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Planning Considerations for Life Insurance and Spousal Trusts

Introduction

The Canada Revenue Agency (CRA) has issued several interpretations indicating that the ownership and funding of life insurance within a spousal or alter ego/joint partner¹ trust will “taint” the life interest trust, potentially resulting in certain negative tax consequences.² In April 2014 CALU made a request to the CRA for a technical interpretation relating to a specific fact pattern where life insurance was to be acquired by a spousal or joint partner trust as part of an estate plan. We asked the CRA to confirm that the deferral of capital gains on capital property transferred to such trusts would be available pursuant to subsections 70(6) or 73(1.01) of the Income Tax Act (Canada) (the “Act”).

In a letter dated Nov. 16, 2015 the CRA responded to CALU’s request for an interpretation. Unfortunately, the CRA continues to take the view that the ownership and funding of premiums by life interest trusts will result in such trusts not qualifying as a life interest trust. In their response the CRA states:

“... we consider the payment of 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.”

It should be noted that at the 2012 CALU CRA Roundtable the CRA also made the following comments:³

- ◊ This view also applies to insurance held in an alter ego or joint partner trust.⁴
- ◊ It doesn’t matter whether the premiums are funded by trust income or capital.
- ◊ The mere power (rather than a duty or obligation) to use trust capital or income to pay insurance premiums is sufficient to disqualify the rollover of property to the life interest trust.
- ◊ The CRA was unable to confirm that a life interest trust’s ownership of shares in a private corporation, which in turn owns a life insurance policy on the life interest beneficiary, will not taint the status of that trust.

Based on the foregoing, CALU formed a technical advisory committee consisting of Chris Ireland, Florence Marino, Angela Ross and Patrick Uzan to discuss planning strategies relating to insurance and life interest trusts. This article will provide some guidance to members highlighting implications for current arrangements and future planning. It is essential that clients obtain the advice of their own tax counsel before proceeding with any of these planning strategies.

CALU's Perspective on CRA's Interpretation

The CRA's position is based on the view that the payment of life insurance premiums is the current use of trust property to benefit the residual beneficiaries by establishing their rights to policy funds after death.

We disagree with the CRA's position for several reasons. Provided the trust remains the owner of the policy and beneficiary of the death benefit, the requirement that "no person other than the life interest beneficiary can receive or obtain, before that person's death, use of the trust capital or income" appears to be satisfied. Further, the Act does not require that the trustee of a life interest trust adopt strategies to maximize income to the life interest beneficiary. On the other hand, trustees typically have a positive duty to maintain capital property (whether it is income producing or not) for the benefit of the capital beneficiaries. We plan to approach the Department of Finance to confirm their views on this matter.

In the meantime, given the CRA's stated position, it is important to arrange the affairs of the trust to ensure its status as a life interest trust is not challenged as a result of the trust owning and funding a life insurance policy on the life interest beneficiary.

Implications for Current Insurance Arrangements

Where the terms of a life interest trust permit the purchase of life insurance (whether or not a policy is actually owned by such a trust), the CRA is of the view that this will taint the trust. This will result in two adverse tax implications for the trust. First, rather than a rollover of capital property into the trust, the settlor/deceased will be deemed to have disposed of such property at fair market value.⁵ This

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will trigger the reporting of all gains associated with the transferred property. In addition, the trust will become subject to the 21-year deemed disposition rule, which could trigger gains in advance of the death of the life interest beneficiary.⁶

However, if the assessment or reassessment period has expired since the transfers took place, it is unlikely that the CRA could successfully extend this period to reassess the settlor/deceased on the basis that the transfer of property took place at fair market value. But the CRA could take the position that the trust is now subject to the 21-year deemed disposition rule.



Planning for Future Insurance Arrangements

With the release of draft legislation that will shift the tax liability arising from the death of the life interest beneficiary back to the life interest trust,⁷ such trusts will continue to benefit from having access to insurance funds on the death of the life interest beneficiary. What is the best way to structure the ownership, premium payments and beneficiary designations to ensure this does not taint the life interest trust? There are several options that can be considered as discussed below.

a) Trust Not Permitted to Own Life Insurance

There appears to be a strong argument that if the life interest trust is not empowered to own life insurance, a subsequent purchase of insurance by the trust will not result in it being tainted. This is based on the CRA's view that the requirements under the Act to qualify as a spousal trust (and presumably an alter ego or joint partner trust) only needs to be met at the time the trust is created.

Paragraph 8 of Interpretation Bulletin IT-305R4⁸ 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".

