Tax, Retirement & Estate Planning Services

WEALTH TRANSFER STRATEGY #4

Considering Insurance Trusts[1] and the annuity settlement option

It's important for you to have options when passing on savings to the next generation. If you desire a structured payment stream an annuity settlement option is available. If a structured payment stream is not the right fit you can consider using a trust as a means of transferring wealth to the next generation. Both options provide you with avenues to transfer wealth.

This brochure will look at each option and provide support material where applicable. It will also consider what option may fit best in a certain scenario.

[1] This Wealth Transfer Strategy applies to all provinces other than Quebec. Residents of Quebec should speak to their tax and legal advisor about using insurance trusts.

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ANNUITY SETTLEMENT OPTION

When certainty is important

The annuity settlement option provides a simple cost-free method of gradually transferring wealth through pre-scheduled income payments to beneficiaries after death. It provides an alternative to a lump-sum payment.

How is it done?

The annuity settlement option can automatically transfer the proceeds of an insurance contract or policy (including a guaranteed interest contract (GIC), segregated fund contract, or a life insurance policy) upon death, into an annuity. The resulting annuity will then make gradual income payments to your beneficiaries as specified by you.

The annuity settlement option replaces a lump sum death benefit with smaller, scheduled payments while providing probate fee savings, increased privacy and potential creditor protection. There are also other benefits, let's consider them.

Control

With the annuity settlement option, you choose the specific annuity terms. You can select an annuity that makes payments to your beneficiaries, following your death, for the rest of their lives or for a specific time period. Guarantee options can also be added to ensure a minimum number of payments are made.

Flexibility and simplicity

If you decide to change the beneficiaries or the terms of the annuity, a new annuity settlement option form can be done at no cost. It is that simple.

Where there are multiple beneficiaries the annuity settlement option allows you to differentiate between beneficiaries. Terms may be selected for payout that best meet the needs of your particular beneficiaries.

As an alternative to a trust

Where a structured payment stream with no conditions fits best with your planning objectives, this option may be a good choice. It also has some benefits over a trust. Trusts have costs associated with set-up and on-going maintenance. If changes need to be made in the future, there are fees to amend or re-draft a trust agreement or will. This is not the case with the annuity settlement option.

TRUSTS

It's important to have the right information when it comes to ensuring a beneficiary designation is done correctly. This is especially true when a trust is named as a beneficiary. Unlike other investments, annuity products including segregated fund contracts and registered funds allow for a beneficiary designation to be made.

Beneficiary designations can be complicated and naming a trust can add to that complexity. That is why it is important to have the right information to assist you when making a designation using a trust.

It is always recommended that a formal trust be created to help ensure that the intention of the person settling the trust is clear and that the funds ultimately reach the hands of the intended beneficiary.

A trust may be a good alternative when you want certain conditions met before a beneficiary can receive death benefit proceeds and where a structured payment stream is not the right fit.

A trust may work better than the annuity settlement option in certain situations. For instance, you may wish to have a payment stream delayed and trust provisions will allow the trustee the ability to do just that.

As an alternative to the annuity settlement option, a trust may be preferred for tax planning reasons (as discussed below) or to control when and how payments will be made to a beneficiary.

The most common use for a trust is often to benefit a minor. Death benefit proceeds cannot be paid directly to a minor and would therefore have to be paid into court or to the Public Guardian and Trustee depending on the jurisdiction. To avoid this from happening, the death benefit proceeds from the contract are received by the trustee for the benefit of the minor and the terms of the trust will permit the trustee to make payments out of the trust that will benefit the child.

A trust is also useful in other situations too. Let's consider a few examples.

Control distribution

When a child turns age 18, and no formal trust provisions exist, that child can request that payment of the entire death benefit proceeds be paid out entirely to him or her. This may not however be a desired outcome. A trust can be created to address this issue by providing appropriate distributions from the trust that may better meet that child's needs and maturity level.

Trust provisions can also address what funds can be used for and how they may benefit the beneficiary. For instance, funds out of the trust can be used to meet financial needs for education.

A trust may also be appropriate where a beneficiary is a spendthrift or unable to manage their own financial affairs. Where a trustee is given discretionary power over distribution payments from the trust to the beneficiary, payments can be timed in such a way so that the beneficiary receives the money when they actually need it. Timed payments can also be done so that funds do not end up in the hands of creditors of the beneficiary or become part of a matrimonial dispute.

In a second marriage situation a trust is one way to help ensure that family members from a first marriage are taken care of while still ensuring a new spouse is also considered.

Family members of beneficiaries who are disabled and receiving government benefits want to ensure that those benefits remain intact. This may be accomplished by using a discretionary trust.

Tax reasons

When a trust is named as beneficiary, the trust can be a testamentary trust. This means that the trust arises as a result of the death of the individual who settled the trust (the settlor). Testamentary trusts are now taxed at top personal tax rates and not graduated tax rates. For disabled beneficiaries, a Qualified Disability Trust (QDT) can be used because it still enjoys the graduated rates. The QDT is treated as a testamentary trust and will be taxed at the graduated rates on income in the trust.[2] To be considered testamentary, the trust cannot be settled with any property during the lifetime of the settlor. The trust can be created before death but it does not arise until the death of the settlor occurs and the death benefit proceeds from the contract are settled in the trust.

Income splitting may also be possible by using a trust where family members are named as beneficiaries. While income splitting may be somewhat limited from a tax perspective it still can be used in the overall planning of the individual. Income may be distributed out over a period of time where the intended beneficiary is in a lower tax bracket.

COMPARING THE OPTIONS

The chart below looks at some of the comparisons between an annuity settlement option and a trust and indicates where the fit might be better.

Scenario	Annuity settlement option	Trust
Payment to a minor		X
Payments to a disabled beneficiary		X
Conditions and control		X
Simple	X	
Cost efficient	X	
Gradual payment of death benefit over time	X	X
Income splitting/tax reasons		X

TRUST AS A SUCCESSOR OWNER

A trust can also be named as a successor owner of the contract. This ensures the contract does not become ownerless on the death of the owner in a situation, for example, where the owner is not the annuitant or there is a successor annuitant or Joint Life. It may be desirable to have the income stream continue for instance under a RetirementPlus contract but to have the contract controlled pursuant to the terms of the trust.

[2] There are certain requirements that must be met to qualify as a QDT. These include the trust being testamentary, resident in Canada and the beneficiary must be eligible for the disability tax credit. Where the trust no longer qualifies as a QDT a claw back tax is imposed.

WHERE TO GO FROM HERE

Now you know where to consider a trust and where the annuity settlement option may also provide an alternative solution. Additional tips can be found below. If you are interested in how an insurance trust may be implemented see the *Advisors Guide to Insurance Trusts*, available on Repsource.

TIPS

- Conduct an annual review of existing designations and declarations to ensure they reflect your intentions
- Review all designations and declarations when life changing events occur e.g. birth, death, marriage, separation
- Work with your professionals to ensure designations are up-to-date and reflect your current situation
- Where a minor is involved use the box available in the appropriate form that makes reference to a trustee for a minor instead of creating a designation that refers to a minor on the form in the primary or secondary beneficiary designation space.

To find out more about this innovative solution,
speak to your advisor or visit manulife.ca/investments

MK2145E 09/17