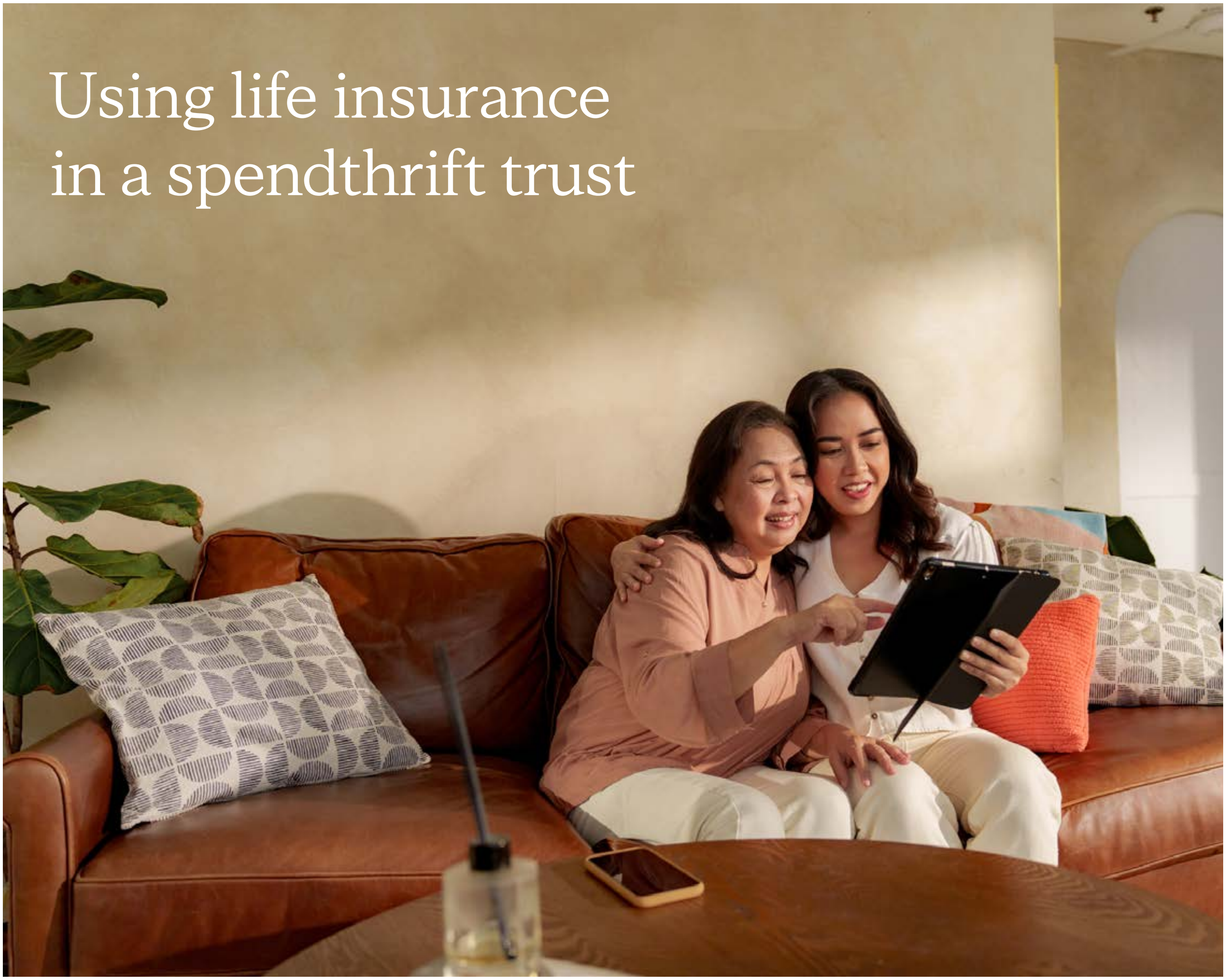

Using life insurance in a spendthrift trust

Who is a spendthrift trust established for, and why?

A spendthrift trust is designed for the benefit of individuals who are unable—or likely to be unable—to responsibly manage money on their own. These individuals are often referred to as "spendthrifts." They may be immature, impulsive, financially illiterate, battling addictions, vulnerable to exploitation, or simply unable to exercise sound judgment with wealth.

A spendthrift trust's primary purpose is protection. The trustee controls the distribution of trust assets and income to the spendthrift in order to protect those assets from the spendthrift mismanaging or dissipating them. By so doing, the trustee also protects the spendthrift from themselves and from others, including creditors, predatory lenders, and those who may attempt to exploit the spendthrift's lack of financial experience.

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Where does life insurance fit?

A parent or grandparent could be financially supporting the spendthrift, and may be concerned that without continuing income support, the spendthrift could become destitute after the parent's or grandparent's death. Life insurance provides a tax-free lump sum payment that the trustee can manage for the spendthrift's benefit. Additionally, a parent or grandparent may be concerned that measures they take for the spendthrift's benefit could result in an unequal distribution of their estate, to the detriment of their other beneficiaries. Life insurance benefits paid to the parent's or grandparent's other loved ones can help make an unequal distribution of their estate more equitable.

What is a spendthrift trust?

The settlor establishes a spendthrift trust – also known as an absolute discretion trust – for the benefit of a trust beneficiary who lacks financial discipline or experience. The trustee administers the trust and manages the assets according to the trust's terms. Those terms usually include strict provisions limiting the beneficiary's direct access to trust capital or income.

The settlor may establish such a trust during their lifetime as a standalone trust, or at death through a will. One essential feature of a spendthrift trust is the trustee's absolute discretion. The trustee has full authority to decide if, when, and how much of the trust's income or capital should be distributed to the beneficiary. The beneficiary has no say in the matter, and cannot compel any income or capital distributions.

