

# Financial Advisor

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## Meeting complex needs through life insurance ownership within a joint partner trust

For complicated estate issues, a will may not be enough to carry out a person's wishes. These clients need something else, like a trust. With the proper language, a trust can own almost any kind of property, and a trustee can exercise the kind of judgment required to respond to almost any contingency, yet still do what the person who created the trust would have wanted.

In particular, trusts can own life insurance policies, manage a person's business, and, within limits, give property and income to anyone named in the trust document.

### Case study

Bob, age 67, is contending with several challenges. His second wife Alice, age 65, cannot care for herself since suffering a stroke a few years ago. She is physically disabled and mentally incompetent. Otherwise, she is in good health and likely to live for many years. Bob is growing exhausted looking after both Alice and his business, BobCo. To make matters worse, he was recently diagnosed with cancer and has been given only a few years to live.

Bob owns a \$1 million SunTerm life insurance policy on his own life, with XYZ Charity named as beneficiary. He also owns a \$1 million joint-last-to-die *SunUniversalLife* insurance policy on himself and Alice. The joint policy is intended to cover capital gains taxes on the sale of his business when he and Alice die.

Bob has three children from a previous marriage. However, for various reasons, none of his children are ready, able or willing to take on the responsibility of managing the business or caring for Alice.

Paid, full-time care for Alice seems to be the only option. Bob can afford the cost of Alice's care now, but worries about whether his estate will have enough money to pay for her care for an extended period of time if he dies before her. He wants to keep XYZ Charity as the beneficiary of the SunTerm life insurance policy, but worries that Alice may need the money from that policy to pay for her care. In addition, Bob is concerned that if Alice dies before he does, his children also may need the money.

As if Bob did not have enough to worry about, he recently heard that XYZ Charity may lose its charitable status or be taken over by the government. While he isn't too concerned about the charitable donation credit, he doesn't want his donation going to a non-charity – or to the government.

Bob's first thought is to name his children as beneficiaries to his SunTerm policy and let them decide if Alice needs the money if he dies before she does. If they decide that she does not need the money, they could keep it. On the other hand, if they decided that they did not need it, they could give the money to XYZ. If XYZ no longer existed at Bob's death, his children could donate the money to another charity with similar objectives. Bob is concerned that his children may keep the money – even if Alice needed it or if she predeceased Bob – and that they would not give any of the money to charity. Philanthropy is an important part of Bob's estate plan; however, he knows that it's a passion his children do not share.

Bob's lawyer says he could build in some donation flexibility in his will but Bob doesn't want details of his insurance proceeds open to public knowledge and subject to probate taxes and executor fees. He also suspects that his family might even try to challenge his charitable plans if he included those plans in his will.

Nor can Bob transfer insurance policy ownership to Alice since she's incapable of acting on his behalf. Only a policy owner can change beneficiaries. Even Bob's power of attorney for property can't adjust the beneficiary designation, and in any event, those powers will end with Bob's death.

Bob needs someone he can trust who will look after the financial needs of his wife and family, follow his wishes regarding his life insurance and estate, and take his dedication to charitable causes seriously.

## Creating and using a joint partner trust

Since Bob and Alice are both over 65, Bob's advisors recommend that he establish a joint partner trust (JP trust). Unlike the case with an ordinary inter-vivos trust, Bob can transfer all his stocks and bonds, and the shares of BobCo to the JP trust without triggering any tax consequences.<sup>1</sup> He can also transfer the life insurance policies to the trust, but will have to treat the transfer as a disposition of the policies taxable for the portion of the cash surrender value (CSV) that exceeds the policy adjusted cost basis (ACB). The trustees can then manage those assets for the joint lifetimes and joint benefit of Bob and Alice. Bob and Alice will be entitled to trust income for as long as they live. After that, the trustee can distribute the trust property to any person or institution Bob has chosen, or manage the property for their benefit.

One advantage to using the JP trust is that trust income distributed to Bob and Alice will be taxed at their marginal tax rates. If left in the trust, the income would be taxed at the top federal/provincial rates. Another advantage to a JP trust is that during Bob and Alice's lives, the 21-year deemed disposition rule that applies to other inter-vivos trusts will not apply to the JP trust until the survivor dies. After they die, however, and if the trust continues, the rule will apply. All trust property will be deemed to have been disposed of every 21 years, thereby generating potential capital gains tax consequences. Of course, the trustees can avoid this consequence if they have the power after Bob and Alice have died to simply distribute the trust assets and terminate the trust.

The trust lets Bob benefit from property ownership with the assurance that if he becomes unable to manage his property, someone he trusts will be able to do it for him. When he dies, the JP trust will function as a will substitute, managing or distributing the trust assets in a probate-free and confidential fashion. Bob can even be the original trustee. Naming backup trustees provides continuity when Bob dies or can no longer carry out the duties of trustee. An added benefit is that the trust distribution to charity on Alice's death will be much harder for unhappy heirs (like Bob's children) to challenge.

