TESTAMENTARY INSURANCE TRUSTS -- AND OTHER FICTIONS

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TESTAMENTARY INSURANCE TRUSTS -- AND OTHER FICTIONS

Introduction

Under existing rules, the *Income Tax Act*[1] bestows a significant advantage on the testamentary trust over the inter vivos trust. While the latter is taxed at the top marginal rate on every dollar of income earned,[2] the former is subject to taxation at the same graduated rates as are individuals. What makes this feature even more advantageous is the ability to tax the trust on income[3] and capital gains[4] that are paid or payable to a trust beneficiary. So, for example, if the terms of a testamentary trust require all income to be paid to an individual (say A), that income can be split between A and the testamentary trust so as to take advantage of the existence of two separate taxpayers who are taxed at graduated rates.

In order that a trust can qualify for "testamentary" status, it must arise "on, and as a consequence of, the death of an individual."[5] However, not all trusts that meet this test will necessarily be testamentary for income tax purposes. Certain other circumstances can disqualify the trust as a testamentary one:

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[1] R.S.C. 1985 (5th Supp.), c. 1, as amended (hereinafter, the "*ITA*").

[2] *ITA*, subs. 122(1).

[3] *ITA*, subs. 104(13.1).

[4] *ITA*, subs. 104(13.2).

[5] See the definition of "testamentary trust" in *ITA*, subs. 108(1).

1. The trust must not be one that has been created by a person other than the individual.[6] Suppose, for example, that A and B enter into a contract whereby B will, immediately upon A's death, declare himself or herself to be a trustee of a particular investment account owned by B for the benefit of A's children. While the trust may be said to have arisen on, and as a consequence of, A's death, it was in fact created by someone other than A.

2. Certain third-party "post-mortem" contributions to a trust that is otherwise testamentary may put the trust offside.[7] One category of such contributions is harmless: namely, a contribution made on and as a consequence of the death of an individual other than the person whose death gave rise to the trust in the first place. Suppose, for example, that a husband's will creates a trust for his son. Upon the husband's death, that trust -- having arisen on, and as a consequence of A's death -- will be testamentary. Suppose further that the wife dies a year after her husband, leaving a will that directs her residuary estate to be transferred to the trust created for her son under her husband's will. That contribution to the trust will not taint the trust (although it may not be a prudent planning idea, since it will result in a lost opportunity to create a separate testamentary trust taxed at graduated rates).

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[6] *Ibid*.

[7] *Ibid*.

Whether any other category of post-mortem, third-party contribution will taint the trust's testamentary status depends, in part, on when the trust was established. For trusts created after November 12, 1981, any such contribution will put the trust offside – and will do so permanently. For trusts established on or before November 13, 1981, there was a limited window for such contributions that closed on June 28, 1982. The fair market value of all such contributions made during that 7-1/2 month period could not exceed the fair market value of the property acquired from the individual whose death gave rise to the trust in the first place. However, in this case, the test is applied at the end of each taxation year of the trust. A trust that was put offside as a result of excess contributions made during that window of time could recover its testamentary status for a subsequent taxation year if, prior to the end of that taxation year, it distributed to a trust beneficiary a sufficient amount of the post-mortem, third-party contributions so that the fair market value totals met the test described above.

3. Bill C-10, when ultimately passed by the Senate and given Royal Assent,[8] will introduce another anti-avoidance rule, intended to avoid inappropriate income-splitting through loans made to a testamentary trust. The intention of the proposed amendment to the definition of "testamentary trust" in subsection 108(1) of the *ITA* is to cause any loan that has an improper income-splitting motive to taint a testamentary trust. Loans made on or before

[8] Bill C-10 received Second Reading in the Senate and was referred to Committee on December 4, 2007.

> December 20, 2002 did not taint the testamentary status of a trust. A loan made after that date by a beneficiary of the trust or by a person who does not deal at arm's length with a beneficiary of the trust will void the testamentary status of the trust unless repaid within 12 months after it was made (or within such longer period as the Minister of National Revenue approves).[9]

Insurance Trusts

The Uniform Insurance Act in effect in all of the common law jurisdictions in Canada contemplates the appointment of a trustee to receive insurance proceeds on behalf of a beneficiary. By way of example, subsection 193(1) of Ontario's *Insurance Act* provides: "An insured may in a contract or by a declaration appoint a trustee for a beneficiary and may alter or revoke the appointment by a declaration." Who is the "insured" for the purpose of this subsection? The term "insured" is defined in the following terms:

> "insured",
>
> (a) in the case of group insurance, means, in the provisions of this Part relating to the designation of beneficiaries and the rights and status of beneficiaries, the group life insured, and

[9] Since existing loans made after December 20, 2002 might still be outstanding at the time the amendment takes effect, there is a transitional rule permitting repayment of such loans within 12 months after the amending legislation receives Royal Assent (or within such longer period as the Minister approves).