Spendthrift trusts also contain another essential feature, the spendthrift clause. The spendthrift clause prohibits the beneficiary from assigning their interest in the trust to others in exchange for money or assets. This clause also prevents creditors of the beneficiary from accessing trust property or income before it is distributed.

Spendthrift trusts are typically irrevocable, meaning they cannot be altered or revoked once established. Importantly, they provide significant protection against claims from creditors, including lawsuits arising from personal liability such as motor vehicle accidents involving serious injury.

How does a spendthrift trust work?

A lawyer will carefully craft a spendthrift trust to minimize the beneficiary's control and maximize the trustee's. In some cases, the trustee may manage nearly all aspects of the beneficiary's financial life. For instance:

- The trustee may rent an apartment for the beneficiary to live in, pay the rent, home insurance, and utility bills, and own the furniture.
- The trustee may lease a vehicle in the trust's name, but for the spendthrift's use, and pay for the vehicle's insurance and maintenance.
- The trustee may apply for a debit or credit card for the spendthrift to use, but with strict spending limits. The trust will pay the monthly charges.

In less restrictive scenarios, the beneficiary may receive periodic allowances or lump-sum distributions, depending on milestones or behavioural achievements. For example, the trust document may stipulate that distributions occur after completing a post-secondary education, maintaining employment, or reaching a certain age. In such cases the settlor may be less concerned about the trust beneficiary being reckless and more concerned with the trust beneficiary acquiring financial judgment and experience as they grow older and receive more of their inheritance.

Some trusts include incentive provisions such as additional distributions for acquiring education or achieving milestones (like a specified amount of time free from addiction). However, courts will generally strike down conditions that are contrary to public policy, such as requirements to remain unmarried or to marry only individuals with certain ethnic, racial or religious characteristics.

Exceptions

While spendthrift trusts offer strong protection, there are notable exceptions:

- **Necessaries of life:** Creditors who supply essential needs (food, shelter, clothing) may still bring claims against the trust.
- **Pre-existing creditors:** Creditors with enforceable judgments that predate the trust may succeed against the trust with their claims.
- **Government claims:** The Canada Revenue Agency can pursue trust income or assets to collect unpaid taxes the spendthrift owes.
- **Support obligations:** Courts may allow claims for spousal or child support from trust assets.
- **Self-settled trusts:** A settlor generally cannot establish a spendthrift trust for their own benefit to avoid their own creditors.

Tax treatment of a spendthrift trust

Most trusts in Canada are taxed at the top federal/provincial marginal rate applicable to individuals. If the trust flows its income to its trust beneficiaries, that income can instead be taxed in the trust beneficiary's hands at their presumably lower marginal rate. However, this beneficial tax treatment usually does not apply to spendthrift trusts because the trustee will often retain the trust's income.

One exception is the graduated rate estate (GRE), which is a testamentary trust that is taxed at graduated rates during its first three years.

Appointment of trustee

Choosing the right trustee is one of the settlor's most important decisions. The trustee must have the judgment, integrity, and fortitude to say no when the trust's terms require it, even when the beneficiary is upset or manipulative. A family member may be too emotionally entangled. An independent professional, trust company, or corporate trustee is often preferable to a friend or close family member.

The trustee must also have the ability to manage finances prudently, follow tax rules, and maintain detailed records. The job is ongoing and demanding. Compensation is generally drawn from trust assets, adding to the importance of good trustee selection.

Advantages and disadvantages of a spendthrift trust

Advantages

- **Financial protection:** Keeps the spendthrift from squandering assets or falling prey to bad investments, fraud or manipulation.
- **Creditor shielding:** Helps prevent future creditors from accessing the trust's income or capital.
- **Maturity-based distributions:** Allows a young beneficiary to gradually acquire control over wealth as they gain experience.
- **Value reinforcement:** Can tie distributions to achievement of goals (education, employment, sobriety).
- **Conflict avoidance:** Places an independent person or institution between the settlor and the spendthrift, reducing family friction.
- **Asset protection for high-risk beneficiaries:** Even responsible beneficiaries in high-risk professions (e.g., doctors, business owners) can benefit from the trust's creditor protections.

Disadvantages

- **Cost:** There is a cost to having a lawyer draft the trust. Further, administrative costs can be high, particularly with institutional trustees.
- **Misunderstanding by settlor:** The settlor might use the trust to punish or control the beneficiary rather than to protect that person.
- **Unreasonable conditions:** Poorly drafted conditions could be oppressive or legally unenforceable.
- **Reduced flexibility:** Trust provisions can limit adaptability to changing circumstances.

How can life insurance serve the interests of the settlor and trust beneficiary?

Life insurance is a powerful tool for funding a spendthrift trust. The settlor can own a life insurance policy on their own life, and name the trust as beneficiary. When the settlor dies the tax-free death benefit provides a significant sum to the trust, which the trustee can then manage for the spendthrift's benefit.

Key advantages to using life insurance with a spendthrift trust:

- Immediate liquidity: Ensures the trust is well-funded upon the settlor's death, without delay or asset liquidation.
- Tax efficiency: Death benefits are not subject to income tax and can be structured to avoid probate tax in Ontario.
- Creditor protection: If the trust is named as an irrevocable beneficiary the death benefit may be protected from claims by the settlor's creditors.
- Predictable funding: A known death benefit can be tailored to meet the beneficiary's anticipated long-term needs.
- Simplified estate planning: Assets pass directly to the trust, bypassing the estate and avoiding potential disputes or probate delays.

When life insurance is used in this context, it creates a reliable financial foundation for the trust, even when other support systems—such as the settlor—are no longer available.

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