Life Insurance Trusts: The Whys and Whens

A life insurance policy offers a simple solution to some complex estate planning issues, by creating a pool of funds available to the beneficiaries of the policy shortly after the death of the policyholder. A life insurance trust is a lesser known, but sophisticated wealth management tool that can amplify and diversify the benefits of a life insurance policy on the death of the insured.

A life insurance trust provides the same benefits as insurance to a named beneficiary: privacy, speed of access to funds on death, and avoidance of the probate process; thereby saving fees, expenses and time. Properly structured, an insurance trust can offer the following further advantages which are unavailable when a policy is paid as a lump sum to named beneficiaries:

- Creditor protection for the beneficiaries;
- Reduced potential exposure to family law claims;
- Benefit to persons under the age of majority who cannot receive the funds directly;
- Protection for vulnerable beneficiaries from depletion of their inheritance;
- Protection of entitlement to social assistance benefits for disabled beneficiaries; and
- Reduced overall tax burden on families by allowing income to be taxed in the hands of beneficiaries in a lower tax bracket.

What is a Life Insurance Trust?

The mechanics of a life insurance insurance trust cause life insurance proceeds to fund a testamentary trust on the death of the insured. Until that time, the policy retains its creditor-exempt status, provided the beneficiaries of the trust are from the prescribed class of family members (spouse or common-law partner, child, grandchild or parent).

The life insurance trust can be created in the Will or in a separate insurance trust document or "insurance declaration."

A Joint Last to Die policy can also be used to fund a life insurance trust on the second death. The designation creating the life insurance trust can allow the trustees to pay the debts and taxes of the deceased insured before funding the trust.

Strategies for creating a Life Insurance Trust

A life insurance trust can be created in the Will, and if done through the Will, it is advisable:

- To name trustees of the life insurance trust separate from the executor;
- Provide the identifying particulars of each policy that will fund the trust;
- Clearly identify the beneficiaries of the life insurance trust; and
- Provide different trust terms than may be provided elsewhere in the Will.

Doing this will help ensure that the proceeds of the life insurance policy are not treated as part of the estate, and thereby be subject to the probate process and its attendant fees, where applicable.

Where privacy, avoidance of the probate process, and protection from estate creditors are of concern, a separate insurance trust document is advisable. According to commentary from the Canada Revenue Agency ("CRA"), where the terms of the trust have been set out in the lifetime of the individual in a separate insurance trust document, it may nevertheless qualify as a testamentary trust when it receives the proceeds of a life insurance policy on the death of the individual, if certain conditions are met, namely:

- The trust must be designated as the beneficiary of the insurance policy;
- The trust is not funded until the insurance proceeds are paid into the trust on the death of the individual; and
- No one else has or will contribute assets to the trust.

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Taxation of a Life Insurance Trust

Life insurance proceeds from exempt policies are received by the trustee, as the beneficiary of the policy, tax-free. They are not subject to the deemed disposition that otherwise occurs when capital property is transferred to a trust, giving rise to a capital gain or loss at that time.

As with other personal trusts, any income paid or payable to a beneficiary of a life insurance trust in the year is taxed in the hands of the beneficiary, provided the trust claims the offsetting deduction from its income. An amount is considered payable, if "the beneficiary was entitled in the year to enforce payment of it." Income or gains retained in the trust are taxed at the top marginal rate, unless the insurance trust qualifies as an Age 40 Trust, is a Qualified Disability Trust ("QDT"), or a Preferred Beneficiary Election ("PBE") is made, as discussed below.[1]

Furthermore, a personal trust is generally subject to a deemed disposition of its assets every 21 years from the date of death, although this rule does not apply to certain trusts, including a spousal trust (i.e., where the sole beneficiary of the trust is the spouse during his or her remaining lifetime).

Age 40 Trusts

Graduated tax rates for income retained in the life insurance trust may be accessed where the beneficiaries of the trust are under the age of 21 for the duration of the year, and have a vested right to the income and the capital of the trust. Only the payment is deferred on condition that the beneficiary attains a prescribed age, and that age must be 40 or less. In order for the trust to access the graduated rates for income retained in the trust, the payment of income or capital to the beneficiary cannot be subject to the exercise of (or failure to exercise) any discretion on the part of the trustees.

