Life insurance and life interest trusts
(previously titled "Spousal trusts and life insurance")

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Learning objectives

- Life Interest Trusts: The Basics
- History + Perspectives (Life Insurance Ownership)
- Implications: Existing Arrangements
- Planning: Future Arrangements
- Recent Developments

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Basic overview of life interest trusts

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Life interest trusts – Some basics

A – TRANSFER TOOL

Common way to transfer property to another individual (i.e., family member or spouse)

B – WHO BENEFITS

Life interest beneficiary enjoys property for life, but legal ownership remains with trust

C – ON DEATH

On death of life interest beneficiary, property of the trust can be held for, or pass to, the residual beneficiary(ies)

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Life interest trusts – Estate planning uses

- Provide for surviving spouse after death
- Inheritance protection for children from last, or previous relationships
- Possible creditor protection
- Avoid probate process and probate fees (for inter vivos trusts)
- Reduce Will variation risk
- Privacy

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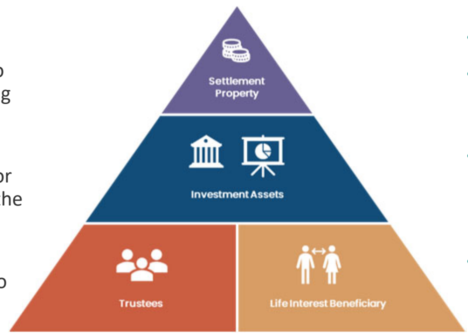
Typical life interest trusts

Spousal trusts (inter vivos or testamentary)

- The spouse beneficiary is entitled to receive all income of the trust during their lifetime
- No person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust
- If above conditions met:
  - rollover of capital property to trust available
  - "regular" 21-year rule doesn't apply until death of life interest beneficiary



Alter ego / Joint partner trusts

- Trust created by settlor (age 65+)
- Settlor (or spouse in the case of joint partner trust) is entitled to receive any income of the trust during their lifetime
- No other person could, before the last to die of the spouses, receive or otherwise obtain the use of any income or capital of the trust
- If above conditions met:
  - rollover of capital property to trust available
  - "regular" 21-year rule doesn't apply until death of life interest beneficiary(ies)

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History and perspectives

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Insurance and life interest trusts: Some history

- **November 2, 2006 [2006-0174041C6]: 2006 CALU CRA Roundtable**
  - CALU asked about transferring an existing life insurance policy to a spousal trust with premiums paid from trust capital
  - Question was: will this taint the trust for purposes of ss. 70(6)? [Ss. 70(6) allows rollover of capital property of a deceased taxpayer to a spousal trust]
- **CRA's response**
  - A duty to fund a life insurance policy out of trust capital or income would be one under which a person, other than the spouse, may obtain the use of trust capital or trust income
  - This is because the premium payment is assumed to maintain, for the period covered by the premium, the rights to receive insurance proceeds

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Some history: Topic revisited, with several questions

- **May 8, 2012 [2012-0435681C6]: 2012 CALU CRA Roundtable**
  - Situation: Transfer of existing life insurance policy to testamentary spousal trust with premiums paid from trust capital
  - Specifically asked CRA, who, other than the spouse, may be entitled to income or capital before the spouse's death?
    - CRA reiterated their 2006 response and added as the reason: "this is because premium payment is assumed to maintain the rights to receive the insurance proceeds by the policy beneficiary – which will never by the surviving spouse"

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Some history: Topic revisited, with several questions (cont'd)

- **May 8, 2012 [2012-0435681C6]: 2012 CALU CRA Roundtable (cont'd)**
  - Next question: Would placing a positive duty on the trust to retain property (e.g., shares of a corporation, rental property, etc.) taint the trust?
    - CRA responded that a duty to retain income-earning properties [emphasis added] "is not analogous, in their view, to the payment of insurance premiums by the trustee to maintain rights to receive the insurance proceeds by the policy beneficiary after the death of the spouse"

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Some history: Topic revisited, with several questions (cont'd)

- **May 8, 2012 [2012-0435681C6]: 2012 CALU CRA Roundtable (cont'd)**
  - Next question: If the trust document allows the trustees to acquire insurance, but there is no absolute obligation to purchase and retain such insurance, can CRA confirm the trust is not tainted?
    - Response: The "mere possibility" of a person other than the survivor spouse obtaining, before the survivor's death, use of trust capital or income is sufficient to disqualify the trust. In CRA's words, whether they have "an obligation or mere power to encroach on the capital" is enough to disqualify the trust

