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Via email: shawn.porter@fin.gc.ca

Dear Mr. Porter:

Re: Life insurance owned by life interest trusts

On behalf of the Conference for Advanced Life Underwriting (CALU) we are making this submission to request an amendment to the *Income Tax Act*[1] in response to Canada Revenue Agency (CRA) interpretations relating to the ownership of life insurance by a life interest trust.

The CRA has taken the position that, where the terms of a trust permit the trustee to fund a life insurance policy, the trust will not meet the conditions set out in subparagraph 70(6)(b)(ii) or 73(1.01)(c)(i) to be a spousal or common-law partner trust.[2] In particular, the CRA's view is that if the terms of the trust permit the payment of premiums by the trust, this can result in the use of trust property to establish the residual beneficiaries' rights to funds from the policy during the lifetime of the surviving spouse or common-law partner (i.e., for the benefit of someone other than the spouse or common-law partner).[3]

[1] The *Income Tax Act*, R.S.C. 1985, C.1 (5th Supplement), as amended. Herein the "Act". Unless otherwise stated all references in this submission are to the Act.
[2] Please see the attached document with a summary of CRA interpretations relating to this issue (herein the "summary document").
[3] This view also applies to alter ego and joint partner trusts (CRA TI 2012-0435691C6 dated May 8, 2012).

CALU previously made an extensive submission to the CRA in an attempt to modify their views on this matter.[4] However, with the recent release of Income Tax Folio S6-F4-C1[5] it is clear that a legislative amendment is needed to avoid the potentially onerous tax implications of their interpretation.

Introduction

The Act contains specific rules governing transfers of capital property to "life interest trusts", which includes *inter vivos* and testamentary spousal trusts, and alter ego and joint partner trusts. Generally, the transfer of capital property to a life interest trust takes place at the adjusted cost base of that property, avoiding the realization of any capital gains (and any resulting tax on those capital gains) at the time of transfer.[6] Instead, any unrealized gain on the transferred property will generally be realized by the trust on a subsequent disposition of the property or on the death of the life interest beneficiary or beneficiaries.[7] The relevant provisions of the Act have been reproduced below:

Testamentary spousal trust – Subparagraph 70(6)(b(ii)

(6) Where any property of a taxpayer who was resident in Canada immediately before the taxpayer's death that is property to which subsection (5) would otherwise apply is, as a consequence of the death, transferred or distributed to

[…]

(b) a trust, created by the taxpayer's will, that was resident in Canada immediately after the time the property vested indefeasibly in the trust and under which

(i) the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death, and

(ii) 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 of any of the income or capital of the trust […]

Inter vivos spousal, alter ego or joint partner trust – Subsection 73(1.01)

(1.01) Subject to subsection (1.02), property is transferred by an individual in circumstances to which this subsection applies where it is transferred to

(a) the individual's spouse or common-law partner;

(b) […]; or

[4] See the attached interpretation request by CALU dated April 22, 2014 (the "2014 interpretation request") and CRA's response in TI 2014-0529361E5 dated November 16, 2015. The CRA also forwarded the 2014 interpretation request to the Department of Finance.

[5] This Tax Folio has an effective date of February 3, 2022. See paragraph 1.33 reproduced in the summary document.

[6] Otherwise, the transfer would take place at fair market value either by virtue of subsection 70(5) (on death) or paragraph 69(1)(b) (for an *inter vivos* transfer). Note that the rollover rule in subsection 70(6) does not apply on the transfer of a life insurance policy to a testamentary spousal trust. Instead, the proceeds of the disposition for the policy will be determined under subsection 148(7).

[7] Paragraph 104(4)(a).

(c) a trust created by the individual under which

i. the individual's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death and 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 of any of the income or capital of the trust,

ii. the individual is entitled to receive all of the income of the trust that arises before the individual's death, and no person except the individual may, before the individual's death, receive or otherwise obtain the use of any of the income or capital of the trust, or

iii. either

(A) the individual or the individual's spouse is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the spouse and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust, or

(B) the individual or the individual's common-law partner is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the common-law partner and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust.