Thus, if the terms of the life interest trust do not permit the trustee to purchase insurance and pay premiums, but the trust terms are subsequently amended⁹ to permit the life interest trust to acquire and fund a life insurance policy on the life interest beneficiary, this should not result in that trust being tainted.¹⁰ This would not only permit the rollover of property to the trust, but the 21-year deemed disposition rule would not be applicable until after the death of the life interest beneficiary.¹¹

b) Use a Tainted Trust

The settlor/testator could establish a second "tainted" trust to own and fund the life insurance policy on the life interest beneficiary under the life interest trust. The life interest trust would then be designated as the beneficiary of the policy. The settlor/trustee of the "tainted" trust would transfer sufficient assets¹² into the trust to ensure that the policy can be fully funded over the required timeframe. Since life insurance is not capital property, it will not be subject to the 21-year deemed disposition rule, and the insurance proceeds will flow tax-free to the life interest trust. The CRA has also indicated that in these circumstances the payment of insurance proceeds to a testamentary spousal trust will not impact the rollover of property to the trust, nor its status as a testamentary trust.¹³

c) Transfer of Paid-Up Insurance

The CRA has confirmed that a life interest trust will not be tainted if paid-up life insurance is transferred to it.¹⁴ In other words, it is possible for life interest trusts to own life insurance as long as there is no obligation to fund the premium in the future. However, it does raise the question of what happens, for example, if the policy is paid-up based on current credited or dividend rates, but the paid-up status is not fully guaranteed. It might be argued that since, at the time the trust was created there was no expectation or requirement to fund future premiums, the trust should not be tainted.

d) Corporate Owned Life Insurance

Another approach would be to transfer shares of a private corporation, which in turn owns life insurance on the life interest beneficiary, into the life interest trust. On the death of the life interest beneficiary, all or a large portion of the death benefit can be paid out as a tax-free capital dividend to the life interest trust, which in turn can be used by the trust to pay any tax or other liabilities arising on the death of the life interest beneficiary.

As noted above, the CRA has been asked to comment on whether the ownership of the corporate shares in these circumstances might taint the life interest trust. The CRA indicated that it could not confirm that ownership of shares (where the corporation is funding life insurance) would not taint the trust.¹⁵ However, most tax professionals are of the view that the CRA should not be able to “look through” the corporation in determining whether the trust might be tainted or not.

e) Ownership of the Insurance by the Life Interest Beneficiary

It would also be possible to structure the life interest trust to require the trustee to make annual capital distributions to the life interest beneficiary with the intention that the life interest beneficiary use the distributions to fund a life insurance policy under which the trust is the beneficiary. In the case of an alter ego trust (and perhaps a joint partner trust) there should be no major concerns with the policy being maintained, as the interests of the life interest trust and the life interest beneficiary are aligned. But where a spousal trust is involved, the life interest beneficiary may decide to use the capital distributions for purposes other than funding the life insurance policy. Additional planning steps might therefore be required to ensure that the insurance policy remains in force and the proceeds are paid to the life interest trust.

Another possible approach when dealing with a spousal or joint partner trust would be for the testator/settlor to purchase joint first to die life insurance on his or her life and life of the spouse. On the death of either spouse the insurance proceeds would be paid to the trust and retained until the death of the second spouse. While the insurance premium would be higher, it would ensure that the death benefit is received by the trust and available to pay the tax liabilities arising on the death of the surviving spouse.


Again, the payment of insurance proceeds to a testamentary spousal trust will not impact the rollover of property to the trust, nor its status as a testamentary trust.¹⁶

In Summary

Despite the position taken by the CRA relating to the ownership of insurance in life interest trusts, there continues to be a number of ways to structure the ownership, premium payments and/or beneficiary designations to ensure that life insurance will be available to a trust to cover tax liabilities that arise on the death of the life interest beneficiary. Clients should consult with their professional advisors to determine which approach is most appropriate in their personal circumstances.

Endnotes

- ¹ In this article collectively referred to as life interest trusts or individually as a life interest trust.
- ² CRA interpretations 2006-0174041C6 and 2006-185551C6 and CALU 2012 CRA Roundtable held on May 8, 2012.
- ³ CALU 2012 CRA Roundtable held on May 8, 2012.
- ⁴ The rollover for alter ego and joint partner trusts is found in subparagraphs 73(1.01)(c)(ii) or (iii) and subsection 73(1.02) of the Act.
- ⁵ Subsections 69(1) and 70(5) of the Act.
- ⁶ Paragraph 104(4)(b) of the Act. Otherwise, the first deemed disposition date occurs on the death of the life interest beneficiary.
- ⁷ Finance Canada – Jan. 15, 2016.
- ⁸ “Testamentary Spousal Trusts”, Oct. 30, 1996 [Archived].



⁹ Alternatively, if the trustee makes such a purchase in breach of the terms of the trust.

¹⁰ It should be noted that the CRA has previously expressed the view that a significant amendment to the terms of the trust may be treated as a “resettlement” of a new trust, which would result in the deemed disposition of trust assets. Arguably an amendment to allow the purchase of insurance would not be considered to be a significant revision to the terms of the trust.

¹¹ This interpretation would also save current arrangements where life insurance is already in place, provided the terms of the life interest trust did not provide the trust with a power to own and fund a life insurance policy.

¹² Assets without significant accrued gains would be transferred to the trust at fair market value.

¹³ See questions 4, 4.1 and 4.2 of the 2012 CALU CRA Roundtable, although the continuing status of the spousal trust as a testamentary trust will only be of concern if the trust, after the spouse’s death, will be a qualified disability trust.

¹⁴ Association de planification fiscale et financière (APFF), 2012 Conference, Financial Strategy and Instrument Taxation Roundtable - Question 1, October 5, 2012. The fact situation posted to the CRA involved a joint second to die policy on the lives of two spouses, with premiums payable to first death.

¹⁵ See question 2.3 of the 2012 CALU CRA Roundtable.

¹⁶ Supra note 13.