> (b) in all other cases, means the person who makes a contract with an insurer;[10]

Thus, in the case of an individually owned contract, the person who makes the contract with an insurer is the "insured".[11] The "insured" and the "life insured" are not necessarily the same person. For example, where a parent purchases a contract of insurance on a child's life, the parent is the insured and the child is the life insured.

For group insurance, the insured is the "group life insured". Who is the group life insured? The *Insurance Act* offers the following definition:

> "group life insured" means a person whose life is insured by a contract of group insurance but does not include a person whose life is insured under the contract as a person dependent upon, or related to, him or her;[12]

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[10] See the definitions in subsection 171(1) of the Insurance Act, R.S.O. 1990, c. I.8 (hereinafter, the "Insurance Act").

[11] There are two situations where someone other than the person who entered into the contract with the insurer may become the insured:

(a) Section 199 of the Insurance Act contemplates a contract or agreement between the insurer and the insured nominating a successor owner (subsection (1)) or a series of successor owners (subsection (2)). Upon the death of the insured, the successor owner becomes the insured. In the case of a series of successor owners, the death of each successor owner gives ownership to the next successor owner. (This chain of ownership will be broken by the death of the life insured.)

(b) Subsection 200(3) of the Insurance Act provides that where an insurance contract is assigned by the insured to another person unconditionally and not as security, the assignee becomes the insured.

[12] Insurance Act, subsection 171(1).

So, for example, if an employee is covered by a group contract owned by his or her employer, the employee is the "group life insured" -- and therefore the "insured". As a consequence of the exclusion set out in the definition, the employee is also the insured when it comes to the coverage available under the group contract on the life of any of the employee's dependants.[13]

Where the insured makes a declaration that appoints a trustee to receive the insurance proceeds for the benefit of another, the terms of the trust imposed on the insurance proceeds will be established by means of the declaration – either through express language in the declaration or by reference to a separate document (typically, the insured's will). The separate insurance trust has been a widespread technique employed by estates practitioners for many years, allowing the best of all worlds: imposing a testamentary scheme on the insurance proceeds, on the one hand, while keeping the insurance proceeds out of the estate (and hence safe from estate administration tax and creditor claims), on the other hand.[14]

While the insurance declaration has legal effect from the time it is made, the trust will not be established until there is trust property placed in the hands of the trustee. Accordingly, it is only on, and as a consequence of, the death of the life insured that the trust will come

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[13] Some contracts that cover an identifiable group and offer separate coverage to dependants of the group are not necessarily group contracts. To determine the nature of the coverage on the dependant and whether he or she is, in relation to the insurance on his or her life, the insured, the key question to ask is this: If the member of the group ceases for any reason to be a member, does the coverage on the former member's dependant fall away or does it have a separate existence? In the latter case, the dependant would be the insured with respect to that separate coverage.

[14] See B.S. Corbin, "Separate Insurance Trusts: Eating One's Cake and Having it Too", 12 E.T.J. 104.

into existence.[15] Thus, the insurance trust meets the basic requirement. Do any of the limitations referred to above cause a problem? The Canada Revenue Agency has for many years maintained the view -- expressed through numerous public pronouncements that, admittedly, do not have the force of law -- that even though it is the insurer who funds the trust, it is the insured who, by virtue of having made the insurance declaration, is considered to be the person who created the trust.[16] On this view, it would follow that the payment of the insurance proceeds to the trust would not be considered as a post-mortem, third-party payment that taints the testamentary status of the trust – at least where the insured and the life insured are the same person.[17]

Taxing the Insurance Trust as a Separate Trust

Suppose that the insured's will creates a trust for his or her child and that the insurance proceeds payable on the insured's death are subject to a declaration that creates a trust for that child with similar terms. Can the trust created under the will and the trust created

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[15] Arguably, the trust comes into existence upon the death of the life insured, even if there is a delay in payment by the insurer. Until payment, the trust may be considered to hold a chose in action; namely, the right to enforce payment of the insurance proceeds (contingent upon providing notice and proof of death to the insurer, as required by the statute).

[16] See, for example, the technical letters of interpretation in Appendix "A".

