Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

# Insurance trusts for estate planning

Life insurance can be a versatile tool in an estate plan. For many people, life insurance provides the necessary liquidity after death to fulfill their testamentary intentions. For example, life insurance is often used to ensure there's cash available to support and maintain a lifestyle for loved ones. It's common to name a beneficiary on the insurance policy documentation. On the life insured's death, the tax-free death benefit is paid directly to the named beneficiary, outside of the deceased's estate, and may avoid probate tax. The proceeds are immediately available for the beneficiary's use.

Paying the life insurance proceeds outright to your intended beneficiary, however, may not be an attractive option in certain circumstances. This may be the case, for example, where your beneficiary is a minor or mentally disabled beneficiary and the proceeds cannot be paid to them directly, or where your beneficiary is a spendthrift, and you don't want them to have immediate access to the proceeds on your death. In these circumstances, you may want to consider having the life insurance proceeds paid to a trust for the benefit of your beneficiary. A trust may be used to control how and when a payment is made to a beneficiary.

This article outlines the creation of insurance trusts and various circumstances when using an insurance trust may add value to your estate plan. This article applies to all provinces and territories with the exception of Quebec, where the use of insurance trusts is limited due to the manner in which a trust must be established under the Quebec Civil Code.

*Any reference to a "spouse" in this article also includes a common-law partner.*

## What is an insurance trust?

The term "insurance trust" typically refers to a trust that is funded with life insurance proceeds on the death of the life insured. This type of trust can be testamentary (i.e. a trust that is created on the death of the settlor) or inter-vivos (i.e. a trust that is set up during lifetime). The term "insurance trust" can also be used to refer to an inter-vivos trust that's set up to be the holder of an insurance policy. The trust assets may be used to pay the policy premiums and may receive the life insurance proceeds on the death of the life insured. The remainder of this article will focus on insurance trusts funded with life insurance proceeds on the death of the life insured.

An insurance trust may provide you with a number of advantages — for example, you may be able to attach terms and conditions to the distribution of insurance proceeds. In some cases, it may be possible for the insurance proceeds to bypass your estate, reducing probate tax payable on death. This may also help shelter the proceeds from your estate creditor claims, and help maintain confidentiality.

## Insurance trust funded with proceeds at death

There are three ways you can create an insurance trust funded by life insurance proceeds on the death of the life insured:

1. Create a separate trust instrument
2. Include an insurance trust clause within a Will; or
3. Designate a testamentary insurance trust within an insurance contract.

### 1. Creating a separate trust instrument

You can set out the terms of an insurance trust in a separate trust instrument, known as a trust deed or trust declaration. The trust instrument will identify the settlor, the trustee, the beneficiary and the terms under which the trust assets will be managed. This document can be as simple or as complex as you desire in order to meet your objectives and the needs of your beneficiary.

Note that if the trust is only set up to receive the insurance proceeds on the death of the life insured (and is not the policy holder), then the trust will likely only be settled on the death of the life insured and will be considered to be a testamentary trust.

When using this strategy, the trustee of this trust will generally be designated as the beneficiary of the insurance proceeds on the forms provided by the life insurance company. Alternatively, a beneficiary declaration may be included in the trust document itself and a copy of the trust agreement provided to the life insurance company.

You can set out the terms of an insurance trust in a separate trust instrument, known as a trust deed or trust declaration. The trust instrument will identify the settlor, the trustee, the beneficiary and the terms under which the trust assets will be managed.

An advantage of using a free-standing trust instrument is that it provides you with the most flexibility and offers you a complete document that can stand on its own, distinct from your Will. In general, if you make frequent changes to your Will or if your Will may be challenged after your passing, this method may be the most appropriate. This is because if the terms of the insurance trust are part of your Will, a revocation of your existing Will will result in the revocation of your insurance trust as well. On the other hand, a separate insurance trust won't be affected by the revocation of your Will or the Will being successfully challenged and set aside by the Court.

Another advantage of using a separate trust instrument is that it can be used to successfully exclude the insurance proceeds from the estate assets, and thus probate taxes.

