The Institute™ for Advanced Financial Education

COMMENT

Edition 321 - Nov/Dec 2020

A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

CRA Review on Joint Spousal Trusts and Life Insurance

Life insurance clauses in joint spousal trusts threaten the tax status of the joint spousal trust. The Canada Revenue Agency (CRA) has indicated that life insurance can provide a benefit that is not permitted under the conditions set out for joint spousal trusts.

Joint spousal trusts have special treatment under the *Income Tax Act* (ITA) when the conditions are met. For instance, they are not subject to the 21-year deemed disposition rule that generally applies to trusts. Rather, the deemed disposition occurs when the surviving spouse dies.[1] It is also possible to transfer property to a qualifying joint spousal trust on a tax-deferred basis,[2] though transfers out of the trust are only tax-deferred if they are transfers to one of the spouses.[3]

If an individual has a spouse and is considering whether a joint spousal trust makes sense, they will need to assess if they are willing or able to meet the following conditions:

1. The individual creating the trust is alive and at least 65 years old,
2. The trust was created after 1999,
3. The individual or the spouse are entitled to all of the income from the trust while alive,
4. No one other than the individual and the spouse could receive or otherwise be entitled to income or capital of the trust until both the individual and the spouse have died.

Alex and Chris are spouses who are both 65 years old and able to meet the first two conditions. They are interested in establishing a joint spousal trust as part of their estate planning. Alex has health problems, but Chris is in good health, and they expect that Chris will likely live longer as a result. It is important to them to protect the trust's ability to provide for Chris. They are also interested in using life insurance to ensure that there will be resources to pay tax and transfer property on to their children once Chris dies. They ask if the trust could hold the life insurance in order to keep their affairs organized in the trust. Unfortunately for Alex and Chris, it's not a valid option.

The CRA takes the position that an obligation in the trust deed to fund a life insurance policy with the trust as a beneficiary would be offside and prevent the trust from being a qualifying joint spousal trust.[4] Recall that one of the conditions for a joint spousal trust is that no one other than the spouses can benefit from the income or capital of the trust before the death of the surviving spouse. The CRA interprets this condition broadly. The possibility that someone else might benefit is enough to bring a trust offside. The CRA views a life insurance clause as raising that possibility.[5] This is because the premiums are presumed to maintain the right of the beneficiary of the life insurance to receive funds. In a situation where the trust is the beneficiary of the life insurance, it is not a spouse who is benefiting from the premiums directly.

If the life insurance is a joint last-to-die policy or a later policy on the life of the surviving spouse to cover taxes or other obligations after their death, this is even clearer. The surviving spouse cannot benefit from a pure life insurance policy on their own life. The CRA's concern about who receives the benefit of the policy even extends to insurance on the life of a residual beneficiary.[6]

Since a possibility of a benefit to someone else is enough, a clause authorizing — but not mandating — the trust to obtain life insurance would also disqualify the trust for the same reasons.[7] This means that it is not necessary for the trust to actually acquire life insurance in order to be tainted.

Alex and Chris may try to create a separation between the trust and the life insurance by allowing someone other than the trust to be the life insurance beneficiary. Unfortunately, if the trust is still paying the premiums, that approach is not sufficient to protect the trust. The life insurance beneficiary is benefiting from the premiums that are coming out of either the income or capital of the trust. This may also result in tax consequences for the life insurance beneficiary, as the CRA could seek to include the benefit in the life insurance beneficiary's income.[8] That consequence does not depend on the life insurance beneficiary also being a beneficiary of the trust.[9]

So far, we have seen that if a trust that is intended to be a joint spousal trust pays life insurance premiums the CRA will likely take the view that it does not qualify as a joint spousal trust. This holds whether the trust deed has a clause mandating that it hold insurance and whether the trust or someone else is the beneficiary. Another possibility is that the trustees are named as the beneficiaries of the life insurance policy on behalf of the trust, but the trust does not pay the premiums. The CRA was asked to comment on such a scenario and indicated that the trust receiving the insurance proceeds would not, in and of itself, bring the trust offside.[10] That said, taxpayers should still be cautious given the CRA's broad interpretations in this area.

Here's the other possible situation. Let's say the trust is not a beneficiary and does not pay the premiums. The CRA was asked about a situation where a corporation — the shares of which were to go to the trust — paid the premiums and was the beneficiary under the life insurance policy. In this scenario, the directors also signed a resolution to maintain the policy until the death of the survivor and to pay out the insurance proceeds to the trust as a dividend. The CRA declined to provide a definitive answer regarding whether this would taint the trust, indicating that a review of the full facts would be needed.[11] It may be the directors' resolution in the scenario that gave the CRA pause. The CRA may also have had a concern that the amounts the corporation used to pay the premium would otherwise have been paid to the trust as dividends and become trust property.

When held in an intended joint spousal trust, life insurance may also have consequences beyond the trust itself. The CRA has considered an *inter vivos* trust such as a joint spousal trust that holds life insurance that it pays into the estate on the death of the person whose life is insured. According to the CRA, this will exclude the estate from qualifying as a graduated rate estate because the amount was not received from the individual or as a consequence of their death.[12]

As we can see, with estate planning we must ensure that steps taken to advance one consideration do not undermine the other. ©

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1 *Subparagraph 104(4)(a)(iv)*
2 *Section 73.*
3 *Subsection 107(4).*
4 *2018-0761511C6 — Rollover to spousal trust on death, 2012-0435681C6 — CALU CRA Roundtable Q2, 2012-0435691C6 — CALU CRA Roundtable Q3, 2014-0529361E5 — Spousal trust and life insurance, 2006-0185551C6 — Rollover to trust on death, 2006-0174041C6 — Rollover to trust on death.*
5 *Ibid.*
6 *2018-0761511C6 — Rollover to spousal trust on death*
7 *2012-0435681C6 — CALU CRA Roundtable Q2.*
8 *2006-0174041C6 — Rollover to trust on death.*
9 *If the life insurance beneficiary is not a beneficiary under the trust, benefit from the trust can still be taxed under section 105 of the ITA.*
10 *2012-0435701C6 — CALU CRA Roundtable Q4, 2010-0358461E5 — Spousal trusts*
11 *2012-0435681C6 — CALU CRA Roundtable Q2*
12 *2016-0634891C6 — 2016 STEP—Q3—Estate beneficiary of IV trust.*

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