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THE TAX, WEALTH & INSURANCE PLANNING
GROUP AT SUN LIFE FINANCIAL

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Trusts owning insurance – Part II

Planning the smooth transition of policy ownership to a testamentary trust can save taxes and help clients achieve non-tax objectives.

A previous edition of Advisor Notes considered the use of an inter-vivos joint partner trust to own life insurance. This issue considers the use of a testamentary trust.

Case Study

Bob (age 65) is terminally ill with cancer. Furthermore, his wife Alice (also age 65) suffered a stroke a few years ago and is incapable of self-care. However, her general state of health is otherwise good and her life expectancy is not reduced. In addition to running his own company, BobCo, Bob has been Alice's primary caregiver. Bob has delegated most of the operation of BobCo to key professional managers, and expects that they will continue to work there after his estate becomes the owner. Still, the burdens of his own illness, caring for Alice, and having ultimate responsibility for BobCo are weighing heavily on him.

Bob owns a substantial Sun*Term* life insurance policy on himself, currently earmarked for charity. However, he worries that the charity he currently favours may lose its charitable status in the future, or be taken over by some level of government. He also owns a joint-last-to-die Sun *Universal*Life insurance policy on himself and Alice. That policy is intended to pay the capital gains taxes that will be due on the shares of BobCo when both he and Alice are gone.

Bob wants assurances that Alice will be properly cared for and have continued financial security. He also wants some flexibility in his estate plan to accommodate emergency requests for funds from his children if they need money (Bob has children from a previous marriage – he and Alice have no children of their own). Lastly, Bob wants to know that after Alice dies the proceeds from the sale of his BobCo shares and from the joint last-to-die life insurance policy will go to his children, and that any funds left over will go to charitable causes he would favour.

Fortunately, Bob's advisors can offer the comfort of some good solutions using a combination of testamentary trusts to look after various aspects of his estate plan.[1]

[1] See CRA Views 2006-0174041C6 – Rollover to trust on death, November 2, 2006.

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First trust to manage money for Alice's care and donations to Bob's charity

With the help of his legal advisors, Bob creates a trust that will come into effect at his death. The trust will receive the death benefit from the Sun*Term* life insurance policy Bob owns on his own life. Bob can renew or convert the term life insurance policy he owns to make sure that it remains in force until he dies. He will also need to change the beneficiary designation to name the trust as beneficiary.

After payment of the death benefit to the trust, the trust will manage the money to generate income for Alice's care during her lifetime. If Alice needs more money, the trustees are authorized to pay trust principal to her, also. Anything left in the trust when she dies will go to one or more charities named in the trust document. If none of the charities named in the trust document exist when Alice dies, the trustees are authorized to donate the remaining funds to the local Community Foundation to create a perpetual charitable fund in memory of Bob and Alice.

Two important concerns for Bob are that his charitable intentions remain private, and that his intentions be capable of withstanding an attack from disgruntled heirs (like his children). Bob's arrangement addresses both concerns. The life insurance policy is a private contract between Bob and Sun Life. Except for some very limited circumstances, a life insurance company has no authority to disclose the terms of a client's insurance policy with third parties. The trust is also a private document. It is not created through Bob's will, even though it comes into effect at his death, and therefore will not normally become a public document at Bob's death or be challenged through an attack on the validity of Bob's will. While it is possible to attack the validity of a trust, it is more difficult to do so when the trust stands alone, and not as a document created through a will.

Second trust – spousal trust for BobCo shares

Bob also writes his will to create a testamentary spousal trust. Like the trust referred to above, this trust will come into effect only at Bob's death. Unlike the trust referred to above, however, its language is found in Bob's will, and its existence depends on the validity of the will. It also differs from the trust referred to above in that it will be a *spousal* trust.

A spousal trust is created for the benefit of a surviving spouse, and is able to receive capital assets from the deceased spouse's estate without triggering capital gains tax liability. During the surviving spouse's lifetime, he or she must be solely entitled to any income the trust generates, and any distributions of trust principal. The twenty-one year deemed disposition rule will not apply during the surviving spouse's lifetime. However, when the surviving spouse dies, there will be a deemed disposition of all the capital assets the trust owns. Capital gains taxes will then be paid, and whatever remains in the trust could be distributed outright to the surviving trust beneficiaries, at which point the trust would terminate.

