



Life insurance in a life income trust

What is a life income trust (LIT), why would someone need one, and how does life insurance help?

As we get older, we risk losing the capacity to manage our assets. A power of attorney (POA) can address this problem, but a trust could be a better choice. It offers the same or superior management of the assets, and offers some advantages for transferring wealth at death.

Transferring assets into a conventional trust will trigger taxation of half of any capital gains in those assets. However, an individual age 65 or over can transfer assets into a life income trust (LIT) without triggering immediate capital gains tax consequences.

Life insurance can provide the money at death needed to pay capital gains taxes and other estate expenses. However, the Canada Revenue Agency (CRA) has stated that the mere right in an LIT trust document to own a life insurance policy, even if the LIT in fact never owns a policy, will taint the trust (CRA documents 2006-0174041C6, November 2, 2006 and 2012-0435691C6, May 8, 2012). This means that the transfer of assets from personal to trust ownership will not be tax-free.

In this article we'll consider what an LIT is, how it works, its advantages and disadvantages, and how to plan around the CRA's prohibition against an LIT owning life insurance.

What is an LIT?

There are three varieties of LITs: alter ego, joint partner, and spousal trusts, discussed below.

Alter ego trust

An alter ego trust is created by someone (the settlor) age 65 or older who transfers non-registered assets into the trust on a tax-deferred basis. The settlor may name themselves as trustee, and could name a trusted friend, relative or professional to administer the trust if the settlor resigns as trustee or becomes incapable of discharging their duties.

The settlor also names themselves as the lifetime income and capital beneficiary. While alive, the lifetime beneficiary must receive all the income the trust generates in a particular year. Income in the lifetime beneficiary's hands retains the same character it had in the trust (interest, dividends, capital gains, foreign income, etc.). Further, no one other than the lifetime beneficiary can receive capital distributions from the trust during the lifetime beneficiary's life. Generally, an alter ego trust's settlor will name remainder beneficiaries (often the lifetime beneficiary's spouse and children) to receive the alter ego trust's assets at the lifetime beneficiary's death, after which the trust will end.

Assets move into the trust with the same adjusted cost base (ACB) as the settlor's, meaning they move into the trust without capital gains tax. Capital gains tax is deferred until the assets are actually disposed of or until the settlor's death (or the death of a surviving spouse or common-law partner if the trust's assets are transferred to that person, and the requirements for a tax-free rollover are met). The 21-year deemed disposition rule doesn't apply during the lifetime beneficiary's life. However, if the trust remains in existence after the lifetime beneficiary's death, the 21-year period begins to run from the date of death.

Joint partner trust

A joint partner trust differs slightly from an alter ego trust. It is also created by a settlor age 65 or older, but it's created for the benefit of the settlor and their spouse or common-law partner. Both settlor and spouse or common-law partner are the lifetime income and capital beneficiaries. Though the settlor's spouse or common-law partner need not be age 65 to be a lifetime beneficiary, they must be age 65 or older to contribute assets they own to the trust on a tax-deferred basis.

Spousal trust

A spousal trust is a trust that an individual establishes in their will, and into which they transfer assets at their death for the benefit of their surviving spouse or common-law partner. Only the surviving spouse or common-law partner can receive any benefit, income or capital, from the trust during their lifetime. At the spouse or common-law partner's death, the assets are distributed or retained to or for the benefit of other trust beneficiaries according to the terms of the trust.



What are the advantages and disadvantages of using an LIT?

Advantages

- **A will substitute:** The LIT's terms determine who receives the trust's assets at the lifetime beneficiary's death. A POA does not offer this feature.
- **Privacy:** At a person's death, any beneficiary or financial institution with an interest in the estate's assets can require probate of that person's will. Probate assures everyone who deals with the executor (estate trustee in Ontario) that the executor has the authority to deal with the estate's assets. However, when a will is probated it becomes a public document. Trusts are more private. Except in rare circumstances (like the trust becoming subject to litigation), a trust document does not have to be made public.
- **Probate tax avoidance:** Another consequence arising from probate is probate tax (estate administration tax in Ontario). If the settlor's will is probated, a probate tax may apply, depending on the province or territory. But a trust's assets will not be subject to probate tax because they won't pass to the trust beneficiaries through the deceased's estate. Having said that, assets passing to a spousal trust must do so through the settlor's will, making them potentially vulnerable to probate tax.
- **Asset control:** particularly in second marriages, the settlor can provide an income and ability to encroach on capital for the surviving spouse during their lifetime, but also provide that trust assets go to their own children at the surviving spouse's death, not to the surviving spouse's children or to a new spouse. A will is more vulnerable to attack from disgruntled beneficiaries than a trust.
- **Management:** A trust allows a trustee to manage income and assets for the benefit of the settlor(s) or a surviving spouse who cannot (for example, because of Alzheimer's dementia).
- Defer capital gains tax and the application of the 21-year deemed disposition rule until the surviving spouse's death.

