spouse where the parties have not yet divorced even though there is also a common-law spouse.



Before entering into any settlement arrangements, the parties need to understand the tax implications relating to a policy. To illustrate what should be considered, the paragraphs below review various scenarios with a tax discussion.

Transfers and ownership considerations

a) Transfer of a life insurance policy owned by one spouse transferred to another spouse

Subsection 148(8.1) provides an automatic rollover where both the policyholder and the recipient spouse or former spouse are resident in Canada at the time of the transfer (see paragraph 148(8.1)(b)).

Where the transfer is between current spouses that are both resident in Canada, the rollover provision in subparagraph 148(8.1)(a)(i) applies and the transferring spouse 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 spouse will be deemed to have acquired the interest in the policy at a cost equal to those deemed proceeds.

On the other hand, if the transfer is between former spouses the rollover provision in subparagraph 148(8.1)(a)(ii) allows for a tax effective transfer of a

life insurance policy to a former spouse in settlement of rights arising out of their marriage. Obtaining a rollover is especially important where the transferred life insurance policy has a high cash surrender value. However, the rollover provision only applies to former spouses during lifetime and will not apply at death (see the discussion below).

In the situation where there is a subsequent disposition of the life insurance policy after the transfer to a spouse, the attribution rules in subsection 74.1 of the Act will apply. Any policy gain will be taxable to the original policyholder. However, where the ex-spouses are divorced, 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 and the policy gain, if any, will be taxed to the current owner.

b) Jointly owned policies and the parties continue to hold the policy jointly after separation/divorce

When spouses are divorced, they continue to hold a life insurance policy jointly, and if one spouse (who is not the insured) dies, there may be tax consequences. An automatic rollover to transfer an interest in the policy to a policyholder’s spouse on death only applies where the parties are still spouses (see ss. 148 (8.2) of the Act).



The rollover is not available if the parties are divorced. As a result, there would be a disposition of the policy on the death of the joint owner; no rollover would be available, and there could be tax triggered if the CSV was greater than the ACB of the policy.

c) Jointly owned policies, joint-last-to-die (JLTD) and joint-first-to-die

If a JLTD policy is jointly owned during their marriage or relationship and ownership is transferred to just one of the owners in settlement of rights under their relationship, that transfer is done on a rollover basis.

If only one of the spouses owns the policy and dies two outcomes are possible: a) the policy passes to the deceased spouse/owner's estate and via their will is distributed to the ex-spouse or other beneficiary under the will, or b) via a successor/contingent owner designation directly. In either situation the transfer would not get the rollover treatment because there is no language in ss.148(8.2) to contemplate a transfer to a former spouse on death. A T5 may be issued to the estate of the deceased policyholder to the extent that the cash surrender value at the time of death exceeded the adjusted cost basis of the policy.³

Finally, where a policy is jointly owned and is payable on the first death of the two insureds under the policy there would be no tax consequences arising from that death. The payment is not subject to tax because it is paid as a death benefit. Since payment has been made on the first death the contract terminates.

Looking at the various scenarios it is apparent that many factors must be considered before deciding what to do with a life insurance policy on marital breakdown. Where there are separate coverages on the spouses and there is a desire to split the policy into separate policies, the contract must first be reviewed to determine if this is possible and the available options. Consideration must be given to the ultimate tax outcome to make an informed decision. Remember that any policy acquired during the marriage should not be cancelled or transferred before all the options have been considered to preserve insurability. ©


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¹ However, in *Paterson v. Remedios*, 1999 SKQB 6 (CanLII) the court concluded that although term policies generally have no value, persons who are terminally ill may in fact receive some or all the proceeds of the term insurance prior to death, and therefore term insurance policies do have a value.

² See Technical Interpretation # 9425755 dated October 19, 1994.

³ Note that practices of insurance carriers may differ as to the issuance of the T5 slip. Clarity from the Canada Revenue Agency has been requested by both CLHIA and CALU in the past on whether a transfer on death of a joint owner where no rollover applies can have a prorated gain for a percentage interest. This question has not yet been answered.





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