In spite of these advantages, several issues arise when establishing a JP trust for someone like Bob.

One difficulty lies in transferring shares of BobCo to the JP trust. When the trust ultimately sells the shares, it will not be able to use the \$750,000 capital gains exemption. The exemption is available only to individuals, not to trusts or corporations. Considering a nil ACB for the shares, one way around this problem is for Bob to rollover \$750,000 of his BobCo shares to a different class of share before transferring them to the trust. By electing to not roll the shares tax-free, Bob would trigger a \$750,000 capital gain, and could use his lifetime capital gains exemption to eliminate the tax liability. To the extent that Bob has recognized the capital gain on his shares the adjusted cost base (ACB) of those shares will rise. The shares could then be rolled over again, this time to the trust, along with the rest of his BobCo shares, with an increased ACB. By using the exemption now, Bob reduces the capital gains tax exposure the trustees face when Bob and Alice die and the BobCo shares are sold.

Bob's next problem is to make sure that XYZ Charity (or another deserving charity if XYZ has been deregistered, is not in existence or has been taken over by the government) gets the life insurance proceeds from Bob's SunTerm policy, assuming that neither Alice nor his children need the money. As mentioned above, one drawback is that Bob cannot transfer ownership of his life insurance policies to the trust without having to recognize taxable policy gains. For Bob's SunTerm policy, this is not a problem because the policy has no taxable gains. Further, the joint-last-to-die *SunUniversalLife* insurance policy has been minimum funded since issue, so it does not have large policy gains, either.

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<sup>1</sup> The term, "inter vivos" means "through life" and is the term that applies to trusts created during the person's lifetime, in contrast with the term "testamentary", which describes trusts that have been established through a person's will and which come into existence only after the person has died.

After the transfers are complete, the trust, as the new owner, can convert the term insurance to a permanent plan, and reconsider the funding level for both policies. Since Bob put in all the assets, he gets all the income from the trust anyway. The same benefit of income sheltering through exempt life insurance continues to apply inside the trust for Bob and Alice's lifetime.

Trust ownership of the policies can also allay Bob's concerns about managing the beneficiary designations on the policies. The trustees could name the trust as beneficiary to receive all the policy proceeds, and could then distribute them according to Bob's instructions in the trust document. This procedure is necessary to deal with any money intended for Alice's care because she is mentally incompetent, and could not be named as a beneficiary herself. Since the trustees will need to use the money for her benefit, it's best to name the trust as beneficiary for the proceeds.

If Alice did not need the money at Bob's death, or if she had predeceased Bob, the trustees could determine whether Bob's children needed the money (according to guidance Bob would have provided in the trust document). If Bob's children needed some or all of the funds, the trustees could distribute the money to them in whole or in part (with the balance to charity). The trustees could also choose to distribute all the money to XYZ Charity (or to a charity with similar aims if XYZ did not exist or was deregistered at the time of Bob's death). The trust rollover benefit will no longer exist if an income or capital distribution occurs to a third party before the death of the last surviving spouse.

A major advantage of the charitable donation is that it creates a tax credit the trust may use to offset some or all of the tax it owes from the sale of BobCo. The trustees will have some flexibility regarding when they sell BobCo and when they make their donation to XYZ Charity. The trustees will probably not want to sell BobCo until both Bob and Alice have died since they will want to use at least some of the income from BobCo to pay for Alice's care.

If Bob predeceases Alice, the trustees could retain the death benefit from the policy on Bob's life. When Alice dies, they could sell BobCo and make the donation. On the other hand, if Alice predeceases Bob, the trustees would receive the death benefit, sell BobCo, and make the charitable donation in the same year. Unlike the case with individuals, the trustees will not be able to use the tax credit to eliminate tax from the year prior to Bob's death.

In order for the trustees to receive a charitable income tax credit, the trust document must contain specific language authorizing the trustees to make a charitable donation. Bob's legal advisors must draft the trust document to make sure that the trust can get the tax credit if they want to use it to offset taxes that they may owe on the sale of BobCo shares and any other assets that will be sold when Bob dies.

## Advising clients

As the foregoing discussion about Bob's estate plans suggests, some clients may need a trust to ensure that their wishes are respected within the context of changing circumstances. No one could properly plan for all the contingencies that Bob's situation presents. In situations such as Bob's, the best recommendation may be to have someone handle it during the client's lifetime and after they have died.

Trust planning will become an increasingly important activity as the population ages. Trust ownership of insurance products is just a new application of a tried and true solution. The creation of a trust can even signal an opportunity to discuss additional insurance protection.

Joint-last-to-die insurance may be in place to pay a tax bill when both spouses are gone. Long-term care insurance is another product that is worth considering. But the unanticipated financial threat of supporting a vulnerable surviving spouse may require new single life coverage on healthy senior spouses.

The value of the assets required to justify a trust is largely based on how important the objectives are to the client and the complexity of the trust administration required.

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 and fee. The good news is that life insurance proceeds can be used to pay for any expert services required to enable the trust to perform properly.

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