August 30, 2013

Canada Revenue Agency
Income Tax Rulings Directorate
Financial Sector and Exempt Entities Division
320 Queen Street, 16th Floor
Place de Ville, Tower A
Ottawa, Ontario
K1A 0L5

Attention: Phil Kohnen, Manager, Trusts Section

Dear Sirs:

Re: Ownership of Life Insurance in a Spousal Trust

We are writing to seek further clarification relating to the Canada Revenue Agency ("CRA") responses to questions posed by the Conference for Advanced Life Underwriting ("CALU") at the 2012 CALU AGM CRA Roundtable. In a series of questions CALU sought the CRA's views on the following questions:

1. If a testamentary trust is obligated to fund a life insurance policy on the life of the surviving spouse[1] (from either trust income or capital) and the trust is the beneficiary of the policy, would this taint the trust and preclude it being a spousal trust pursuant to subsection 70(6) of the Income Tax Act (the "Act")?
2. Would the CRA's views be different if the trustees of the trust (either inter vivos or testamentary) had the ability to purchase life insurance on the life of the surviving spouse but there is no absolute obligation to purchase or retain such insurance?
3. If shares in a private corporation are transferred to a testamentary spousal trust, and the corporation has acquired insurance on the joint lives of the shareholder and his or her spouse, would the ownership of the life insurance by the private corporation impact the trust's status as a testamentary trust?

The CRA responded to questions 1 and 2 in a similar manner, indicating as follows:

[1] For purposes of this submission it may be assumed that a reference to a spouse includes a common law partner.

For purposes of the rollover provisions in subsections 73(1) and 70(6) of the Act, subparagraphs 73(1.01)(c)(i) and 70(6)(b)(ii) require the trust to be a trust under which no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use any of the income or capital of the trust.

The CRA is of the view that the mere possibility of a person other than the survivor receiving or obtaining, before the survivor's death, use of the trust capital or income is sufficient to disqualify the property transfer from the rollover. This view is consistent, whether the trustee has an obligation or mere power to encroach on the capital of a trust for the benefit of persons other than the surviving spouse or common-law partner.

With respect to question 3, the CRA indicated that it was unable to confirm that such a structure would not taint the status of the testamentary trust **or** impact the rollover of property under subparagraph 70(6)(b)(ii) of the Act.

Discussion Relating to Questions 1 and 2 – Ownership of Insurance by a Spousal Trust

The main issue to be determined with respect to this matter relates to the proper interpretation of the requirements that "no person except the spouse may, before the spouse's or common law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust." [2]

The view that appears to have been expressed in the CRA interpretations is that since the "benefit" of the insurance policy is not available to the surviving spouse, then it must mean that another person or persons (i.e. the residual beneficiaries) has the right to "receive or otherwise obtain the use of the income or capital of the trust" while the spouse is alive.

We have difficulty with this view for a number of reasons. First, we would submit that no one other than the spouse has the right to receive or otherwise obtain the use of the insurance policy while he or she is alive. For example, if the policy is surrendered or otherwise disposed of by the trust for a gain, such gain is treated as "income" which under the terms of the trust would be receivable by the spouse. Should the trustee have the discretion to make a capital distribution out of the insurance proceeds realized on a disposition while the spouse is alive, the only possible recipient can be the spouse. The residual beneficiaries of the trust merely have a contingent interest in the trust assets including the life insurance policy, and this interest only becomes crystallized if the policy remains in force until the death of the spouse.

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[2] There have been a number of tax cases that have considered the meaning of this phrase under both the Estate Tax Act and the Income Tax Act. However, it is submitted that all these cases clearly dealt with situations where someone other than the spouse had the right to income or the use of trust property *prior to the death of the spouse.* For example, see Matson Estate v. MNR (1971) Tax A.B.C. 708; Clouston Estate v. Minister of National Revenue, (1974) C.T.C 2163 (Tax Review Board); Gilbert v. Minister of National Revenue, 1983 C.T.C 2172 (Tax Court of Canada) and Peardon v. Minister of National Revenue (1986, 1 C.T.C. 2083 (Tax Court of Canada).

Even if a benefit test can be imputed into subsection 70(6), the CRA appears to have accepted that no benefit would accrue to any beneficiary under this type of arrangement. In a 2008 technical interpretation[3] the CRA considered a situation where a discretionary trust owns an insurance policy on the life of Ms. A. The beneficiaries of the capital and income of the trust included Mr. B as well as 10 other individuals. Under one of the scenarios outlined in the request for a technical interpretation, the trust was paying the insurance premium from trust capital, and was also designated as beneficiary of the policy. The CRA was asked whether in these circumstances it might apply subsection 105(1) of the Act to confer a taxable benefit on a beneficiary of the trust. The CRA expressed the view that since the beneficiaries have no right to the insurance proceeds, the trust will not have conferred a benefit on any beneficiary when it pays the premiums of a life insurance policy for which it is the designated beneficiary. While admittedly the language in subsection 70(6) varies from the language used in subsection 105(1) of the Act, it is difficult to see how there could be no benefit to any beneficiary while at the same time taking the view that any beneficiary has the use of the capital (or income) of such trust.

This situation is also somewhat analogous to that where a private corporation owns life insurance on the life of a key shareholder under which the corporation is the premium payer and beneficiary. On several occasions the CRA has been asked to comment on whether the payment of the premiums by the private corporation represents a taxable benefit to the shareholder.