Bob writes his will to send his shares in BobCo to a testamentary spousal trust at his death, where the shares will be managed by his trustees for Alice's benefit during her life, then sold at her death. The after-tax proceeds of sale will go to Bob's children outright at Alice's death. Since BobCo is a successful company, and has been in existence for many years, its shares have considerable unrealized capital gains. By sending those shares to a spousal trust, Bob makes sure that the capital gains will not be realized during Alice's lifetime (except in so far as the trustees sell some or all of the shares during Alice's lifetime). He also makes sure that professionals will manage the company so that it stands a good chance of surviving after his death, and continues to provide income for Alice.

Although this second trust is created by Bob's will, and is therefore more vulnerable to an attack from Bob's children than the first trust, Bob's advisors believe that the risk of attack is low, given that Bob's heirs will ultimately receive the proceeds from the sale of the BobCo shares when Alice dies. The usual result of a successful challenge to a will is an intestacy, which will probably result in Alice getting a large part of Bob's estate anyway (it depends on the province Bob and Alice lived in when he dies – each province has its own intestate succession rules). However, if Bob's lawyers believed that there was a greater risk of attack, they could create the spousal trust independently of Bob's will.

Third trust – using a non-spousal trust to manage the joint last-to-die policy

Since Bob alone owns the joint-last-to-die policy on himself and Alice, ownership of that policy will pass to his estate when he dies. If he does nothing more, the will he has written will govern the maintenance and handling of the policy. To avoid the uncertainty that this would create, Bob instructs his lawyers to create a non-spousal trust in his will, to come into effect at Bob's death, to manage the joint last-to-die policy and collect the death benefit from it when Alice dies. The death benefit will be used to help offset the capital gains taxes due on the shares of the BobCo at Alice's death. Bob's children will be the trust beneficiaries, but will not have any entitlement to trust assets until Alice's death.

One unavoidable consequence of this part of the strategy is that this policy will be deemed to have been disposed of at Bob's death, triggering taxation of any policy gains. To minimize the tax consequences, Bob will make the minimum policy payments.

This trust will also be funded with assets from Bob's estate to ensure that the premium obligation can be satisfied. Ongoing premiums will continue to be payable after Bob's death until Alice dies, but these premiums can be increased to help make sure that the policy remains in force.

The reason for creating a non-spousal testamentary trust to own this policy (instead of simply having the spousal trust own it) is that Bob's tax advisors are concerned about holding an exempt life insurance policy in a spousal trust and paying the ongoing premiums out of trust income or capital. The potential problem is that income and capital from a spousal trust must be paid to or for the benefit of a spouse. Since the life insurance policy premiums will pay for a policy that will benefit Bob's children (by providing money that will help make up for them the value of BobCo lost to capital gains tax on Alice's death), Bob's tax advisor has his doubts that those premiums may be paid from spousal trust funds, since the Canada Revenue Agency (CRA) has indicated that the payment of the premium using trust capital or income can disqualify the trust as a spousal trust.[2]

This third trust is not subject to the restrictions of a spousal trust and can be an ideal trust to own and pay for the ongoing life insurance policy. When Alice dies, the trustees can pay the capital gains tax owing on the BobCo shares from the life insurance proceeds, and give the balance to Bob's children. Since Bob's children are the ultimate recipients of this money, this trust is less vulnerable to attack from them.

Advising clients

- Testamentary trusts can achieve powerful tax and non-tax objectives, including ongoing insurance ownership. Whether a trust is justified depends on how important the objectives are to the client and the complexity of the trust administration required.
- Clients can 'mix and match' insurance, testamentary, and inter-vivos trusts to meet their needs.
- Build relationships with will and trust experts to expand your professional network and enable you to meet sophisticated client needs with profitable solutions.
- If a trust company/professional trustee is required to protect the beneficiary or for a long term administration, there will be a minimum account size/minimum fee. The good news is that life insurance can be used to pay for the expert services required.

This article is intended to provide general information only. Every effort has been made to ensure the accuracy and currency of the information provided, but any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors, after considering the facts of the specific case.

[2] CRA Views 2006-0174041C6 – Rollover to trust on death, November 2, 2006.