Given that the conditions to be satisfied are virtually the same for all types of life interest trusts, and the CRA has indicated their position relating to the use of life insurance in all types of life interest trusts is the same, the discussion in the remainder of this submission will focus on the implications of the CRA position to testamentary spousal trusts. However, we are seeking a legislative solution that would apply equally to all types of life interest trusts.

Fact situation

For the purposes of discussing the impact of the CRA's position on the tax and estate planning of individual taxpayers, we will consider the two slightly different fact situations below:

Scenario 1[8]

- Mr. A (age 65) resides in Ontario and is in a second marriage, to Mrs. A (age 60) who similarly resides in Ontario.
- Mr. A owns all the shares in Opco, which is a Canadian-controlled private corporation carrying on an active business. The shares of Opco are currently worth $4 million and the adjusted cost base (ACB) and paid-up capital (PUC) of the shares is a nominal amount.

[8] This scenario is similar to the one set out in the 2014 interpretation request.

- Mr. A's two adult children (from his first marriage) are active in the business of Opco, whereas Mrs. A is not involved in the business. Opco's profits are regularly reinvested in the business, in which there is little liquidity.
- Mr. A is in the process of implementing an estate and business succession plan which will include the following elements:
  - He will undertake an estate freeze whereby all his common shares will be converted to preference shares with a redemption value of $4 million, a fixed dividend of four per cent, and nominal ACB and PUC.
  - New common shares with nominal value and PUC will be issued equally to his two children.
  - Under Mr. A's new will, assuming Mrs. A survives him, his preference shares will be transferred into a testamentary spousal trust (the spouse trust) designed to qualify for the rollover under paragraph 70(6)(b). The trustees of the spouse trust would be Mrs. A and the two children. His two children will be residual income and capital beneficiaries of the spouse trust. If Mrs. A predeceases Mr. A, the preference shares will transfer equally to the two children or the survivor of them.
  - Mr. A will acquire a $1 million joint second-to-die life insurance policy[9] (the life insurance policy) which is intended to fund taxes that will arise upon the deemed disposition of the preference shares upon the later death of himself and Mrs. A. Specifically, this tax liability will arise upon Mr. A's death (under subsection 70(5) assuming Mrs. A predeceases him) or upon Mrs. A's death (in the spousal trust under subsection 104(4) assuming Mr. A predeceases her).
  - The availability of the life insurance on death is intended to ensure that shares in Opco (or corporate assets) do not have to be sold (or liquidated) to help fund this tax liability.
  - The life insurance policy would be a "permanent" insurance policy with level premiums payable as long as either Mr. or Mrs. A is alive. Mr. A will fund these premiums while he is alive.
  - Assuming Mrs. A survives Mr. A, the life insurance policy would be transferred to the spousal trust and future premiums would be funded from the capital of the trust.[10] This would ensure the life insurance policy remains in force and will be used for the intended purpose of paying the capital gains tax arising on the Opco preference shares upon the death of Mrs. A.
  - The terms of the spousal trust might specifically permit the trustees to own a life insurance policy and fund the premiums from trust capital provided it is the owner and beneficiary of the life insurance policy. Alternatively, the trust document might make no reference to the ownership of a life insurance policy and the trustees could rely on the "prudent investor rules" under provincial trust law to continue to own and fund the life insurance policy.[11]

Scenario 2

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[9] The life insurance policy will pay the $1 million death benefit on the death of the survivor of Mr. and Mrs. A. Such policies are less expensive than acquiring coverage solely on the life of Mr. A.

[10] The transfer of the policy to the spouse trust will result in a disposition of the policy with the proceeds of the disposition determined under subsection 148(7).

[11] For example, subsection 27(1) of the *Ontario Trustee Act*, R.S.O. 1990, c. T.23.