[17] *Quaere* whether the identity of the person who pays the premiums ought to be relevant. If so, it would be of no help in the case where, for example, an employer's group benefit plan includes basic life insurance (although it would presumably allow some form of allocation where the employee purchases optional additional coverage). It is certainly difficult to make a policy argument for putting at a disadvantage the employee who cannot afford to purchase, or perhaps would not qualify medically for, insurance coverage on an individual basis. Moreover, if the source of the premiums were relevant to the proper characterization of the insurance trust, there would be nothing -- short of a legislative anti-avoidance provision added to the Income Tax Act -- to stop a third party from gifting money to the insured to allow him or her to make the premium payment(s). While estates practitioner should applaud the idea that the identity of the payer of premiums should not affect the testamentary status of the insurance trust, in the writer's view it is a bit of a stretch to say that the mere declaration of trust by the insured results in the trust's creation. The declaration is obviously a necessary step for creating the trust, but it is surely difficult to ignore the fact someone else is paying the premiums and therefore indirectly contributing to the trust.

under the insurance declaration be treated as separate trusts for income tax purposes? If so, there will be one more taxpayer who pays tax at graduated rates as a result of the declaration.

By virtue of subsection 104(1) of the *Income Tax Act*, a reference in the statute to a “trust” includes a reference to the trustee who has control of the trust property. This is an important provision for the proper interpretation and administration of the taxing statute, having regard to the fact that, as a matter of trust law, a trust is not a legal entity but a relationship between the person(s) having legal ownership of property, on the one hand, and the person(s) who are to enjoy the benefit of that property.

The *Income Tax Act* contemplates the possibility that a testator may be inclined to take undue advantage of the beneficial tax treatment of a testamentary trust. Suppose a testator creates two separate trusts in his or her will, each one being for the benefit of the same child, S. Suppose further that the testator appoints T_1 as the trustee of one trust and T_2 as the trustee of the other trust. As a matter of trust law, there are necessarily two separate trusts, since there are two separate relationships, one between T_1 and S, and the other between T_2 and S. Can each of the trusts be treated as a separate taxpayer, thereby enjoying the benefit of being taxed at graduated rates?

There is a specific provision in the *Income Tax Act* intended to deny the use of a multiplicity of such trusts for income-splitting purposes. Subsection 104(2) provides as follows:

> A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual, but where there is more than one trust and
>
> (*a*) substantially all of the property of the various trusts has been received from one person, and
>
> (*b*) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries,
>
> such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

In our example, the two trusts are prime candidates for a Ministerial designation under this subsection. Firstly, all of the trust property has been received from one person (the testator); and secondly, the income from each of the trusts accrues, or will ultimately accrue, to the same beneficiary (S). Upon that designation, T_1 and T_2 will be deemed to be the same person having control of all of the property of each trust and the income derived from both trusts will be lumped together for taxation purposes.

How is the Minister apprised of the existence of the separate trusts at the time the trust return for each of the trusts is being assessed? The trust return requires the trustee of a trust to answer numerous questions about the trust. One of the questions asked is this: "Is the trust one of a number of trusts created from contributions by the same individual?" Presumably, an affirmative response to that question will prompt – or at least enable -- the Canada Revenue Agency to make further inquiries, thus giving the Minister the opportunity to designate the two (or more) trusts as the same trust.

Returning to the example, suppose that the two trusts for S have been respectively created under two separate wills, the first appointing T_1 as estate trustee and the second appointing T_2 as estate trustee. If neither estate trustee knows of the existence of the other, each of them could quite properly give a negative response to the question posed on the trust return. Suppose, after a number of years of filing separate returns, one of the estate trustees becomes aware of the other estate trustee and the terms of the other will and, as a consequence, files a return in which an affirmative answer is given to the question regarding the existence of the other trust. One might ask whether the Minister's power to designate the two trusts as the same trust can be applied retroactively, opening the door to a reassessment of prior year returns.

The CRA would almost certainly argue that, at a minimum, the Minister ought to be able to reassess the returns for taxation years that are not yet statute-barred. (In our example, because each of the estate trustees has given an honest answer to the question as to the existence of the other trust, the Minister should be barred from reassessing a prior taxation year's return once three years have elapsed from the date of the last (re)assessment of that taxation year.) In response, the taxpayer would be expected to argue that if Parliament had intended the Minister to be able to make retroactive designations, it would have said so in clear language. Furthermore, one could envisage situations in which T_1 might legitimately argue that it would be unfair to allow the designation to operate retroactively. For example, if the income distributions are discretionary, T_1 may have decided in one or more prior years to accumulate trust income, rather than pay it out to the beneficiary, based on the marginal rates at which the trust and the beneficiary would respectively be taxed on that trust income. A retroactive Ministerial designation could result in the trust's income in the prior year being taxed at a higher marginal rate.

