

INSURANCE TRUSTS

A. Introduction

An insurance trust is a unique estate planning tool that can avoid probate charges, maintain secrecy or avoid creditors. When an insurance trust is structured like a testamentary trust it receives favorable tax treatment.

An insurance trust is a trust funded by life insurance proceeds and established outside of and apart from an individual's estate. This paper will outline some of the advantages and the technical requirements of this specialized estate planning vehicle.

B. The Insurance Designation and General Considerations

The legislation of various Provinces and Territories across Canada allows life insurance proceeds to be paid to designated beneficiaries other than the executors of an estate by way of beneficiary designation. Where that occurs, the insurance money does not form part of the estate but is paid directly to the individuals who are designated as the beneficiaries thereof. This makes the proceeds free from claims by creditors of the estate and free from probate fees. This creditor proofing will only occur if the proceeds are not paid into the estate but to a specified individual.

In an insurance trust, a beneficiary designation is put in place whereby the proceeds of the life insurance policy are paid to an individual who receives the proceeds as trustee. The proceeds are paid to that individual by name, as a flesh and blood person. As an example: "The proceeds of life insurance policy X332211 with Insurance Co. of Canada shall be paid to John Smith, as the trustee of an insurance trust established within the terms of an insurance declaration executed by me on September 25, 2003."

Legal requirements to a valid insurance designation include: the maker must be able to make a contract, that is, he or she must be over 18 years of age; the maker must be acting voluntarily, not under duress; and the maker must understand the nature and effect of the instrument. The maker does not need to meet the more onerous requirements of capacity for making a will.

C. Advantages of Insurance Trusts

Aside from their utility as tax reducing vehicles (discussed later), insurance trusts are used to achieve a number of objectives. These include:

1. Avoiding probate fees – Insurance payments that are not routed into the estate on the death of the individual do not comprise part of the assets of the estate for purposes of the probate fee calculation. An insurance trust does not attract these court fees on the death of the individual. On a \$1,000,000

policy, a saving of \$6,000.00 in probate fees will be generated in Manitoba. In Ontario the saving is \$15,000.00.

2. Confidentiality – Since the insurance proceeds do not pass through the estate, the insurance proceeds do not have to be disclosed when applying for probate and, thus, the amount of proceeds and their destination do not become a matter of public record. Further, the terms of the insurance trusts themselves can be set out in a separate document (separate from the will), so that the terms do not become a matter of public record. The terms of the trust must be disclosed to CRA but not to any next of kin not directly involved in the administration of the trust.

Some people have complicated personal relationships that may result in certain moral obligations to different families. An example of this is where a past relationship (or an extramarital relationship) has resulted in a moral obligation to provide for a child on the death of the individual. It may be difficult to allocate family owned assets to fulfill this obligation, yet if not done it may result in nasty litigation after the individual dies. An insurance trust can be tailored to resolve this difficult situation. An insurance trust can be set up as a fully secret trust. The family of the deceased does not have to go through the emotional turmoil that could result if the dependent child of the deceased sues the estate for support.

In addition, some people may want to favour one family member. For example, they might have several children and want to make a special or extra allowance for one of them without the others' knowledge.

3. Creditor proofing – The law from Province to Province in Canada expressly makes insurance proceeds free from the claims by creditors of the deceased. This is the case as long as the proceeds pass outside of the estate. There may be claims that arise against estate assets that virtually wipe out any hopes of security for the survivors. Setting up one or a number of insurance trusts for dependent beneficiaries may be the alternative for these clients.

4. Taxed as a Testamentary Trusts - An insurance trust can be established as a testamentary trust and a testamentary trust can be an effective tax planning tool. Estate planners want to be aware of the tax benefits to establishing a testamentary trust so that their clients can take advantage of these benefits if the conditions are right. Usually a testamentary trust is created by an individual's last will and testament with the assets that comprise that individual's estate. If the assets of the testator are sufficient and the beneficiaries have alternate sources of income, a testamentary trust can be created by a testator's will with the advantages set out below.
 - o The income of the trust is taxed as a separate income earner at the graduated rates (with no personal exemption), the testamentary trust

being a second taxpayer with a second return, therefore doubling access to the lowest tax bracket.

- The trustee can designate to have the income taxed in the testamentary trust and the beneficiary can receive the income after taxes if he or she is at a higher tax bracket than the trust.

- The income can be paid out directly to the income beneficiaries (children or a spouse for example) to take advantage of their personal exemptions and/or lower rates. This results in an income splitting plan to reduce overall income taxes payable in the family unit.

This can result in thousands of dollars per year in tax savings in the hands of beneficiaries.

D. Canada Revenue Agency Treatment of Insurance Trusts

When setting up an insurance trust it is integral that Canada Revenue Agency (CRA) recognizes the insurance trust as a valid testamentary trust. CRA has commented on the issue of insurance trusts and their requirements on several occasions. This commentary is outlined below in chronological order.

In technical interpretation No. 9238555 *Trust* (February 4, 1993), CRA stated:

In our opinion, a trust funded from the proceeds of a life insurance policy available on the death of an individual and the terms of which have been established by the individual during his lifetime, separate from his will, will be viewed as a testamentary trust within the meaning of paragraph 108(1)(i) of the Act. However, it would not constitute a trust created by a taxpayer's will within the meaning of subsection 70(6.1) of the Act.

This makes it clear that not only is an insurance trust possible in the view of CRA but that the terms can be expressed and the trust can be set up in a free standing document other than the deceased's will.