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Some history: Topic revisited, with several questions (cont'd)

- **May 8, 2012 [2012-0435681C6]: 2012 CALU CRA Roundtable (cont'd)**
  - Next question: An individual owns shares in Opco, which are transferred to a testamentary spousal trust. The Opco owns a JLTD policy on the individual and the spouse. Opco is required to maintain the policy until the last death and then pay the insurance proceeds as a dividend to the trust. Will this taint the trust?
    - Response: CRA is "unable to confirm that such a structure would not taint the status of a testamentary trust"
- **May 8, 2012 [2012-0435691C6]: 2012 CALU CRA Roundtable**
  - When asked, CRA confirmed that the above applies equally to alter-ego and joint partner trusts

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More history

- **November 16, 2015 [2014-0529361E5]**
  - April 2014: CALU requests a CRA Technical Interpretation to obtain further clarification on previous CRA responses
    - Detailed facts: life insurance to be acquired by spousal trust or joint spousal trust
    - The ask: Can CRA confirm deferral of capital gains on capital property would be available pursuant to 70(6) or 73(1.01) of ITA?
  - CRA response: No change in their position – "we consider the payment of life insurance premiums by the trust to be property **used** to establish the residual beneficiaries' rights to funds from the policy that will be realized after the death of the spouse".

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Key elements of CRA responses

1. IT JUST DOESN'T MATTER

It does not matter if premiums are paid with trust income or capital

2. FIRST YOU GET THE "POWER"

The mere power (rather than a duty or obligation) to use trust income/capital to pay insurance premiums is sufficient to "taint" the trust (i.e., no rollover and 21-year rule implications)

3. NO COMMENT

CRA unable to confirm that life interest trust's ownership in shares of private corporation, which owns a life policy on life interest beneficiary, will not taint the trust

4. THE VIEW

The payment of life insurance premiums is the current use of trust property by someone other than the spouse

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CALU's Perspective – April 2014 Technical interpretation request

- ***No requirement*** in the Act that the life interest beneficiary actually receive or otherwise benefit from the trust property while alive; it only requires that no other person can
- Residual beneficiaries ultimately benefitting from expenditures made by the trust while the life interest beneficiary is alive is not the same as beneficiary "receives or otherwise obtains the use of" trust property while the life interest beneficiary is alive
- Life interest beneficiary can indeed receive or obtain the use of the life insurance during lifetime – access CSV, for example
- Trustees also owe fiduciary duty to residual beneficiaries

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Other rebuttal thoughts re: CRA position

- ***Why should tax result be different from a personal-owned insurance situation?***
  - Example: spouse transfers funds to other spouse to purchase life insurance, naming children as beneficiaries of the policy – no tax implications.
- ***Per CRA: the trust will be tainted simply by trustees having "the mere power to encroach on the capital of the trust for the benefit of persons other than the surviving spouse"***
  - Why is funding insurance premiums an "encroachment", but investing in other property is not (e.g., shares, real estate, etc.)

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Other rebuttal thoughts re: CRA position

- ***Conflicting views in other published positions:***
  - [2006-0189931E5] – renunciation of interest in the trust by the spouse does not taint the trust until capital beneficiaries ask the court to amend the trust to receive a distribution.
  - APFF CRA Roundtable 2012 – CRA's comments seem to acknowledge that the trust can earn income from the insurance (like other income-earning investments) during the lifetime of the spouse

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Other rebuttal thoughts re: CRA position (cont'd)

- ***Per CRA: premiums paid by trust is "property used to establish the residual beneficiaries' right to funds from the policy" [Nov. 16, 2015 response]***
  - But the trust is the owner and beneficiary. What if proceeds are used to settle income tax liability? What if the policy is surrendered at some point and proceeds on surrender used for other purposes or acquire other investments in the trust (which, per CRA, do not taint the trust)?
  - How does paying the premiums establish residual beneficiaries' rights to funds from the policy?

