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INSURANCE TRUSTS

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If a person already has life insurance in place, consideration should be given as to whether the proceeds may be structured in an insurance trust, to provide more advantageous ongoing results for the surviving family members.

An insurance trust is a trust funded by insurance proceeds. Instead of making a spouse or children the direct beneficiaries of an insurance policy, a person could instead direct these proceeds to a trust, which would list the spouse or children as the beneficiaries.

The *Insurance Act* in British Columbia permits an insured to appoint a trustee for a beneficiary, via a “declaration”. Such an “Insurance Declaration” is essentially a detailed insurance beneficiary designation, which can be utilized to create separate trusts to deal with the insurance proceeds.

Insurance Declarations provide the same benefits of insurance generally, such as avoiding the probate process for the funds (thereby saving expenses and fees), and offering privacy. In addition however, trusts created by Insurance Declarations will be seen as “testamentary trusts” (so long as the deceased was the sole owner and life insured of the policy). Testamentary trust planning provides the following benefits for the insurance proceeds:

1. asset protection, as these assets are not directly owned by any of the beneficiaries;
2. income splitting, as the income produced by these assets can be taxed separately and apart from the income and salaries of the beneficiaries, or allocated to the beneficiaries who earn less income, thereby resulting in less tax payable overall; and
3. control and flexibility, as the main beneficiaries (i.e. spouse or children) can be appointed as the trustees.

Consider the hypothetical Donald, who is married to Donna, and who has three infant children with Donna. Donald has a $500,000 life insurance policy. If Donald were to designate his spouse as the direct beneficiary, Donna would receive the funds free of income tax and probate fees upon Donald's death. However, the extra income earned every year from the proceeds would be added to Donna's income and increase her taxes, and the proceeds would be available to be executed upon by any of Donna's creditors.

Instead of designating Donna directly, Donald could utilize an Insurance Declaration and set up an insurance trust to receive the proceeds. These funds would still be received free of income tax and probate fees by the Insurance Trust, just as before. As well, since Donna would be the trustee, she would still have the same control as owning the funds outright. However, these funds would now be out or reach of any third party creditors of Donna, and so would always be available for Donna and the children. Furthermore, Donna and her children would all be current beneficiaries, to provide for more efficient splitting of income for tax purposes among the whole family class. Donna would be able to allocate the income generated by the proceeds at her discretion among the trust, herself, and her children, to achieve the best tax result possible every year. Finally, upon Donna's death, the insurance trust would provide for an alternate trustee, and the remaining funds would all flow to Donald's children, again avoiding Donna's estate and any probate fees at that time.

Still a further advantage can be seen for Donald, if we assume that, due to Donald's mortgage and other liabilities, Donald's net worth is negative. Donald wants to ensure that a specific value of funds ends up in a trust for Donna and his children. By using an insurance trust, Donald could now rest assured that the face value of his insurance would bypass his estate and any probate fees and creditors, and be placed intact in a trust for his family. There would be no surprise payments or liabilities that would reduce the available insurance proceeds. In such circumstances, an insurance trust could end up having more financial importance for Donald's family than his Will.

Insurance trusts are generally underutilized in estate planning, and offer very interesting opportunities. We recommend that their use be explored in estate planning.

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