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Life insurance to secure support obligations – Common problems

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Life insurance can be a source of funding to back-stop child or spousal support obligations either in a court order or negotiated separation agreement. Here is a non-exhaustive list of common questions and problems that can arise in this context.

Spoiler alert: Some problems can't be solved – there would just be a series of alternatives to consider with pros and cons.

Case example

X and Y are separated. They have 2 minor children. In their separation agreement, both X and Y, are obligated to contribute equally to support the children's monthly expenses until the children reach age 19. The agreement requires X and Y to have life insurance to secure this obligation. There is another section of the agreement that addresses expenses for post-secondary education and other extra-ordinary expenses requiring X and Y to share agreed-upon expenses 50/50. Both X and Y work and earn equivalent salaries.

Can existing life insurance be used to fund this type of obligation?

Yes, and ideally, it's personally held. This obligation is a personal obligation. An existing corporately held life insurance policy should not be repurposed to do this job. For example, if the beneficiary designation were changed to benefit someone other than the corporation, the shareholder may be assessed a shareholder benefit under subsection 15(1) for the premium (or some portion of it) under the policy.

Transferring the policy out of a corporation so that it may serve this purpose personally, would result in a disposition of the policy and could give rise to tax consequences. There are two levels of tax here. If the policy has a cash surrender value (CSV) in excess of the adjusted cost basis of the policy, the corporation would receive a T5 for the taxable policy gain per subsection 148(7). In addition, the

shareholder receiving the policy may have a shareholder benefit under subsection 15(1) for the amount of the fair market value (FMV) of the policy. There would be no shareholder benefit if the shareholder pays FMV but if FMV is greater than CSV, that is the proceeds on the disposition to the corporation under subsection 148(7) and the T5 would reflect that.

FMV is a question of fact. (For more on FMV of life insurance see: The rundown on in-kind charitable gifts of life insurance and some recent clarifications – Tompkins Insurance.)

What kind of life insurance works best here?

Term.

Many of the issues relating to dispositions and cash values would not present themselves with term. But if the obligation is not for a period of years and is truly permanent, then matching the duration of a permanent obligation can't be done with term insurance.

And this all assumes X and Y can obtain life insurance!

Who should own the policy? And how should the beneficiary designation be structured?

This IS tricky. Let's face it, there's usually a reason why people separate and it is not a stretch to say, there may be some level of distrust between the parties.

All too commonly, the separation agreement requires that X and Y own their own policy, designate the other as beneficiary "as trustee" for the children and that they prove to each other that the policy is in force and the beneficiary has not changed annually. Can this work?

Only if people do what they say they're going to. Unfortunately, often, that does not occur.

So, to restrict the owner's ability to deal with the policy, what is often suggested is that the designation be made irrevocably. Problems with irrevocable beneficiary designations are many.

An irrevocable beneficiary is required to consent to the following actions – a change of beneficiary; a surrender or partial surrender (withdrawal of cash value); a collateral assignment of the policy; a change in investment options under the policy, if any; a conversion to permanent insurance if the policy is a term insurance policy. The insurer would ask for the irrevocable beneficiary's sign off. However, if the policy lapses for lack of premium payment, the irrevocable beneficiary would not be automatically notified.

An irrevocable beneficiary must be capable of giving consent and what this means is that if a minor child were named as irrevocable beneficiary, they could not give their consent until the age of majority (in the relevant province). This would prevent any of the above actions from taking place and prevent the owner from doing any of those things until the child could consent.

Can a trustee for a beneficiary be named irrevocably? The thing about naming a trustee for a beneficiary is that there is no trust yet. The trust would be settled with life insurance proceeds at the time of death. Can the "trustee" consent to these types of transactions? Many insurance carriers would not accept an irrevocable designation in respect of an "in trust" designation.

OK so what about if X and Y jointly own each policy so they get notice of whether premiums are paid and transactions are occurring that would impact the other's obligations? The main problem with this approach relates to what happens on the death of X or Y in respect of the policy that they jointly own on the survivor. By operation of law the policy would pass to the surviving joint owner.

However, there would be a disposition of the policy on the survivor from the deceased ex-spouse that will not qualify for a rollover under subsection 148(8.2). Unless they remain spouses and never get divorced, 148(8.2) would not be met and the disposition would occur pursuant to subsection 148(7). Insurers' practices vary for common law provinces. Some acknowledge that the disposition of the deceased joint owner's interest in the policy would be for only 50% but others would view 100% of the policy to have been disposed of.

And what about if X owned Y's life insurance and Y owns X's? Same problem on death, the policy owned by the deceased on the survivor would be subject to a disposition. On this disposition the policy would not automatically roll over to the surviving ex-spouse. The disposition by the deceased holder of the policy would be pursuant to subsection 148(7) and the proceeds on the disposition would be the greater of ACB and CSV in this case.

Could the kids be named as successor owners of each policy? Yes, but the same subsection would apply and if CSV exceeds ACB, there would be a T5 to the deceased/estate. What if there is no successor owner designated and the policy passes by way of the deceased's ex-spouse's Will to say, their second spouse – so X dies holding a policy on Y and X's second spouse ends up holding insurance on Y. Very messy.

No matter what, there is no good answer here. Either X and Y have to trust each other enough to do the right thing by their kids or they choose a method that has practical problems and potentially tax issues.

Is it possible to accommodate a diminishing support obligation through automatic reductions in coverage?

There is really no such product. Reducing coverage is an ownership action and if the policy is subject to an irrevocable beneficiary designation this would need their consent.

If the coverage amount under the policy does not change and merely the portion of the death benefit allocable to support the obligation changes, can this be accommodated in advance and could it be done irrevocably? Few insurers would take this on and if they do, it would be case by case with the supporting legal documents setting out a detailed schedule of reductions/reallocations clearly spelled out. Otherwise, it would be a change in allocation filed each year to name X or Y for a reduced

percentage and other beneficiary(ies) for the remainder. And if irrevocably designated, X and Y would both have to sign off.

The final word?

There is no silver bullet.

FOOTNOTE:

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