Let us return to the insurance trust. Suppose that the testator in our example has created a separate insurance trust, having appointed T_1 as trustee to receive the insurance proceeds payable on the testator's death. Suppose also that T_1 is the executor of the testator's will. Is it open to T_1 to file separate returns for each of the trusts and to give a negative response on each return as to whether there is another trust created by contributions from the same individual?

As noted above, the CRA has administratively allowed the separate insurance trust to have testamentary status. That administrative position does not alter the fact that it was the testator alone who contributed to the trust created under the will, and the insurer alone who contributed to the trust created by the insurance declaration. The condition precedent set out in subsection 104(2) that empowers the Minister to make the designation of both trusts as the same trust is whether "substantially all of the property of the various trusts has been received from one person." Clearly, the answer to that question is no.

Accordingly, it is submitted that T_1 could honestly give a negative response to the question on each of the trust returns. It is further submitted that if, despite the negative response to the question, the CRA should become apprised of the factual link between the two trusts, T_1 should succeed in fighting any attempt by the Minister to use the power to designate the two trusts as one and lump together the income derived from each of them.

If one accepts this view, it should also suggest an important practice point for the estates practitioner in connection with the use of separate insurance trusts. Suppose that a client who has purchased life insurance from two different insurers (say, I_1 and I_2) intends to use the separate insurance trust technique for the insurance proceeds paid out under these insurance contracts. Not only are each of I_1 and I_2 separate from the insured, but each of them is separate from the other. Accordingly, each insurance payment could constitute a separate insurance trust to be taxed at graduated rates, while being immune from a Ministerial designation under subsection 104(2). This opportunity would evidently be lost if the client were to sign a single insurance declaration covering both insurance contracts and directing the insurance trustee to put all of the proceeds into a single trust.

Whether it makes sense to have separate insurance declarations for multiple insurance contracts will depend on the quantum of insurance, on the one hand, and the costs associated with maintaining separate trusts, on the other hand. There would have to be sufficient income tax savings on an annual basis by splitting the income between two trusts to offset the annual incremental professional fees incurred to file separate returns. Consider a simple example. Suppose that each of two insurance contracts on the client's life pays $1 million on the client's death. Suppose that the insurance trustee is able to generate annual interest income of $100,000 a year on the aggregate $2 million proceeds. The federal tax brackets for 2007 are as follows:

2007 Taxable Income	**Tax Rate**
First $37,178	15.50%
Over $37,178 up to $74,357	22.00%
Over $74,357 up to $120,887	26.00%
Over $120,887	29.00%

If the entire interest income is taxed on the basis that there is only one trust, the aggregate federal tax payable in 2007 would be $20,609. If, on the other hand, one-half of the interest income is taxed in each of two separate trusts, the aggregate federal tax payable in 2007 would be $17,167. There would be additional provincial tax savings, based on Ontario's 2007 tax brackets. That annual tax saving would have to be measured against any professional fees for preparation of an extra trust returns.[18] For substantially higher

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[18] As long as all trust expenses are being allocated between the trusts in proportion to the respective insurance payouts, there would be no practical reason for the insurance trustee to maintain separate sets of trust accounts.

aggregates of trust income, the maximum federal tax saving per separate trust for 2007 would be $9017.

Conclusion

The separate insurance trust is a very useful estate planning device in the hands of a careful estates practitioner. It can shield insurance proceeds from both estate administration tax and creditor claims against a client's estate, while permitting the client to impose trust terms and conditions that are consistent with the client's overall estate planning objectives. The potential for significant income tax savings is yet one more reason to keep this device in clear view.

APPENDIX “A”

9238555 -- Testamentary trust -- insurance proceeds

Date: February 4, 1993

Reference: 108(1)(i), 70(6.1)

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the Department.

5-923855

XXXXXXXXXX M. Lambert

(613)957-8283

Attention: XXXXXXXXXX

February 4, 1993

Dear Sirs:

This is in reply to your letter dated December 22, 1992 whereby you requested our opinion on whether a testamentary trust can be established by some method other than a will.

You gave the example of a trust, the terms of which are established during a person's life and separate from his will, funded with the proceeds from a life insurance policy which is available on death of an individual.

