LIFE INSURANCE TRUSTS

Combining two distinct estate planning components into a simple,yet sophisticated wealth management tool

Insurance & Investments
Simple. Fast. Easy.®

Traditional view of life insurance

Life insurance is commonly (and appropriately) portrayed as a simplifying solution to often complex estate planning needs. Though emotional loss at death is always paramount, life insurance proceeds can nonetheless serve as a financial proxy for the loss of a key breadwinner.

But is it enough to merely cause a pool of money to come into being, or is there more that one can do to have ongoing meaningful effect on the lives of those left behind?

Using a life insurance trust

A life insurance trust is a simple, yet sophisticated wealth management tool that allows one to create a means for addressing important estate planning challenges where the blunt instrument of life insurance alone might be inadequate:

- Facilitating beneficiary creditor protection
- Planning against the incursion of matrimonial law claims
- Protecting a spendthrift from improvidently depleting an entitlement
- Mandating qualified wealth management for young or immature beneficiaries
- Creating a tax-preferred vehicle for business buy-sell and/or succession
- Arranging for optimal support and opportunities for disabled beneficiaries
- Monitoring a charitable gift to assure that funds are used for intended purposes
- Providing for ongoing tax relief to spouses, children or other high net worth persons

Nature of a trust

A trust is not a legal entity, but rather the expression of a property ownership relationship.An original owner of property separates legal ownership from equitable ownership by placing legal title to the property in the trustee/s whose responsibility it is to manage that property with a view to the best interests of the beneficiary/ies.

Varieties of trusts

For tax purposes, the major distinction among trusts is the time at which a trust is 'settled', or comes into existence.

A trust that is settled by a 'settlor' (the original property owner) while living is an inter vivos trust, and it is taxed at the highest personal marginal tax rate of the province where the trustee is resident.

By contrast, a trust that is settled at death (usually by the Will of the 'testator' but may be via a standalone document) is a testamentary trust and is described under ss 108(1) of the Income Tax Act (Canada). In unusual circumstances a testamentary trust may also come into being by court order. Graduated tax rates are not available to insurance trusts.

It is also possible that a trust settled at a person's death is deemed by the Canada Revenue Agency (either at that time or at some later date) to be an inter vivos trust. While this may be unavoidable, it could be the result of an error in drafting or administering the trust — a jolting reminder that professional advice is critical.

Varieties of insurance trusts

The phrase 'insurance trust' is somewhat vague, and what we must achieve is clarity While insurance and trusts may interact in many ways, there are two criteria that have to be understood and managed:

- Whether the trust is inter vivos or testamentary
- Whether the trust is the policyholder, or the receiver of insurance proceeds

Generally the desired structure is to cause insurance proceeds to fund a testamentary trust at the death of the life insured.

Lynchpin to being a testamentary trust

A trust is settled in law when the three certainties of trusts merge:

- Intention to create a trust relationship
- Identification of objects (beneficiaries)
- Settlement of subject matter (property)

A trust indenture document may be drafted with the first two certainties, but there can be no property settled into the trust until the death and related payout of the insurance proceeds. While the trustee will still be able to manage the funds, the trust will be inter vivos for tax purposes if the property is settled before the death of the life insured/owner or annuitant/owner.

As a further qualifying criterion, a testamentary life insurance trust can only arise out of a policy owned by the life insured. This obviously excludes spousal criss-cross or other cross-ownership arrangements, as well as corporate-owned life insurance policies.

Beware the phantom insurance trust

It is common to name a trustee for minor beneficiaries when using an insurer's application or policy change forms.

While valid in principle, this arguably establishes the trustee as a mere custodian without powers to manage the funds. The result is that while the beneficiary is a minor there is limited ability to manage or distribute funds, and at the age of majority the beneficiary can demand full payout.

How to create a life insurance trust

A life insurance trust has all of the benefits of a testamentary trust in allowing the policy owner to control the timing and use of life insurance proceeds following the death of the insured.

1. Separate trust agreement. This is a standalone document.
2. Insurance trust clause within a will. Specific clauses directing the insurance proceeds to a newly formed trust which sets out the terms and purpose of the trust including handling and distribution of the proceeds and names a trustee(s). Although they may mirror the original distribution of the will, they are often different.
3. Beneficiary designation in the insurance application or separate beneficiary designation filed with the insurance company. The beneficiary designation refers to the will and uses the same distribution as the residue distribution found in the will. The insurance carrier should receive a copy of the executed will. Here again, be mindful of falling into the trap of setting up a phantom insurance trust.

People thinking of life insurance trusts tend to focus their view on life insurance paying out a death benefit. An important consideration is that segregated funds are defined as life insurance under the Uniform Insurance Act and may also fund a life insurance trust.

Benefits of Life Insurance Trusts

Probate and associated estate settlement costs may be avoided if the insurance trust is properly drafted. Proceeds bypass the estate, and generally offer:

1. creditor protection at the estate level,
2. safety from those who may contest the will and
3. privacy
4. speed. Trusts can be funded by insurance proceeds in a few weeks vs. what may take years otherwise.

This is all unique to a life insurance trust.

Payment of the insurance proceeds to a trustee allows the policy owner to ensure that the funds are received for the benefit of a named beneficiary including a minor beneficiary. This also provides flexibility with respect to the terms under which the beneficiary is to benefit from the use of the proceeds and how they may eventually receive the proceeds.

Drafting the trust

In order to have an ongoing trust, a lawyer will use detailed drafting to preserve the trust from being prematurely collapsed.

Under provincial Insurance Acts which are based on the Uniform Insurance Act, it is possible to use a written instrument such as a Will or separate trust indenture to make a beneficiary designation.

The use of either of these instruments should not draw the proceeds within probate or estate creditor reach, but some lawyers still prefer the separate trust for extra comfort. As a counterpoint, using the Will is somewhat simpler and less costly.

Informing the insurer

As an insurer is generally entitled to rely on the last beneficiary designation it has in its records, it is imperative that the insurer be made aware of the change. Though a misdirected payout is not fatal to the legal existence of the trust, from a practical viewpoint it could do irreparable damage.

STEPUP

Providing you with the estate planning and wealth strategies that matter most, the Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team is comprised of practicing professionals whose primary objective is to support you as you help your clients reach their financial goals.

This document reflects the views of Empire Life as of the date issued. The information in this document is for general information purposes only and is not to be construed as providing legal, tax, financial or professional advice. The Empire Life Insurance Company assumes no responsibility for any reliance made on or misuse or omissions of the information contained in this document. Please seek professional advice before making any decision.

® Registered trademark of **The Empire Life Insurance Company**. Policies are issued by The Empire Life Insurance Company.

The Empire Life Insurance Company
259 King Street East, Kingston, ON K7L 3A8

Insurance & Investments – Simple. Fast. Easy.®
empire.ca   info@empire.ca   1 877 548-1881

INS-3076-EN-06/21