Spousal trusts and life insurance

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The spousal rollover is an effective tax planning technique that lets you defer capital gains taxes until the last to die of you and your spouse. However, if you don't want to transfer your entire estate, or certain assets, directly to your spouse when you die, then a testamentary spousal trust may be a solution.

This article discusses spousal trusts and outlines some planning measures to current tax issues affecting these trusts that were brought about by statements from the Canada Revenue Agency.

What's a testamentary spousal trust?

A testamentary spousal trust is a special type of trust created in your Will for the benefit of your surviving spouse. They're typically used by those who want to achieve a tax-deferral on valuable assets, like company shares, but also want to ultimately decide how these assets get distributed after the death of a surviving spouse.

Tax deferral

You're deemed to sell your capital property at fair market value ("FMV") for tax purposes when you die. This could trigger a capital gain on a particular asset if its FMV is higher than its adjusted cost base ("ACB"). There's an automatic tax rollover, however, when you transfer assets to either your spouse or a spousal trust – assuming he or she survives you. This means the assets are inherited by your spouse or the spousal trust at their ACB. These assets may include private company shares, marketable securities and/or real estate. Taxes on those assets will be triggered either on their sale or upon your spouse's death. In the case of a spousal trust, any resulting capital gains tax liability is the trust's liability. The 21-year deemed disposition rule doesn't apply to spousal trusts.

Deciding what happens to the assets after your spouse's death

If you don't want your surviving spouse to control and determine the ultimate distribution of your estate, then a spousal trust may be an attractive option. For example, a spousal trust could be used to ensure assets don't leave your family should your surviving spouse remarry. In the case of second marriages, a spousal trust can be used to ensure that assets go to your children, rather than your surviving spouse's children. Or, by using a professional trustee, a spousal trust can also be useful for making sure an asset is managed properly so that the capital survives for the next generation. Other reasons for using a spousal trust include creditor protection and planning for estate administration taxes (probate).

Tax rules for establishing a spousal trust

The *Income Tax Act* (Canada) ("ITA") sets out certain criteria to be met for a trust to qualify as a spousal trust:[i]

1. The deceased spouse must be a resident of Canada immediately before death;
2. The trust must remain resident in Canada;
3. The trust must be created by the deceased's will;
4. The surviving spouse must receive all the income of the trust during his or her lifetime;
5. No other person may "receive or otherwise obtain the use of any of the income or capital of the trust" during the surviving spouse's lifetime (hence spousal trusts are a type of so-called "life interest" trusts); and

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6. The property must vest indefeasibly in the spousal trust within 36 months of the deceased spouse's death[ii].

Spousal trusts and life insurance

It may make sense for a spousal trust to own life insurance on the surviving spouse's life. As noted, a spousal trust may have a tax liability following the death of the surviving spouse. Insurance coverage through a joint-last-to-die (JLTD) life insurance policy on you and your spouse's lives can be a cost-effective way to fund the payment of this liability. Since the tax liability belongs to the spousal trust, ideally it would own the policy, although as discussed below, this isn't always necessary and business owners may prefer corporate ownership of the policy. A life insurance policy with cash value could also be used as an attractive tax planning tool for the trust to accumulate wealth.

Despite these opportunities, there are still tax issues affecting spousal trusts and life insurance that were highlighted by comments from the Canada Revenue Agency ("CRA"). These CRA comments have added some complexity to insurance planning with spousal trusts:

1. A spousal trust would be "tainted" if the terms of the trust include the obligation or power to *fund* a life insurance policy on the life of the surviving spouse[iii].
2. The CRA would not confirm that a spousal trust would not be "tainted" if it owned shares of a corporation that paid for the insurance premiums on a policy on the life of the surviving spouse[iv].

A tainted spousal trust cannot receive assets on a rollover basis. Instead, the assets would be deemed to be transferred to it at FMV, thus, triggering any unrealized capital gains upon the death of the first spouse.

Why does the CRA have concerns with a spousal trust paying life insurance premiums? The CRA considers the trust's payment of insurance premiums to be a use of trust property to "establish the beneficiaries' residual rights to funds from the policy that will be realized after the death of the surviving spouse"[v]. In other words, the CRA thinks a spousal trust's payment of insurance premiums represent someone other than the surviving spouse using the trust's property during the spouse's lifetime.

Insurance planning and the CRA's concerns

The CRA's concerns can be addressed by life insurance product selection or additional estate planning measures, or both.

Spousal trusts may own a paid-up life insurance policy. Since the CRA's concerns surround the trust funding a policy on the surviving spouse's life, there's no issue with it owing a policy that requires no more contractual premiums. An ideal product selection that accommodates the concerns expressed by the CRA is our JLTD participating whole life insurance policy with *premiums payable to first death*. On the death of the first life insured, all future contractual premiums are waived by Canada Life. This type of JLTD policy makes a lot of sense where one spouse generates the income needed during their lifetime to pay the insurance premiums. Alternatively, if the JLTD policy was on premium offset at the time of the first death and the selected dividend option was paid-up additions ("PUAs"), any future policy dividends paid after the first death would be used to purchase PUAs instead of used to pay the basic premium costs.

