



## Trusts and life insurance

Imagine this: You're meeting with a high-net-worth Client who's concerned about estate planning, tax efficiency, and protecting their family's financial future. You've discussed life insurance options, but something's missing. Then it hits you – this Client, and others like them, has a trust. How can life insurance work within or alongside a trust? How can it help a Client achieve the objectives they're trying to achieve with their trust? And most importantly, how can you help?

This article provides a high level overview of what a trust is, what it does, how it works, the tax and legal rules that apply to it, and how life insurance can add value to a trust. Other articles in this series will discuss specific types of trusts and how those trusts can use life insurance.

## Why include life insurance in a trust?

- **To allow the trust to continue past the settlor's lifetime.** The trust may be providing services or care to the trust beneficiaries, and may have been relying on regular contributions from the settlor. Life insurance provides the money for the trustee to continue providing those services.
- **To preserve control over the life insurance proceeds.** A life insurance policy beneficiary designation may not allow for sufficient control. For example, none of the following features are possible with a life insurance policy beneficiary designation, but are possible with a trust:
  - **Delayed distributions.** The settlor may not want the trust beneficiary to receive all the money all at once, but instead in stages as the beneficiary reaches different ages.
  - **Incentives for receiving distributions.** The settlor may want to encourage the beneficiary to achieve educational or employment milestones to receive distributions.
  - **Restrictions on receiving distributions.** The settlor may want to place restrictions on the use for which the trust beneficiary may use the distribution.
  - **Provision for special distributions (education, medical needs).** The settlor may want the trustee to have discretion to make distributions for specific needs and purposes.
- **To provide detailed instructions for the use of the life insurance proceeds.** Similar to the desire to maintain some control over the life insurance proceeds, the settlor may want to leave instructions to guide the trustee in carrying out their duties in managing the life insurance proceeds.
- **To protect the life insurance proceeds from others.** Keeping the life insurance proceeds in trust can help protect the money from most claims of the beneficiary's creditors, and can help protect the beneficiary against losing those proceeds through poor decisions.
- **To give the trustee the money needed to pay taxes and other expenses arising at death,** without requiring the sale of trust or estate assets or the diversion of trust or other income.

## The trust relationship

A trust is not a separate legal entity but rather a legal relationship among three parties:

- **The Settlor.** The person(s) who creates the trust, appoints the trustee(s) and beneficiary(ies), and transfers property into the trust.
- **The Trustee.** The person(s) holding legal title to the trust property. Trustees manage the trust assets, not for their own benefit, but strictly for the benefit of the trust beneficiary(s).
- **The Beneficiary.** The person(s) holding beneficial title to the trust property. They are the individuals for whom the trust is created and administered.

## The three certainties

To be legally valid, a trust must have three certainties:

1. **Certainty of intention.** The settlor must clearly intend to create a trust. That is to say, the settlor must clearly intend to give certain property to a trustee, and the trustee must accept the duty to manage that property for the benefit of the trust beneficiary(s) according to the trust document, provincial and federal legislation, and common law trust principles.
2. **Certainty of property.** The trust property must be clearly defined and identifiable. It can be money or assets, as long as there's no doubt about the property that the trustee must manage.
3. **Certainty of beneficiaries.** The beneficiaries must be clearly identified, either by name or by class. At any point you must be able to say with certainty, "This person is a beneficiary of this trust, and this other person is not."

One person may occupy more than one role in a trust. For example, the settlor could be the trustee, and could even be one of the trust beneficiaries. There also can be multiple persons in each role. However, one person cannot simultaneously be the sole settlor, sole trustee, and sole beneficiary. That person would be treated as owning the property outright.

All parties (settlers, trustees, and beneficiaries) can be either individuals or corporations. A trust document may also provide for alternate trustees and contingent beneficiaries.



## Formal and informal trusts

Trusts may be formal (written) or informal (unwritten). Both types are governed by provincial and federal legislation as well as common law principles. A formal trust includes terms that supplement and clarify the settlor's intentions, while remaining subject to general trust statute and common law principles.

## The trustee's authority and duties

Trustees appear to third parties as the legal owners of the trust property, seemingly able to treat the trust property as their own. However, they are bound by the terms of the trust document (for formal trusts), by fiduciary duties to act in the best interests of the beneficiaries in their administration of the trust's property, and must act with utmost good faith and loyalty to the beneficiaries.

A trustee's duties include:

- Administering the trust in accordance with its terms.
- Acting prudently with respect to the trust's property and loyally towards the beneficiary(ies).
- Investing trust property with care and diligence.

The duty of utmost good faith and loyalty requires that in all the trustee's dealings with the trust property and trust beneficiaries, the trustee must put the interests of the trust beneficiaries ahead of their own personal interests.