A separate trust instrument also provides an added level of privacy. A probated Will is a public document. If the terms of your insurance trust are included in your Will and the Will needs to be probated, the details of the trust will be available to the public. By creating a separate insurance trust instrument, the existence and terms of the trust will remain hidden from the public.

### 2. Including an insurance trust clause within a Will

In general, you can make an insurance declaration in your Will, and direct that the proceeds be held in trust in accordance with terms set out in your Will. Insurance proceeds paid to an insurance trust created in your Will may not be subject to probate taxes or estate creditor claims provided your Will is carefully drafted and the insurance proceeds are received and managed separately from other assets of your estate. To ensure your probate planning and creditor proofing objectives are achieved, you may wish to consult with a qualified legal advisor as to where the terms of the insurance trust should be located in the body of your Will. You may also want to seek advice from a qualified legal advisor as to whether someone other than the executor should be appointed as insurance trustee and whether specific trust terms should apply to the insurance proceeds that are different from the provisions governing the other estate assets. Without a clear separation, the insurance proceeds could be treated as part of the estate assets.

A disadvantage in creating an insurance trust through a clause in your Will is the possibility that if the Will is ever revoked, the insurance trust will also be revoked. Again, this is something you should be cognizant of if your Will requires frequent updates due to major changes in your life.

### 3. Designating a testamentary insurance trust within an insurance contract

It's possible to create an insurance trust within the insurance policy contract by designating a person or persons to hold the proceeds in trust for a beneficiary. As the beneficiary designation forms provided by the life insurance company generally provide little room for setting out detailed trust terms, the designation could refer to your Will and require your trustee to hold the proceeds on the same trust terms used for the distribution of the residue of your estate. You may wish to include the date of the executed Will in the insurance contract. If your Will is updated or, revoked and subsequently replaced, you may want to ensure that the designation in the insurance contract is updated to reference your most recent Will. This is an important step to ensuring that this strategy remains effective.

This method for creating an insurance trust may not afford the same flexibility and level of control with respect to the distribution of the insurance proceeds as the other two methods previously mentioned. If the insurance trust is to mirror the terms of the residuary trust set out in the Will, then you need to ensure that you're comfortable with the same trust terms applying to the insurance proceeds. You will not be able to segregate the insurance proceeds to be used for a specific purpose.

## Planning considerations when creating an insurance trust

### Probate tax

You may be able to reduce probate taxes on death by having the insurance proceeds paid directly to an insurance trust. To ensure the insurance proceeds do not form part of your estate and subject to probate tax, the terms of the trust must be carefully drafted so that the trust is viewed as separate from the estate. Remember, probate taxes vary quite a bit by province and territory, so this may be a bigger consideration for those who are residents of provinces where probate taxes are higher such as in Ontario or Nova Scotia.

### Creditor protection

There is no substitute for obtaining legal advice regarding creditor protection issues. Please note that these comments are general in nature and should only be used as a starting point for detailed discussions with a qualified lawyer about your situation.

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Insurance proceeds paid directly to a beneficiary, including an insurance trust, are generally protected from claims by any of your creditors as they pass outside your estate. To ensure the proceeds are not subject to your creditors' claims, you will want to ensure with a qualified legal advisor that the insurance proceeds are held in trust separate from the other estate assets.

Whether or not the insurance proceeds are protected against the creditors of the insurance trust beneficiary depends on terms of the trust.

### Income tax

In general, income earned and retained in an inter-vivos or testamentary trust is generally taxed at the highest marginal tax rate in the trust's province of residence, subject to certain exceptions. One exception to this tax treatment is for a Qualified Disability Trust (QDT). In general, a QDT is a testamentary trust that has a beneficiary who qualifies for the disability tax credit and meets other conditions. A discussion of the specifics of a QDT is outside the scope of this article. However, it's important to note that where a testamentary insurance trust qualifies as a QDT, it may be possible for income earned and retained in the trust to be taxed at graduated tax rates.

