Advantages of life insurance trusts for estate planning

Avoid probate fees, pay less income tax

What if your clients ask whom they should name as the beneficiary of a life insurance policy?

- Their children, to avoid probate fees and provide creditor protection?
- Or their estate, so the insurance proceeds receive the beneficial tax treatment of a testamentary trust?

The answer is, the client can accomplish both goals with a life insurance trust.

(In Quebec, a civil law trust differs significantly from a common law trust. This article does not cover trusts under Quebec law.)

Life insurance trusts are increasingly popular for estate planning because of their flexibility, tax advantages, creditor protection and control.

Trusts involve a three-party agreement, in which the person who creates the trust (the settlor) directs property to trustees, who as trustee hold and manage the property for the benefit of the beneficiaries. Trusts must have three certainties: certainty of intent (intention to create a trust), certainty of subject matter (property) and certainty of objects (beneficiaries). Trusts must file a return each tax year as per paragraph 150(1)(c) of the *Income Tax Act* (Canada) (ITA).

There are two types of trusts: *inter vivos* trusts, created during the life of the settlor, and testamentary trusts, created after the death of the settlor. For tax planning, testamentary trusts are generally preferable, because income retained by the trust is taxed at graduated rates. To meet the definition of a testamentary trust, in subsection 108(1) of the ITA, the trust can only receive property from an individual, on or after and as a consequence of that person's death.

A trust can be used to receive life insurance proceeds directly, through the trustee as the beneficiary of the policy, on the death of the life insured. This is an alternative to having the life insurance proceeds paid to the estate and then, in accordance with the will, transferred into a testamentary trust.

A life insurance trust provides the possibility to keep the life insurance proceeds outside the estate, so they aren't subject to probate fees or exposed to claims of the deceased's creditors.

In this way, a life insurance trust can meet the dual objectives of avoiding probate fees and preserving the graduated income tax advantages of a testamentary trust.

Establishing a life insurance trust

A properly structured life insurance trust ensures the trust qualifies as a testamentary trust and the life insurance proceeds do not flow through the estate. The Canada Revenue Agency confirmed this point in technical interpretation #9605575, dated Dec. 17, 1996.

There are several ways to set up a life insurance trust:

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1. Life insurance declaration in the will

The declaration provides that life insurance proceeds are paid to trustees in a separate life insurance trust outside the estate. The wording ensures trustees hold property for the benefit of designated beneficiaries. It clearly identifies the life insurance policy from which the proceeds are payable to the trust, expressly provides it is a life insurance declaration under the relevant insurance act, revokes previous beneficiary designations for the life insurance policy and indicates the life insurance trust is separate from other trusts established by the will.

2. Life insurance trust structured outside the will

The life insurance trust is set up in a trust document separate from the will before death, but the life insurance proceeds actually settle the trust after death. No assets are put into the trust before then. It's extremely important from a tax perspective that the trust arise as a result of death. This approach provides confidentiality.

The most common way to create a testamentary life insurance trust is through a will. However, for clients who frequently change their wills, it may be more appropriate to use a separate document. That's because revoking a will also revokes the life insurance declaration in that will. Clients who anticipate marrying in the future, such as single parents, may also be interested in setting up the life insurance declaration outside their wills. That way, they can avoid revoking the life insurance trust provisions if their wills are revoked when they marry.

3. Hybrid arrangement

The life insurance declaration is made outside the will, but the terms of the insurance trust are set out in the will. These terms are incorporated by reference in the declaration.

How a life insurance trust can help

Any life insurance policy lets you name a direct beneficiary to receive the proceeds in the event of death. However, in many cases, a life insurance trust may be better suited to the client's needs, for both tax and non-tax reasons. While there are some risks to this approach, in most cases they can be minimized through proper planning and drafting.

Of course, advisors need to consider whether the facts of the case justify this type of planning. For example, the client may not be concerned about avoiding probate fees on the life insurance proceeds. In this case, you should probably avoid the life insurance trust declaration strategy. Instead, you should probably favour designating the estate as beneficiary and funding a testamentary trust from estate assets.

If your clients are considering a life insurance trust, it's important you recommend they consult with a legal advisor experienced in estate planning to establish the plan properly.

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