## Trust ownership of life insurance

A trust may own a life insurance policy if permitted under law and by its terms. There are three considerations:

1. **Trust Document Authorization.** The trust document should explicitly authorize the trustee to acquire life insurance policies and pay premiums, and direct how proceeds are used. Failing that, the trust's general provisions must be worded such that a reasonable interpretation of them allows the trustee to acquire and pay premiums for life insurance policies.
2. **Provincial Law.** In Ontario, subsection 27(2) of the Trustee Act, R.S.O. 1990, c. T.23 allows trustees to invest in any asset a prudent investor would consider suitable. Subsection 27(5) provides a non-exhaustive list of the investment criteria a trustee must consider when acquiring property for the trust. The Trustee Act does not specifically authorize a trust to own life insurance. It will depend on the facts and circumstances.
3. **Fiduciary Judgment.** Even if the law and trust document allow the trustee to own life insurance, the trustee must consider whether owning a life insurance policy aligns with the settlor's intentions, the beneficiaries' needs, and the objectives the trust must satisfy. The issue is not whether the trust can own a life insurance policy, but whether it should own one.

If the trust owns a life insurance policy, it has a choice in who to name as the policy beneficiary. It could name the trust beneficiary(s) to receive the proceeds of insurance. However, the better choice may be to name the trustee in their capacity as trustee of the trust. That way the trustee maintains control of the proceeds of insurance, and can manage those proceeds to achieve the trust's objectives.

If the settlor owns the policy, the settlor should name the trust as the policy beneficiary. When naming a trust as the policy owner and/or beneficiary, it's important to use the trust's exact name to ensure proper receipt of the death benefit.

## Paying premiums

If the trust owns the policy the settlor or beneficiary can make contributions to the trustee to allow the trustee to pay the policy premiums. If the trust owns income producing investments, the trustee could also use the after-tax income from those investments to pay policy premiums, if the trust document allows. Also if the trust document allows, the trustee can borrow money to pay premiums. Whatever method the trustee uses must align with the trust document's language, with the trustee's understanding of the settlor's intentions, and with what is in the beneficiary(s) best interests.

<sup>1</sup> Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.) ("the Act"). Unless otherwise stated, all statutory references in this portion of the article are to the Act.



## Taxation of trusts in Canada

Although a trust is not a legal person, the *Income Tax Act*<sup>1</sup> treats it as a person. A Canadian-resident trust is taxed on its worldwide income. Residence is determined by the location of the trust's central management and control: where do those who make the trust's substantial decisions live? A trust's residence is not always where the trustee lives. If the trustee carries out only administrative duties in response to the trust beneficiaries' instructions, then the trust could be resident where the beneficiaries live.

Trusts must file tax returns, reporting income either:

- Retained in the trust (in most cases taxed at the top personal marginal rate); or
- Distributed to beneficiaries (deductible by the trust and taxed in the hands of the beneficiaries at their personal marginal rates).

There are two exceptions where trusts may access marginal tax rates:

- Graduated Rate Estates (GREs) – For up to three years post-death.
- Qualified Disability Trusts (QDTs) – While the beneficiary remains eligible for the Disability Tax Credit.

## 21-year deemed disposition rule

Every 21 years, a trust is deemed to dispose of all its capital property, potentially triggering taxable capital gains. Life insurance policies are not capital property, and are not subject to this deemed disposition. However, the death benefit money retained in the trust is subject to this rule.

## Trust reporting rules

As part of the trust's annual tax filing obligation, the trust must report the name, address, date of birth, jurisdiction of residence and taxpayer identification number (social insurance number for individuals) for the trust's settlor(s), trustee(s) and beneficiary(s).

## Attribution rules

If someone transfers assets to their spouse or common-law partner, or to their minor children, the income from those assets will be attributed back to the person who made the transfer (except capital gains earned by minor children). Generally, using a trust to circumvent the attribution rules will not succeed.

## Transfers of life insurance policies into and out of trust

Transferring an existing life insurance policy into a trust is a disposition, and may result in a taxable gain to the transferor.

Conversely, if a trust transfers a life insurance policy to its capital beneficiary(s), there is no immediate tax to the trust. A life insurance policy is not “capital property” as that term is understood under the Income Tax Act. Therefore, the rules that apply to dispositions of capital property don’t apply to life insurance. Still, a life insurance policy is part of a trust’s “trust capital,” and therefore can be transferred from the trust to the trust’s capital beneficiary(s) on a tax-deferred basis.

## Issues concerning a trust and a corporation’s capital dividend account (CDA)

A corporation may own and be the beneficiary of a life insurance policy. If the life insured person dies, the corporation can claim the policy death benefit, and then credit the death benefit, minus the policy’s adjusted cost basis, to its CDA. Capital dividends are paid to the corporation’s shareholders tax-free.

The Canada Revenue Agency interprets this provision strictly. If a trust owns a life insurance policy for the benefit of a corporation, and the trust receives the death benefit, the trust’s terms may allow the trustee to pay the death benefit to the corporation as a tax-free capital distribution. However, the corporation cannot add the distribution to its CDA because it will have received the death benefit in its capacity as a trust beneficiary, not as a beneficiary of the life insurance policy.

## Summary

Almost all high-net-worth Clients will have a trust, or will need one. Therefore, advisors who want to serve affluent Clients should understand trusts. Trusts can provide detailed control over wealth distribution and can help protect a Client’s wealth. When combined with life insurance, trusts can help ensure continuity of financial support, fund tax liabilities, and allow for nuanced estate planning strategies. From preserving family wealth to caring for beneficiaries with special needs, the synergy between trusts and life insurance opens up many possibilities. However, navigating the complex legal, tax, and financial implications requires expertise. For advisors wanting to practice in the high-net-worth market, gaining that expertise will help them serve this important market and grow their practice.

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

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