It is your view that although the terms of the trust are established during one's lifetime, the trust is not legally created until the time of the payment of the life insurance death benefit as a consequence of the death of the individual and, consequently, such a trust would qualify as a testamentary trust.

Our comments are the following:

1. A trust is not a legal entity. It is essentially the relationship between the trustee and the beneficiary. It is an equitable obligation binding the trustee to deal with property over which he has control (the trust property) for the benefit of the beneficiary. For income tax purposes, the trust is the trustee or group of trustees.

2. The question of whether a trust comes into existence is a matter of fact and trust law. In order that a trust exists three elements, known as the "three certainties", must be present: certainty of intention, certainty of subject matter (the trust property) and certainty of objects (the beneficiaries). The requirement that all three certainties be

satisfied was enunciated in *Kingsdale Securities Co. Ltd. v. M.N.R*., [[1975] C.T.C. 10] 74 DTC 6674 (F.C.A.).

3. A trust will generally come into existence when property is transferred by the settlor to the trustee and legal ownership of the trust property rests with the trustee.

4. The definition of testamentary trust in paragraph 108(1)(i) of the Income Tax Act (the "Act") excludes trusts created after November 12, 1981 if property has been contributed to the trust otherwise than by an individual on or after his death and as a consequence thereof.

5. In our opinion, a trust funded from the proceeds of a life insurance policy available on the death of an individual and the terms of which have been established by the individual during his lifetime, separate from his will, will be viewed as a testamentary trust within the meaning of paragraph 108(1)(i) of the Act. However, it would not constitute a trust created by a taxpayer's will, within the meaning of subsection 70(6.1) of the Act.

We trust that the above comments will be of assistance to you.

for Acting Director

Manufacturing Industries,

Partnerships and Trusts Division

Rulings Directorate

Legislative and Intergovernmental

Affairs Branch

9605575 -- Testamentary trust -- insurance proceeds

Date: December 17, 1996

Reference: 108(1)

SUMMARY: Whether a trust qualifies as a testamentary trust where it is funded by life insurance proceeds.

PRINCIPAL ISSUES:

Whether a trust meets the definition of a testamentary trust where it is funded by insurance proceeds

POSITION:

Where a trust has been established in a testator's will, it is our opinion that the payment of an insurance policy available on the testator's death will not, in and by itself, jeopardize the status of a testamentary trust . Where a trust has been funded from the proceeds of a life insurance policy available on the death of an individual and the terms of which have been established by the individual during his lifetime, separate from his will, we will consider such a trust as a testamentary trust within the meaning of subsection 108(1) of the Act as it has been created on or after the insured's death or as a consequence thereof.

REASONS:

ccm 962597

5-960557 XXXXXXXXXX (613) 957-8953

Attention: XXXXXXXXXX

December 17, 1996

Dear Sirs:

Re: Testamentary Trust

We are replying to your letter of February 1, 1996, wherein you requested our opinion as to whether a separate insurance trust can qualify as a testamentary trust . We apologize for the delay in responding to your inquiry.

As explained in Information Circular 70-6R2, it is not the Department's practice to comment on proposed transactions other than in the form of advance income tax rulings. Taxpayers seriously contemplating proposed transactions are best advised to seek a formal ruling, submitting a complete statement of facts and issues as well as copies of all relevant documents. Should your situation involve completed transactions, you should submit all relevant facts and documentation to the appropriate tax services office for their views. We are therefore not in a position to give you a definite response as to the application of the provisions of the Income Tax Act (the "Act"). However, we can offer you the following general comments which may be of assistance although, in certain circumstances, they may not be appropriate to your specific situation.

The definition of testamentary trust in subsection 108(1) of the Act excludes trusts created after November 12, 1981 if property has been contributed to the trust otherwise than by an individual on or after his death and as a consequence thereof. Where a trust has been established in a testator's will, it is our opinion that the payment of an insurance policy available on the testator's death will not, in and by itself, jeopardize the status of a testamentary trust .

Also, where an individual designates a trust as a beneficiary of an insurance policy available on his death, it is our opinion that even though the terms of the trust have been established by an individual during his lifetime and separate from his will, such a trust will be considered as a testamentary trust within the meaning of subsection 108(1) of the Act as it has been created on or after the individual's death or as a consequence thereof. In other words, it is our opinion that the trust will come into existence when insurance proceeds are paid to the trust rather than when the insured designates the beneficiary in the insurance contract.

We trust that the above comments will be of assistance to you.

For Director

Resources, Partnerships and Trust Division

Income Tax Rulings and Interpretations Directorate

Policy and Legislation Branch