In technical interpretation No. 9625975 *Testamentary Spousal Trust* (October 7, 1996) CRA again dealt with the issue of a free standing insurance trust. That being one established under the terms of a document other than the will. First, CRA clarifies that if the insurance trust is settled during the lifetime of the will maker with even a nominal settlement and the trust is then left dormant until insurance proceeds become available, even this nominal settlement will disqualify the trust as testamentary in nature. CRA takes the position that the trust is not a testamentary trust because it came into existence at the time of the initial nominal settlement. Further, such a trust cannot be a testamentary *spousal* trust as it is not set up within the terms of the will. However, if the terms of the trust were laid out and established in the insured's will and funded from the proceeds of a life insurance policy, the trust is considered to have been "created by the insured's will" and could qualify as a spousal trust.

Technical interpretation No. 9605575 *Testamentary Trust – Insurance Proceeds* (December 17, 1996) confirms the content of the earlier interpretation bulletins as referred to above. CRA indicates that insurance proceeds can be used to fund a testamentary trust, and the trust comes into existence when the insurance proceeds are paid into the trust rather than when the insured designates the beneficiary in the insurance contract. Again, this appears simply to repeat earlier material.

An indirect commentary of CRA's views of a testamentary insurance trust is provided in Technical Interpretation No. 2000 – 0059755 *Trust Receiving Property from an Alter Ego Trust* (March 23, 2001). This Technical Interpretation focuses on whether a trust can receive property from an Alter Ego Trust and then qualify as a testamentary trust. The position by Canada Revenue Agency is “no”. The reasoning for this position explains why an insurance trusts qualifies as a testamentary trust while a trust funded by the proceeds of an alter ego trust does not. CRA refers to Technical Interpretation No. 9238555 (cited above) and indicates:

That opinion was based on the understanding that no amount would be settled on the insurance trust prior to the receipt of funds from the insurance policy as a result of the individual's death, that the individual who died was the owner of the policy and had designated the trust as the beneficiary of the insurance policy and that the insurance designation was a testamentary instrument. Although the terms of such a trust may be set out before the individual's death, separate from the individual's will, our comments were based on the understanding that the trust would not be created until such time as the insurance proceeds were settled upon the trust.

Another technical interpretation issued on the same day and covered the same topic as the one described above is No. 2001 – 0075375 *Trust Receiving Property from a “Alter Ego Trust”* (March 23, 2001). At issue, again, was whether a trust that is created as a consequence of death can be considered testamentary if it receives property from an alter ego trust. Again, the answer was “no”. It repeats the same elements as set out immediately above. This interpretation goes into greater depth relating to the requirement that the transfer has to qualify as a testamentary instrument under provincial law. CRA states:

Since a testamentary trust is defined as one which, among other things, has received no contribution other than a contribution from an individual as a result of that individual's death, a trust created in the circumstances you describe could only qualify as a testamentary trust if the contribution could be considered to have been made by the settlor on or after the settlor's death and as a result of the settlor's death. Since it is our understanding that a person cannot transfer his or her property on or after his or her death otherwise than by will or other testamentary instrument, the transfer of property from an alter ego to a trust created after the death of the settlor of the alter ego trust cannot be considered to be a transfer by the settlor that occurred on or after the settlor's death. Thus, it is our view that a trust which receives the property from an alter ego trust is not a testamentary trust for the purposes of the Act.

CRA has confirmed through the various interpretation bulletins that an insurance trust will qualify as a testamentary trust for the purposes of the *Income Tax Act*.

E. Five Requirements to Qualify as a Testamentary Insurance Trust

When examine the constituent elements of CRA's view's as outlined in the above mentioned bulletins, we find that there are five requirements needed before an insurance trust will qualify as a testamentary trust. These five requirements are:

1. The deceased person creating the insurance trust must be the owner of the insurance policy.
2. The payment of the insurance proceeds has to be caused by the death of the person creating the trust. It must be the settlor's life that is insured.
3. The deceased person must enter into an insurance designation that designates the trustees of the trust as the beneficiaries.
4. No property can be settled on the trust prior to the death of the individual creating it. There are cases where individuals have set up the trusts preparatory to their deaths and erroneously funded the trust with a token dollar, thereby disqualifying the trust as a testamentary trust. Care should be taken that no money or other property is settled in the trust while the maker is still alive. Even if a nominal amount is settled in the trust prior to the settlor's death, the resulting trust will be categorized as an inter vivos trust and lose some of its tax advantages.
5. The insurance designation must qualify as a testamentary instrument. This means that the beneficiary designation must be revocable.

F. Documentation Required

There are two types of documentation which could be put in place to set out the terms of an insurance trust. Those are:

1. Last will and testament

The terms of the insurance trust can actually be set out in the last will and testament. For clarity, the terms should be set out in a portion of the Will which is separate from the portion of the will where the deceased's estate is to be distributed.

2. Trust declaration or trust agreement

The terms of the insurance trust can also be set out in a separate trust declaration or trust agreement. Where that is the case, there need be no reference to the insurance trust in the person's will. It is important to note that an insurance trust will not qualify as a "Spousal Trust" as defined by the Income Tax Act if the terms are expressed in a document other than a will. The reason for this is that one of the requirements of the Act is that the terms of a Spousal Trust, in order to qualify for the special benefits under the Act, must be included in the Will. The benefit of note that a Spousal Trust has over a testamentary trust is that it is not subject to the 21 year deemed disposition rule.

The appropriate life insurance beneficiary designation must be in place to route the life insurance proceeds into the trust.

H. Conclusion

There are advantages to an insurance trust in an estate plan - and complexities. With a carefully coordinated effort between client, advisor and solicitor, the rewards to the plan can be great. In today's complex planning environment an insurance trust may provide the perfect solution to a client's difficult situation.

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