- Mr. A's estate and business succession plan is the same as in Scenario 1 except that Mr. A does not acquire a $1 million joint second-to-die life insurance policy.
- Five years later Mr. A passes away and he is survived by Mrs. A. Pursuant to the terms of Mr. A's will, his preference shares in Opco are transferred to the spousal trust.
- Subsequently the trustees of the spousal trust determine it would be prudent to acquire a $1 million life insurance policy on the life of Mrs. A to fund the tax liability that will be realized in the spouse trust on the death of Mrs. A in respect of the Opco preference shares.[12]
- As in the case of Scenario 1, the terms of the spousal trust may permit the purchase of life insurance on Mrs. A's life provided it is funded with capital of the trust, or alternatively the trustees may rely on the "prudent investor rule" to acquire this policy and use trust capital to fund the premiums of the life insurance policy.

Implications of the CRA position on life insurance in a spousal trust

Based on the CRA's position, the tax implications of the testamentary spousal trust terms including the power to acquire life insurance on the lives of Mr. and Mrs. A, or only on the life of Mrs. A, would appear to be as follows:

- The rollover of Mr. A's preference shares in Opco to the testamentary spousal trust under subsection 70(6) will be denied and a $4 million capital gain will be realized in Mr. A's final tax return.[13]
- The ACB of the preference shares, now owned by the testamentary spousal trust, will be increased to $4 million.
- The trust will be subject to the 21-year deemed disposition rule.[14]
- Assuming Mrs. A is still alive at the time of Mr. A's death, in both scenarios there will be no insurance proceeds payable on Mr. A's death and his estate assets must be utilized to pay this tax liability.[15]
- Assuming the life insurance policy is a joint policy or on Mrs. A's life only, the testamentary spousal trust will receive the life insurance proceeds upon the death of Mrs. A and will ultimately benefit Mr. A's children.

In summary, there is a lack of coordination between the receipt of the life insurance proceeds and the realization of the capital gain on the Opco preference shares. This negatively impacts Mr. A's intended estate and business succession plan, and would likely diminish the value of property being transferred to the testamentary spousal trust for the benefit of Mrs. A.

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[12] Supra Note 7.
[13] There may be the realization of additional capital gains depending on what other capital property is transferred under Mr. A's will to the spousal trust.
[14] Paragraph 104(4)(b).
[15] If there are insufficient other estate assets, Opco may need to be sold in order to generate the cash needed.

Options available to avoid this result

Assuming Mr. A's advisors are aware of CRA's position on life insurance policies held by spousal trusts (which is often not the case), the following alternatives could be considered:

1. In Scenario 1 and 2, Opco could be the owner, premium payer and beneficiary of the life insurance policy. On the death of Mrs. A, Opco would receive the life insurance proceeds, with a substantial portion of those proceeds creating a credit to Opco's capital dividend account.[16] Opco could then redeem a portion of the preference shares (resulting in a deemed dividend for tax purposes that can be elected by Opco to be a capital dividend) and pay the death benefit proceeds to the testamentary spousal trust so that it can fund the tax liability arising on the deemed disposition of the preference shares. However, in a technical interpretation the CRA indicated that it was unable to confirm that such a structure would not also taint the status of a testamentary spousal trust.[17] As well, Opco would need to continue to fund the life insurance premiums to ensure the policy remains in force, with the policy and its proceeds being subject to the claims of Opco's creditors.
2. In Scenario 1, the preference shares could be directly transferred to Mrs. A along with the life insurance policy (which now only insures Mrs. A's life).[18] The concerns with this option are that there is no assurance that Mrs. A will either keep the insurance policy in force (resulting in an unfunded tax liability in her estate in respect of the preference shares) or that the preference shares will be transferred to Mr. A's children upon Mrs. A's death.
3. Mr. A could acquire a $1 million life insurance policy on his life with the death benefit payable to his estate. Ultimately the death benefit would be part of the assets transferred to the spouse trust. The spouse trust could be directed to hold this amount as a capital reserve to fund the tax liability that arises on Mrs. A's death. However, the cost of a policy on Mr. A's life alone would be approximately 80 per cent higher than the cost of joint life insurance policy, which would reduce the value of his estate as compared to using a joint life insurance policy.[19]

As can be seen, utilizing any one of these options could place Mr. A's intended estate plan at risk and/or diminish what is available to the estate beneficiaries upon Mr. A's death.

