LIFE INSURANCE TRUSTS

Combining two distinct estate planning components into a simple, yet sophisticated wealth management tool
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’) is a testamentary trust, and it is taxed as an individual under the graduated tax bracket system (though it cannot use tax credits intended only for natural persons). In unusual circumstances a testamentary trust may also come into being by court order.

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.

As a further qualifying criterion, a testamentary 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 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.
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.

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