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Other rebuttal thoughts re: CRA position (cont'd)

- ***When asked about a situation where the trust owns shares of an Opco, and Opco is the owner and beneficiary of a life insurance policy, CRA stated that they "could not confirm" that such a structure did not taint the trust***
  - There is no legislative basis for "looking through" the corporation in such a case
  - Subsection 70(5.3) applies for purposes of subsection 104(4) and therefore contemplates a life interest trust owning shares in a private corporation which in turn owns (and presumably funds) life insurance

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Implications for current arrangements

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Implications for current arrangements

Where life insurance is funded by trust income or capital, CRA will view life interest trusts as "tainted"

Adverse tax implication #1 – Deemed Disposition

- No rollover of capital property into trust, therefore settlor/deceased will be deemed to have disposed of property at FMV

Adverse Tax Implication #2 – 21 Year Rule

- Deemed disposition on 21st anniversary may trigger gains prior to death of life interest beneficiary

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Implications for current arrangements (cont'd)

To consider:

- Could CRA successfully extend reassessment period to reassess prior situations as FMV transfers?
  - Is the view that life insurance owned and funded in a life-interest trust would not taint the trust attributable to neglect, carelessness, willful default or fraud?
- Could CRA take the position that existing trusts (otherwise statute barred) are now subject to 21-year rule?

IMPORTANT

Given CRA's stated position → Should attempt to arrange affairs to ensure status of life interest trusts not challenged as a result of the ownership/funding of an insurance policy on a life interest beneficiary

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Planning for future arrangements

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Planning for future arrangements

HOW DO YOU AVOID TAINTING TRUST?

BEST WAYS TO STRUCTURE OWNING / PREMIUM PAYMENTS / BENEFICIARY DESIGNATIONS

1. TRUST NOT PERMITTED TO OWN LIFE INSURANCE
2. USE OF TAINTED TRUST
3. TRANSFER OF PAID-UP INSURANCE
4. CORPORATE OWNED LIFE INSURANCE
5. OWNERSHIP OF INSURANCE BY LIFE INTEREST BENEFICIARY

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Planning for future arrangements: Option #1

1 TRUST NOT PERMITTED TO OWN LIFE INSURANCE

PLANNING

- The trust should not have the ability to own / purchase life insurance
- Strong argument that supports a subsequent purchase of insurance:
  - Paragraph 8 of cancelled Interpretation Bulletin IT-305R4 states: *"…once a trust qualifies as a spouse trust under the terms of subsection 70(6), it remains a spouse trust… even if its terms are varied by agreement, legal action or breach of trust".*
  - CRA confirmed in 2016 that this was still their position.
  - Section 1.68 of Folio S6-F4-C1 states: *"It is the terms of the trust upon creation that determine the application of subsection 104(4), even if the terms of the trust are varied by agreement, legal action, or breach."*

BENEFITS

- Allows for rollover of capital property to life insurance trust (although, per the wording in the new Folio, not clear if this is still CRA's position)
- Ensures 21 year rule not applicable until after death of life interest beneficiary

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Planning for future arrangements: Option #2

2 TRANSFER OF PAID-UP INSURANCE

PLANNING

- CRA has confirmed a life interest trust will not be tainted if paid-up insurance is transferred in [2012-0453121C6]
- There must be no obligation to fund premiums in future
- Consider situations where paid-up status not guaranteed (i.e., actual vs projected dividend) → Potential to argue that at the time trust created, no obligation to fund future premiums existed
- However, must also consider tax implications of transferring the policy

BENEFITS

- Allows for rollover of capital property to life insurance trust
- Ensures 21 year rule not applicable until after death of life interest beneficiary

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Planning for future arrangements: Option #3

3 USE OF A "TAINTED TRUST"

PLANNING

- Settlor could establish a second "tainted" trust to own and fund life insurance policy
- The life Interest trust would be designated as beneficiary
- Sufficient assets to be transferred to tainted trust in order to fund future premium obligations
- CRA confirmation that payment of insurance proceeds into testamentary spousal trust will not impact rollover or property to trust [2012 CALU CRA Roundtable]

BENEFITS

- Allows for rollover of capital property to life insurance trust
- Ensures 21 year rule not applicable until after death of life interest beneficiary

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Planning for future arrangements: Option #4