[16] See paragraph (d) of the definition of capital dividend account in subsection 89(1).

[17] CRA TI 2012-0435681 dated May 8, 2012. In this technical interpretation the CRA did not consider the implications of subsection 70(5.3) applying to the deemed disposition of shares held by the testamentary spousal trust for purposes of paragraph 104(4)(a). In effect, subsection 70(5.3) specifically contemplates the situation where a life interest trust owns shares in a corporation, which in turn owns life insurance on the life of the spouse (as life interest beneficiary) or a related person.

[18] The transfer of the life insurance policy to Mrs. A would take place on a rollover basis by virtue of subsection 148(8.2).

[19] The difference in premium results from the fact that the risk to the insurer of an early death claim is much lower under a joint second to die policy (combined with Mrs. A being younger than Mr. A) than a policy on Mr. A's life alone. It is also important to note that if Mr. A is experiencing health issues he may not qualify for single life coverage or such coverage would be "rated" with an even higher premium being payable.

Policy discussion

As illustrated by the above scenarios, life interest trusts are typically used to facilitate the estate planning needs of individuals and their spouses/partners. The rules are specifically designed to allow for the deferral of the taxation of capital gains until the death of both spouses[20] and are similar in effect to the tax rules governing direct gifts to spouses, both while alive and upon death. These trusts are often used by small business owners to ensure appropriate provision is made for the surviving spouse while ultimately transferring shares in the business to the next generation of owners. The liquidity needs that arise on the death of a life interest beneficiary are similar to those applicable to bequests to a surviving spouse under a will and are often best met by having life insurance on the life of one or both spouses.[21]

In our view the ownership and funding of life insurance in a spouse trust is not inconsistent with the restrictions on the use of income and capital in such a trust and in effect represent an extension of what occurs in the absence of using a spousal trust. The surviving spouse is still entitled to the annual income of the spousal trust, and with the trust being the owner and beneficiary of the insurance policy, no person other than the spouse can receive or obtain the use of the policy while the spouse is alive. The trustees of the trust retain the ability to modify the policy, surrender the policy, sell the policy or even transfer the policy to the surviving spouse. And as discussed above, the various other options discussed above are sub-optimal for the deceased, the surviving spouse and/or other estate beneficiaries.

As well, there is significant potential for taxpayers to be inadvertently penalized by the CRA position, as many professional advisors continue to be unaware of the CRA's position and use will and trust precedents that include the power to own life insurance. It is important to also recognize that the CRA position could potentially apply to any spousal trust that does not restrict trust ownership of life insurance, since the terms of the trust don't need to specifically provide the trustees with the power to own and fund a life insurance policy, as they can rely on the "prudent investor" rules to acquire and own a life insurance policy.

Proposed Amendment

In order to properly address these concerns, we request that the Act be amended to include a provision similar to subsection 70(7) that would ensure that a life interest trust may own, and fund from the capital of the trust, a "life insurance policy in Canada",[22] provided the life insurance policy is on the life of the life interest beneficiary (or a related person such as a child or grandchild). This provision would 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.

We would welcome the opportunity to discuss this matter in more detail and respond to any questions you might have.

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[20] Or a subsequent disposition of the property.

[21] Similarly, life insurance may also be required on the lives of the children to facilitate the purchase of their shares should they predecease their parents.

[22] Defined in subsection 138(12).

Yours truly,

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