A JLTD policy with premiums payable to first death could be transferred to a spousal trust; however, life insurance policies cannot be transferred to a spousal trust on a rollover basis. As a result, transferring the policy could produce a policy gain if the greater of policy's cash value and the consideration paid by the trust for the policy, if any, exceeds the policy's ACB. As an alternative, consider the personal or trust ownership options below.

Corporate ownership. A JLTD policy with premiums payable to first death is an ideal way to address the CRA's concerns mentioned above regarding corporate-owned polices on a surviving spouse's life. Also, this arrangement wouldn't require the policy to be transferred to the spousal trust because the shares of the corporate policyowner, not the policy, would be transferred to the trust instead.

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Personal ownership. You could own a JLTD policy with premiums payable to first death jointly with your spouse and name the spousal trust as the irrevocable beneficiary. The spousal trust's receipt of the insurance payout won't affect its status as a spousal trust[vi]. Future policy changes would require the consent of the spousal trust's trustee(s) as the irrevocable beneficiary.

Use another trust. You can set up an *inter vivos* trust today that can own either a JLTD policy or a single life policy on your surviving spouse's life (the latter case assumes you've predeceased your spouse). This trust could exist concurrently with a spousal trust that's created after your death. The spousal trust would be the beneficiary of the policy and receive the insurance payout on death. You would need to ensure that the *inter vivos* trust is adequately funded to pay the insurance premiums or use a JLTD policy with premiums payable to first death. Generally, an *inter vivos* trust's assets are deemed to be disposed of at FMV every 21 years for tax purposes (21-year deemed disposition rule), but this rule does not apply to a life insurance policy.

Taint the spousal trust. Some tax practitioners suggest that a possible way to address the CRA's concerns is by amending the terms of a spousal trust after it's created to permit it to own life insurance and pay premiums. This measure is largely based on an archived CRA document that states if a trust qualifies as a spousal trust then it remains a spousal trust even where its "terms are varied by agreement, legal action or breach of trust"[vii]. Anyone undertaking this measure should obtain a legal opinion to confirm whether this planning works and if varying the trust's terms creates a new trust and, therefore, results in a deemed disposition of the trust's assets at FMV.

A word on alter ego trusts and joint partner or common-law trusts

Alter ego trusts (AET) and joint partner or common-law trusts (JPT) are types of trusts which are primarily used as a strategy for probate planning (estate administration tax, in Ontario). In each case, these trusts are settled on a rollover basis and available to individuals who have attained age 65[viii]. Like spousal trusts, access to the income and/or capital of the trust is limited to the life interest while they are living. In the case of:

- An AET – the settlor is entitled to receive all the income that may arise during his/her lifetime, and is the only person who can receive, or get the use of, any income or capital of the trust during his/her lifetime.
- A JPT – the settlor and his/her spouse, including a common law spouse (for income tax purposes), are entitled to receive all the income that may arise during their lifetimes, and are the only people who can receive, or get the use of, any income or capital of the trust during their lifetimes.

AETs and JPTs are deemed to dispose of their capital property upon the death of the life interest, or the death of the surviving life interest in the case of JPT. Life insurance may provide liquidity to pay any taxes arising in the trust upon the death of the life interest(s); however, the CRA would likely have the same concerns regarding an AET's or JPT's obligation or power to own an insurance policy or pay an insurance premium that it has for spousal trusts, discussed above. If so, this could affect the rollover of assets to the AET or JPT. A simple solution to consider would be to have the insurance policy owned and paid for personally with the AET or JPT as the policy beneficiary.

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[i] Subsection 70(6) of the *Income Tax Act* (Canada).
[ii] In cancelled Interpretation Bulletin IT-449R entitled *Meaning of "Vested Indefeasibly"* the CRA stated that "vested indefeasibly refers to the unassailable right to ownership of a particular property" and "…that such right cannot be defeated by any future event, even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right."
[iii] CALU CRA Roundtable, questions 2 and 3, CRA documents 2012-0435681C6, 2012-0435691C6.
[iv] CALU CRA Roundtable, questions 2.3, CRA document 2012-0435681C6.
[v] CRA Interpretation 2014-052936, dated November 16, 2015.
[vi] CALU CRA Roundtable, questions 4 and 4.1, CRA document 2012-0435701C6.
[vii] Archived CRA Interpretation Bulletin IT-305R4, para 8.
[viii] A life insurance policy may not be transferred to an AET or JPT on a rollover basis.

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