4 CORPORATE OWNED LIFE INSURANCE

PLANNING

- Transfer shares of private corporation (which is owner of life insurance on life interest beneficiary) to life interest trust
- On death of life interest beneficiary, all or part of insurance proceeds can be paid out as tax-free capital dividend to life interest trust
- Trust can use funds to pay tax or other potential liabilities
- CRA has indicated that it cannot confirm that ownership of shares would not taint trust but note ss 70(5.3) appears to supports this

BENEFITS

- Allows for rollover of capital property to life insurance trust
- Ensures 21 year rule not applicable until after death of life interest beneficiary
- Most tax professionals take view that CRA should not be able to look through corporation in determining whether trust might be tainted

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Planning for future arrangements: Option #5

5 LIFE INTEREST TRUST BENEFICIARY OWNS INSURANCE

PLANNING

- Require trustee of life Interest trust to make annual capital distributions to life interest beneficiary
- Intention is for beneficiary to use capital to fund insurance policy where trust is beneficiary
- Risk that beneficiary uses capital for purposes other than funding life insurance
- Other option is to utilize joint first to die contract and ensure capital maintained in trust until last to die

BENEFITS

- Allows for rollover of capital property to life insurance trust
- Ensures 21 year rule not applicable until after death of life interest beneficiary

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Recent developments

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Tax Folio S6-F4-C1

- Effective February 3, 2022
- Section 1.33 confirms CRA position…
  - ***1.33*** *The terms of the trust might permit the trustee to fund a life insurance policy held by the spouse trust on the life of the spouse or common-law partner out of the trust capital or trust income. If so, this would be a situation in which a person other than the spouse or common-law partner may obtain the use of trust capital or trust income contrary to subparagraph 70(6)(b)(ii). This is because for the period covered, the premium payment ensures that the policy beneficiary maintains a right to receive insurance proceeds. Since the policy beneficiary will never be the spouse or common-law partner, it is the CRA's view that the trust would not satisfy the conditions of subparagraph 70(6)(b)(ii)*

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Tax Folio S6-F4-C1

- Section 1.68
  - ***1.68*** *It is the terms of the trust upon creation that determine the application of subsection 104(4), even if the terms of the trust are varied by agreement, legal action, or breach. For example, the wording of subparagraph 104(4)(a)(i) clearly provides for a deemed disposition date that is based on the terms of the trust at the time it was created.*
- Paragraph 8 of former Interpretation Bulletin IT-305R4 read as follows:
  - *8. Once a trust qualifies as a spouse trust under the terms of subsection 70(6), it remains a spouse trust and is subject to the provisions affecting such trusts (for example, paragraph 104(4)(a)) even if its terms are varied by agreement, legal action or breach of trust.*
- The Folio indicates that section 1.68 is "formerly" paragraph 8 of IT-305R4. Note that the comments in the new Folio are limited to the application of ss. 104(4) of the Income Tax Act, which provides for the applicability of the 21-year rule only after the death of the life interest beneficiary. It does not address the rollover provisions.

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Recent developments: Submission to Finance

- In November of 2022, CALU made a submission to Finance to request an amendment to the *Income Tax Act* in response to Canada Revenue Agency (CRA) interpretations relating to the ownership of life insurance by a life interest trust.
- Proposed an amendment to include a provision that would ensure that a life interest trust may own, and fund from the capital of the trust, a "life insurance policy in Canada", provided the life insurance policy is on the life of the life interest beneficiary (or a related person such as a child or grandchild).
  - To apply to life insurance that is transferred into a life interest trust as well as a new life insurance policy acquired by the trustees of a life interest trust.

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Takeaways

- **What's your life interest?:** Spousal trusts, Alter Ego Trusts, Joint Partner Trusts, Testamentary Spousal Trusts
- **Tainted love:** Where life insurance is funded by trust income or capital, CRA will view life interest trusts as "tainted"
- **Plan accordingly:** Strategies exist to structure ownership, premium payments and/or beneficiary designations prudently (i.e., to fund tax on timely basis)
- **Consult with pros:** Ensure the right professionals are involved to help you and your clients navigate the area of insurance and life interest trusts appropriately
- **Potential clarity coming?** CALU Submission to Finance

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Materials of interest

- CALU Special Report, February 2016, *"Planning Considerations for Life Insurance and Spousal Trusts"*

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Questions?

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