As there is no benefit to taxing income in an insurance trust, you may wish to consider structuring your insurance trust in a manner that provides your trustee with discretion to pay out income to the trust beneficiary and have it taxed in their hands. You would need to consider, however, that your beneficiary would generally have a right to any income allocated to them. This discretionary power to allocate income will allow for the capital (i.e. insurance proceeds) to remain under the control of the trustee while the income can be taxed at the beneficiary's marginal tax rate.

While beyond the scope of this article, recent changes to alternative minimum tax (AMT), a parallel tax calculation that is designed to prevent individuals and certain trusts from paying little or no tax, may impact trusts where they earn tax-preferred income or claim certain deductions. For more information, please ask your RBC advisor for a copy of our article on how the AMT rules may impact trusts.

### Legal, accounting and trust administration fees

An insurance trust is a complex planning strategy that should not be attempted without consulting with a qualified legal advisor. There will be an initial expense in setting up the trust, as well as annual costs to administer the trust. With that in mind, it's imperative to start with a cost-benefit analysis to ensure that this structure meets your estate planning goals and is a viable option for your situation.

Depending on your circumstances, you may prefer an outright distribution of the insurance proceeds to a beneficiary due to its simplicity and potential to minimize probate taxes. Alternatively, rather than setting up dual trusts (one funded with estate assets and one funded with life insurance proceeds), you may consider having the life insurance proceeds paid to your estate and administered by your executor in accordance with testamentary trust provisions set out in your Will for other estate assets. In such a case, the life insurance proceeds may be subject to probate taxes and accessible to your estate creditors. However, your legal, accounting and trustee fees relating to the administration of the trust may be reduced as you would only have one trust to administer, not two.

## Potential situations for considering an insurance trust

### Beneficiaries with disabilities or challenging circumstances

An insurance trust may be a suitable option to provide for a disabled beneficiary who's receiving government disability related support. The insurance proceeds can be used to fund a Henson trust (which is a fully discretionary trust), in order to protect the beneficiary's entitlements to asset or income-tested government benefits. In many provinces and territories, the funds held in a Henson trust are not considered to be an asset of the beneficiary for the purposes of certain government disability related support. If you would like more information on Henson trusts, ask your RBC advisor for a copy of our article on Henson trusts.

A fully discretionary insurance trust may also work well for beneficiaries who have substance abuse issues and/or who may have difficulty handling their financial affairs. In both cases, the trustee has control (via the trust deed) over disbursements from the trust. The settlor can even give the trustee full discretion to pay additional amounts in the hope that the beneficiary will one day achieve rehabilitation.

### Beneficiaries who are minors

Certain provincial insurance statutes provide that insurance proceeds can't be paid directly to a beneficiary who's a minor. Instead, the proceeds must be paid "into court" (i.e. paid to a trust account where the trustee is an officer of the court) or to a person who's been appointed by the courts as the guardian of the child's property, and held and managed by them until the child reaches the age of majority. The use of the funds may be restricted. The creation of an insurance trust to hold the insurance proceeds on behalf a minor child will enable the insurance proceeds to be managed and used for the benefit of the minor child as per your wishes.

### Vacation property succession planning

An insurance trust can be used to finance maintenance, taxes and repairs on real estate, such as a vacation property, passed on to your family members. This approach may be beneficial in removing the burden of deciding who will be responsible for the costs associated with the upkeep of the vacation property.

### Fulfilling support obligations

An insurance trust may also be used as a tool to fulfill any support payment obligations you may have at the time of death. These support obligations could be either for a former spouse or for children. If support payment obligations are for minor children, then instead of naming your former spouse as the irrevocable beneficiary of the insurance policy, you can name a trustee for the benefit of your children as beneficiary. The trustee can administer the funds for their benefit. An insurance trust can help ensure that the funds are used to support your children, and prevent any misuse of these funds

## Conclusion

Although there may no longer be an income tax advantage to setting up an insurance trust, there are many non-tax planning goals that may be achieved by using one. If you're using insurance solutions within your estate plan, you may want to discuss the use of an insurance trust in your estate plan with a qualified legal advisor.

*This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.*




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