The CRA has indicated that "where the corporation is the owner and the sole beneficiary of a life insurance policy on the life of a shareholder, and the corporation pays the premiums with respect to such policy, it is our view that the payment of the premiums on such policy would not ordinarily constitute a taxable benefit to the shareholder under subsection 15(1) of the Act."[4] Presumably this is to reflect the legal relationships that exist where only the corporation is entitled to the benefits of the policy while it remains the owner and beneficiary of the policy.

Similarly, while the trust remains the owner and beneficiary of the insurance policy, no person other than the spouse has the right to receive income arising from the insurance policy, or the right to receive or otherwise use any income or capital of the trust including the insurance policy.

We would also note that the conditions necessary to qualify as a spouse trust do not require the spouse to receive or otherwise obtain the use of the capital, but simply prohibit others from doing so during the spouse's lifetime. But the current CRA position seems to imply that if trust property is used to maintain or enhance such property this will taint the trust. This position, if maintained, would have broader implications and could affect a number of other trust arrangements. For example, assume that the terms of the trust allow the trustee to acquire and hold property that may or may not generate a regular income stream, but requires the use of trust capital to maintain the property.[5] Presumably under the CRA's recent interpretation, the ability of the trustee to expend funds to maintain such property would

[3] CRA Technical Interpretation 2008-0301881E5

[4] CRA Views 2012-0446491E5 dated July 25, 2012. See also CRA TI-9813525 dated July 9, 1998.

[5] For example, assume a piece of raw land is transferred to a spousal trust, with the trustee having the discretion to retain such property in its current form, and use trust capital to fund expenses such as property taxes.

also taint the spousal trust, even though such property is not available to any other beneficiary while the spouse is alive. We don't believe the intent of the legislation is to prevent a spousal trust from owning property that may not generate income in any given year but may have associated maintenance or other costs which are funded by the trust.

We would therefore ask the CRA to reconsider its recent interpretations and acknowledge that the ability of a trust to pay the premiums under a life insurance policy on the life of the surviving spouse, the transfer of insurance on the surviving spouse to a spousal trust, or the mere power of a spousal trust to acquire insurance at any time on the life of the surviving spouse, should not taint the trust.

Discussion Relating to Question 3 – Spousal Trust - Corporate Ownership of Insurance

The following is a more complete description of the fact pattern posed to the CRA:

> Assume Mr. B owns all the shares in a private corporation (Opco B) and these shares have a significant capital gain. Under Mr. B's will, on his death the shares are to be transferred to a testamentary spousal trust, and upon the death of Mrs. B, the trust is to hold and/or distribute the shares to the surviving children who are active in Opco B.
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> Opco B has acquired life insurance on the life of Mr. B and Mrs. B under which it is the beneficiary and premium payor. The purpose of the insurance is to create liquidity in the corporation on the death of the survivor of them, which may be accessed by the trustees of the spousal trust to fund taxes arising on the deemed disposition of the testamentary trust's assets including the shares of Opco B. The directors of Opco B have signed a resolution requiring Opco B to maintain the insurance policy until the death of the survivor, and to pay out the insurance proceeds to the testamentary trust as a capital and/or taxable dividend.

In its response that the CRA was unable to confirm that such a structure would not taint the status of the testamentary trust and also impact on the rollover of property under subparagraph 70(6)(b)(ii) of the Act, it was not clear what the concern was that was creating this uncertainty. However, for the reasons discussed above, we are of the view that life insurance owned directly by the spousal trust should not result in the loss of the rollover under subsection 70(6). Therefore, ownership of shares in a private corporation, which in turn owns life insurance, should not taint the spousal trust.

Further, in the case of the transfer of corporate shares to the spousal trust, we don't believe it is intended or appropriate that the underlying assets, liabilities and corporate agreements be considered in determining whether the ownership of shares in a private corporation somehow taints the spousal trust. We would note that both corporate and tax law respects the "corporate veil" and typically an express statutory override is required to treat assets, or income and expenses, of the corporation as belonging to the shareholder. The provisions at issue here do not contain any such language.

The trust would not be using its capital or income to pay a premium under a life insurance policy (which in our view would not give rise to a problem even if it did). As well, the terms of the trust in the trust document would not refer to the steps taken by the corporation.

Again, the test is whether the spouse is entitled to receive all of the income of the trust (including income generated by the shares) and that no person other than the spouse is entitled to receive or otherwise obtain the use of any of the income or capital of the trust. Clarification is required, otherwise, any arrangement, not just the purchase of insurance, which might otherwise reduce or divert the income or capital of the private corporation, could call into question whether the requirements of subsection 70(6) have been satisfied.

We would therefore appreciate the CRA confirming that where the shares of a private corporation are transferred to a spousal trust, and the private corporation owns insurance on the life of the surviving spouse (or anyone else), that such arrangements would not ordinarily result in the tainting of the spousal trust or impact the status of the testamentary trust.

Summary

As discussed above, we are seeking confirmation that the ability of a spousal trust to be the owner, premium payor and beneficiary of a life insurance policy will not taint the trust for purposes of the rollover under subsections 73(1) and 70(6) of the Income Tax Act. We are further asking for confirmation that the transfer of shares in a private corporation to a spousal trust, where one of its assets is a life insurance policy, will similarly not taint a spousal trust for purposes of the rollover under subsections 73(1) and 70(6) of the Act.

We'd be pleased to have further discussions relating to these issues.

Yours truly,

Kevin Wark, LLB, CLU, TEP
President, CALU