canada life™

Trusts and life insurance

Many people want to leave a legacy for their loved ones after they're gone. These individuals may want to control access to the legacy if their heirs are minors, have a physical or developmental disability, are spendthrifts or to provide protection from marital claims and other creditors of the beneficiary. A trust may provide this control and protection.

What's a trust?

A trust is an ownership arrangement over property. A trust's property is provided by the settlor. A trustee has legal title to the trust property and the trust's beneficiaries have beneficial title. The arrangement is typically governed by a written trust agreement that outlines the duties and powers of the trustees and the beneficiaries' entitlement to the trust property. In Quebec, trusts must be governed by documented terms.

Generally, a trust may be used as an estate planning tool that manages a beneficiary's access to assets and may also be used to minimize probate fees, provide potential creditor protection, preserve government benefits for the disabled and facilitate tax planning strategies.

Trusts can be established either while the settlor is living (an *inter vivos* trust), or upon his or her death (a testamentary trust). Previously, testamentary trusts were taxed using graduated tax rates. Starting in 2016, graduated rate estates[i] ("GRE") and qualified disability trusts[ii] are the only types of trusts which may benefit from graduated tax rates. All other trusts are taxed using the highest marginal tax rate applicable to individuals.

A trust structure can be complex depending on the circumstances of the settlor, the trustees and the trust beneficiaries. Trusts are governed by provincial law and rules may vary by province. It's important that a lawyer, or in Quebec either a lawyer or a notary, be involved in the planning and the drafting of the agreement or Will that creates the trust. Similarly, outside of Quebec, it's also important for a lawyer to be involved in the planning and drafting of an insurance declaration that sets up an insurance trust[iii].

Trusts and life insurance

There are two main ways in which life insurance is used with trusts. The first involves an individual that owns the policy and the death benefit settles a testamentary life insurance trust (LIT). The second involves an existing *inter vivos* trust owning a policy and receiving the death benefit.

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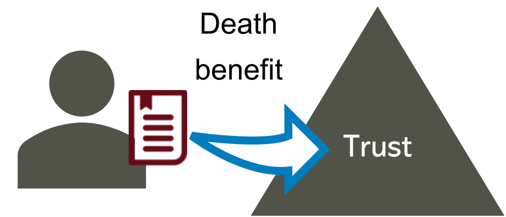
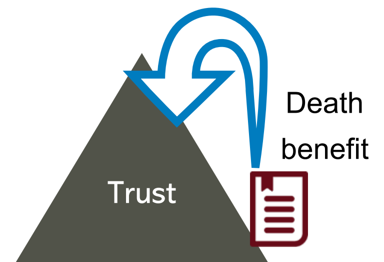
A trust receiving a death benefit (a LIT)



A policy may be owned by an individual and either an existing *inter vivos* trust may receive a death benefit or a LIT may be established as result of receiving a death benefit. In the case of a LIT, its terms may be set up inside or outside of a Will. In each case, the document setting out the terms of the LIT has an insurance designation signed by the policyowner directing the insurer to pay the death benefit to the trustees of the LIT. A LIT is considered a "testamentary trust" provided the deceased was the policyowner[iv]. Similarly, a policyowner's estate may receive a death benefit and then settle a trust set up in a Will. In this context, the GRE would retain its character as a testamentary trust for tax purposes, an important element for an estate to qualify as a GRE; however, the death benefit would be subject to probate or estate administration taxes, depending on the province.

Existing trust as policyowner and receiving a death benefit



An existing *inter vivos* trust may also own a life insurance policy, including a segregated fund policy. A policyowner that is a trust is also typically the beneficiary of the policy for tax reasons. A notable benefit of using a trust to own life insurance is that the policy isn't subject to the tax rule that deems the trust's capital property to be disposed every 21st anniversary of the trust (this exception only applies to life insurance policies and not to segregated fund policies).

Based on the Canada Revenue Agency's current interpretation of the *Income Tax Act* (Canada), a life interest trust such as a spousal trust, alter ego trust or joint partner trust may be "tainted" if it has the power to fund a life insurance policy on the life of the life interest[v]. A tainted trust means that the rollover of assets to these types of trusts may be jeopardized.

Informing Canada Life that a trust is a policy beneficiary

Use caution when either designating a trust as a beneficiary of a life insurance policy or informing an insurer that a trust was designated as beneficiary of a life insurance policy. The risk largely stems from completing an insurer's forms in a way that creates a new trust as the policy beneficiary, thereby revoking a prior insurance designation or replacing the terms of the intended trust agreement. Such a new trust would not have the terms stipulated in the intended trust agreement and instead be governed by basic terms established under provincial legislation and the common law. In Quebec, insurers can't pay an insurance payout to a "trustee" solely on the basis of a designation made on a life insurance form – as noted, trusts must be formally established in a separate document (for instance, an agreement or a Will).