Qualified Disability Trusts

Another exception to the taxation of personal trusts at the highest marginal rate is the Qualified Disability Trust ("QDT"). The Income Tax Act requires that at least one of the beneficiaries of the QDT must be eligible for the disability tax credit ("DTC"), and the trustee must make a joint election with one of those beneficiaries for the trust to be a QDT for the year. However, a beneficiary can only elect for one trust to be a QDT. In addition, the trust must be a testamentary trust; that is, one that "arose on, and as a consequence of," the death of an individual.

A QDT structured as a separate life insurance trust may be desirable as the life insurance trust will qualify as a "testamentary trust" while avoiding the probate process and potential exposure to estate creditors. Due to its access to graduated rates, the QDT may also achieve a degree of income-splitting not otherwise available to the beneficiary if he/she earns income from other sources.

If the objective of the QDT is also for the trust to qualify as a Henson trust and ensure that the beneficiary continues to be eligible for income- or asset-tested social assistance programs, special drafting is required to ensure that the disabled beneficiary will not have a vested right to receive income and/or capital from the trust. A beneficiary may be considered to have a vested interest when he/she has a fixed entitlement to receive income from the trust or is entitled to receive distributions from the capital of the trust at prescribed ages, and no further provision is made for alternate beneficiaries.

Preferred Beneficiary Elections ("PBE")

In circumstances where a life insurance trust is not eligible to be treated as a Qualified Disability Trust, but nevertheless there is a beneficiary with special needs, the trust may be able to benefit from graduated rates on income otherwise payable to such beneficiary but retained in the trust. This is achieved in any year where a beneficiary and trustee make a joint "preferred beneficiary election" to tax in the hands of the beneficiary income or gains earned by the trust even though they are retained in the trust and not, in fact, paid to the beneficiary. In order to qualify as a preferred beneficiary, the beneficiary must be resident in Canada at the end of the year and must either qualify for the disability tax credit or be at least 18 years of age, a "dependant" (as defined in the Income Tax Act) of another person for support because of mental or physical infirmity, and not have income that exceeds the basic personal exemption amount. In addition, the preferred beneficiary must be the settlor of the trust, his/her spouse/common-law partner or former spouse/common-law partner, or child, grandchild, great-grandchild or a spouse/common-law partner of such persons.

For more information on planning for beneficiaries with disabilities, ask your BMO financial professional for a copy of our publication, *Special Needs Beneficiaries Require Special Estate Planning*.

Special considerations in Quebec

From a Quebec perspective, it is possible to designate a trust as the beneficiary of a life insurance policy. While probate planning is not a factor in Quebec as it is in other provinces, concern to protect the insurance proceeds from creditors of the estate is the same. As in other provinces, the trust can be created in the Will or in a separate insurance trust document created during one's lifetime. However, if the beneficiary is a trust created in the Will, it is important in Quebec that the trust exists at the time when the insurance is paid – that it is not funded only by the proceeds of the insurance. It is therefore recommended that the testator bequeath a low value asset by particular legacy to the trust in the Will. As such, the trust will be created automatically at death by this transfer of the particular legacy, and not by the transfer of the life insurance. This will ensure that the insurance proceeds do not form part of the estate and be available to the creditors.

Additional requirements for a Life Insurance Trust

The "insurance trustees" are to be designated as beneficiaries of the policy "in trust." However, the policy provider should confirm their preferred language for the designation on the policy. The designation should be worded in a way that the policy provider approves so that there will be no issue with the policy provider paying the proceeds to the trustees of the insurance trust upon the death of the insured.

As with all aspects of estate planning, probate avoidance shouldn't be the primary concern when considering whether a life insurance trust is appropriate. Privacy, protection from estate creditors and the needs, ages, and circumstances of the beneficiaries should also influence the decision of whether a life insurance trust is appropriate. In the right circumstances and with comprehensive estate planning and tax advice, a life insurance trust can have a meaningful impact on the lives of the beneficiaries.

For more information, speak with your BMO financial professional.

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[1] Depending on the circumstances of the beneficiaries, the proceeds of the policy may receive better treatment from an income tax perspective when treated as part of the estate and not as a separate personal trust. If designated as a Graduated Rate Estate ("GRE"), an estate may enjoy graduated tax rates for a period of up to 36 months from the date of death – an advantage not enjoyed by life insurance trusts.

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