Disadvantages

- **Cost:** An LIT must be written by a lawyer, and may cost more to create and manage than a POA. Therefore, an individual must consider whether the reasons for having the trust are worth the expense in creating and maintaining it. In any event, even the expense in creating a POA is worthwhile when considering the cost of appointing a guardian if the individual loses the capacity to manage their property.
- **Property management only:** An LIT cannot be used to manage an individual's personal care. Only someone acting under a POA for personal care can do that, or someone appointed as a guardian by a judge.
- **Accumulations Act, R.S.O. 1990, c. A-5:** The Accumulations Act and its counterparts in other provinces prevent accumulations of income within the trust for periods longer than those set out in the Act. Since trust income must be distributed each year to the lifetime beneficiary(s) this provision would apply only when the trust remains in effect after the lifetime beneficiary(s)' death to accumulate funds for eventual distribution to the trust's remainder beneficiary(s).
- **Residency requirement for spousal trusts (paragraph 70(6)(b)):** The settlor must be a Canadian resident immediately before their death, and the trust must be resident in Canada immediately after the property vests in the trust.
- **Spousal trusts:** Capital property must vest indefeasibly in the trust (subsection 70(6)).
- An LIT cannot own or have the right to own life insurance policies.
- **No access to graduated tax rates:** Trust income not distributed to the remainder beneficiaries will be taxed at the top federal/provincial rate.
- Non-registered assets only. An LIT may not own registered assets like RRSPs and RRIFs. Many people have significant wealth in registered assets. For them, a POA may be the better choice than a trust.
- Potential for capital gains taxation at surviving spouse's death on their terminal return at their marginal rates.



Appointment of trustee

The settlor can name themselves as the trustee of an alter ego or joint partner trust. Since an alter ego trust can continue after the settlor's death, and a joint partner trust can continue after the settlor's and joint partner's deaths, the settlor must also name an alternate trustee or trustees to an alter ego or joint partner trust to take over at the settlor's or joint partner's death. For spousal trusts, the testator (the person who creates the will) must name someone other than themselves as trustee because the spousal trust will take effect only after the testator's death.

Regardless of the type of trust, the settlor or testator should name an alternate trustee or trustees in case the initial trustee becomes incapable of managing the trust assets. The trust document should provide a mechanism for appointing a successor trustee or trustees in case the alternate trustee is unable or unwilling to serve.

Finally, the settlor or testator should provide a letter of wishes to accompany the trust and guide the trustee on the settlor's intent regarding their and the lifetime beneficiary's income needs.

How can life insurance serve the interests of the settlor and trust beneficiary?

A permanent life insurance policy on the life of the lifetime beneficiary(s) can provide a tax-free lump-sum death benefit to the trust when that person dies. The death benefit can help pay the capital gains tax and other expenses associated with the lifetime beneficiary(s)' passing. This can be particularly useful when the property that has attracted capital gains tax is difficult to sell, or one that the settlor wishes the beneficiaries to receive intact, rather than liquidate to pay taxes.

The CRA's prohibition against an LIT owning life insurance, and how to deal with it

The CRA has stated that having the LIT pay life insurance premiums for a trust-owned life insurance policy would taint the trust such that the tax-free rollover of property into the trust would not apply (CRA document 2006-0174041C6, November 2, 2006). The CRA has reasoned that the death benefit would be paid after the lifetime beneficiary's death. At that point the only people who could benefit from the policy would be the trust's remainder beneficiaries, not the lifetime beneficiary. Therefore, the premiums to maintain that policy would be paid from trust income or capital for the benefit of persons other than the lifetime beneficiary(s), thereby tainting the trust.

Although the CRA provided its opinion in the context of a testamentary spousal trust, it confirmed that its opinion applies also to inter vivos (during lifetime) alter ego and joint partner trusts (CRA document 2012-0435691C6, May 8, 2012).

There are several approaches to dealing with the CRA's prohibition, yet still providing the benefits for the trust and remainder beneficiaries that life insurance offers:

- Have a different, non-LIT trust own the life insurance policy. The non-LIT trust owns the policy and claims the death benefit, then uses the death benefit for the same purposes that the LIT would. This strategy avoids tainting the trust but is more expensive to create than the LIT alone, and more cumbersome to administer.
- Transfer a paid up policy into the trust. No premiums will have to be paid, so the CRA's concerns will be satisfied. However, the transfer will be a disposition with potential tax consequences to the current policy owner.
- Have a corporation own the life insurance policy; the LIT will own the shares in the corporation. The strategy relies on the trust itself not owning the life insurance policy. However, the CRA has not provided guidance on this strategy, and may regard the strategy as effectively the same as having the LIT own the policy, especially if the corporation exists only to own the policy, and if the trust pays the premiums through transfers to the corporation. On the other hand, if the corporation carries on a business, has a need for the life insurance policy it owns (apart from any need that the LIT may have), and pays the premiums from its own resources, the CRA may allow it.
- Have the settlor or beneficiary own the policy, with the trust named as irrevocable beneficiary. This strategy keeps the trust from being tainted, but the strategy depends on the settlor or beneficiary maintaining the policy. The settlor or beneficiary should have a power of attorney to allow the attorney to maintain the policy if the settlor or beneficiary becomes incapacitated.

Conclusion

Life insurance in an LIT can provide funds at death for many purposes. Although the CRA will not allow an LIT to own and pay premiums for a life insurance policy, there are ways to provide the LIT and its beneficiaries with the benefits of life insurance without offending the CRA's guidance.

While we have made every effort to ensure that the information presented in this document is accurate and up-to-date, please note that the examples and information provided are for illustrative purposes only. No one should act upon the information presented here without first seeking the professional services of a personal advisor and having a thorough analysis of his/her legal or tax situation performed.

The legal rules governing trusts in this document are primarily based on common law. As a result, some of these rules may differ in the province of Quebec

Sun Life Assurance Company of Canada is the insurer of these products and is a member of the Sun Life group of companies.
© Sun Life Assurance Company of Canada, 2026. 810-5379-03-26



Life's brighter under the sun