To avoid this outcome, use the following designation formats and procedures when designating a trust as policy beneficiary or informing Canada Life that a policyowner has designated a LIT to receive the death benefit.

Designation format – use this language in our forms	Procedure
An existing trust	
"[Name of trustee(s)], trustee, or any successor trustee of the [name of trust], dated [insert date]"	Follow this procedure: • Provide a copy of the trust agreement (and any amendments) to the insurer

Designation format – use this language in our forms	Procedure
	• If limited by characters in an electronic application use "Trustees for [name of trust], [insert date]" • Insurer will verify it's dealing with the correct person(s) as trustee(s) when insurance payout distributed
Insurance trust set up inside a Will	
"As per the Will, dated [insert date], of [the life insured]"	Follow this procedure: 1. Provide a cover letter informing insurer that trustee(s) designated in the Will are to receive the insurance payout on behalf of the insurance trust 2. Include a notarized copy of the terms of the trust in the Will and its signature pages
Insurance trust set up outside of a Will (not applicable in Quebec)	
"As per the Insurance Trust, dated [insert date], of [the life insured]"	Follow this procedure: 1. Provide a cover letter informing insurer that trustee(s) designated in the trust settlement agreement are to receive the insurance payout on behalf of the insurance trust 2. Include a notarized copy of the terms of the insurance trust and its executed signature pages

Trusts and probate

A death benefit doesn't form part of a deceased policyowner's estate when it's paid to an existing trust or a LIT set up either inside or outside of a Will. In the case of a Will that creates a LIT, the document needs to be drafted so that it's clear the death benefit is to be received directly by the trustee(s) as policy beneficiary and doesn't flow through the estate.

Settlement options as an alternative to a trust

A death benefit can be paid to the designated beneficiary as a lump sum, a term annuity, a life annuity or a combination of these options. This flexibility may be attractive to policyowners concerned about the beneficiary receiving a lump-sum payment. The choice of settlement options may be a simple and cost-effective alternative to using a trust, as it doesn't include professional fees. If the policyowners' estate planning needs are beyond what these settlement options offer, then they can use a trust with more specific terms.

A practical example

Mrs. Jones is 65 and has wealth that she would like for her two adult children and four grandchildren to inherit. She doesn't want her child or grandchild to have direct access to his or her share of the inheritance until age 45. Her advisor introduces her to an insured inheritance strategy using a permanent life insurance policy and a LIT to provide control over the inheritance. Mrs. Jones has her lawyer update her Will to include an insurance declaration in favour of a LIT created upon her death. The advisor provides a copy of the Will to Canada Life, as described above. Mrs. Jones has effectively met her estate planning goal and more by:

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- Obtaining insurance protection and immediately enhancing her estate
- Using the trust to control her children's and grandchildren's access to the inheritance
- Adding flexibility for a potential source of additional income during her lifetime using the policy's cash value, if any
- Minimizing taxes on asset growth and probate fees, which would erode her legacy
- Potentially providing the beneficiaries with creditor protection benefits using through the LIT

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[i] Generally, a GRE is an estate that arises as the result of the death of a person on or after December 31, 2015, and no more than 36 months after the person's death and the estate designates itself as a GRE in its first year's tax return.

[ii] Generally, a qualified disability trust is a testamentary trust that arose on the death of a particular individual, that jointly elects, with one or more beneficiaries under the trust to be a qualified disability trust for the year. Each electing beneficiary must, be eligible for the disability tax credit.

[iii] In Quebec a trustee may not receive a death benefit from an insurance declaration.

[iv] It may be possible for an existing testamentary trust to receive property from a person other than the person who created it as long as it's received as a consequence of death.

[v] For each of these types of life interest trusts, the trust income or capital cannot be used to benefit other persons other than the spouse or settlor of the trust, as the case may be, during their lifetime. The Canada Revenue Agency is of the view that premiums paid by a testamentary spousal trust, for example, on a life insurance policy on the spouse's life results in assets of the trust used for the benefit of persons other than the life interest. See CALU CRA Roundtable, questions 2 and 3, CRA documents 2012-0435681C6, 2012-0435691C6. There may be limited reasons for an alter ego trust or joint partner trust to own a life insurance policy; however, there may be valid reasons for a testamentary spousal trust to own a life insurance policy given that it may have a tax liability arising upon the death of the life interest spouse. In this regard life insurance may provide the liquidity the trust needs at this time. There are planning options for insurance in this context, see the Canada Life article tilted, "Spousal Trusts and Life Insurance".

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