

Help your client plan for a spendthrift beneficiary

Ling, a middle-aged widow has a big concern. Her daughter Kai has consistently demonstrated bad money management. As Ling puts it, “Kai can’t keep a nickel in her pocket. She spends her money faster than she makes it”. For years Ling believed that Kai would learn to manage her money as she matured, but now with Kai in her mid-thirties she is worried that Kai’s spendthrift ways are going to haunt her for the rest of her life.

Ling wants to make sure that the money she leaves Kai after her death is protected because, as Ling puts it, “Kai is definitely going to need any inheritance I leave to support her in retirement.” Thinking about how to protect Kai is all consuming for Ling as Kai is her only child and the most important person in her life.

For Ling, and thousands of other Canadians with similar concerns there are several options available; the most common being creating a trust for the spendthrift beneficiary or by buying an annuity with Kai’s share of the inheritance, either by directing her executor to do so.

The annuity option

An annuity is an insurance product that can provide a fixed sum of money typically paid on a monthly or yearly basis. Including a direction in her Will that Kai’s share of any inheritance is to be used to purchase an annuity will ensure Kai has a steady stream of income. Typically, a direction to purchase an annuity is used in more modest estate plans where the cost of a trust would be prohibitive. It is also possible to invest in a segregated fund with an annuity option for Kai after Ling’s death.

Should Ling decide to protect Kai through an annuity she should seek professional advice from both an estate planning lawyer and an annuity specialist. The use of annuities to protect a beneficiary can be complex and should be fully researched before proceeding. The option that is right may depend on a range of factors including the size of the inheritance and the residency of the beneficiary.

The trust option

The other option Ling might consider is creating a trust to protect Kai as part of her estate plan. Trusts allow Canadians to ensure the needs of specific family members, such as disabled beneficiaries, minor

children, spouses and spendthrift beneficiaries are protected. Before deciding if a trust is the right tool to protect Kai, Ling should consider several factors including the choice of trustee. Choosing a family member might have a detrimental effect on Kai’s relationship with the family, and may make it difficult for the trustee to make prudent decisions regarding Kai’s access to the funds of the trust.

Often overlooked, but an important factor for Ling to consider are the investment clauses which should be placed in the will. These clauses are often seen as common precedents but they are extremely important as they will form the road map to how the funds in the trust may be invested. Some clauses to consider are:

(i) Employment of an investment advisor

The trustee acts of the various provinces allow a trustee to retain an investment advisor on a discretionary basis. Ling may wish to consider including a clause telling the trustee the identity of the investment advisor she hopes the trustee will retain. Although the trustee is not bound to follow Ling’s choice it is good guidance for the trustee and is the best way for Ling to ensure her management team who helped her while she was alive is available to Kai. The clause will also ensure the fees charged by the investment advisor are authorized as expenses of the trust.

(ii) A “Haslam” Clause

Often an investment advisor will want to use mutual funds as one of their investment tools. In a trust, mutual funds ensure professional management and diversification. However, there is a question as to whether an investment advisor retained by a trustee can use mutual funds unless a clause specifically provides the investment advisor the ability to do so. *Haslam v. Haslam*, a 1994 Ontario decision held that while mutual funds are now an authorized investment, if an investment advisor, to whom decision-making has been delegated, invests in a mutual fund it is sub-delegation and not authorized.

To remove any uncertainty and ensure mutual funds are available for the trusts a Haslam clause specifically authorizing their use is something Ling should consider.

(iii) Definition of income

Typically, a trust has two different beneficiaries, a life tenant and a residual beneficiary. The life-tenant, is usually entitled to the “net income” earned by the trust whereas the capital beneficiary is entitled to the residue remaining in the trust when the trust is terminated. A trust may also be drafted to permit the life-tenant access to the capital of the trust should the testator decide to do so.

Trust law defines income differently than does the Income Tax Act. For instance, in a trust, a cash dividend (including a capital dividend) is income whereas a stock dividend or proceeds from a share redemption is capital. However, for income tax purposes, all dividends (other than capital dividends) are included in income.

Depending on the investment tools used the divergent definitions of income can lead to investment confusion and administrative burden.

Ling should consider whether she wants to include a term redefining income to comply with tax and investment law as opposed to trust law.

(iv) Ability to encroach on the capital

One of the matters Ling must decide is whether Kai, as the life tenant will have any ability to access the capital of the trust, and if so on what basis. Ling might not wish Kai to have any access to the capital. On the other hand, if Ling wants Kai to have access she must decide how liberally or conservatively she will allow access.

Even if Ling chooses not to allow Kai to access the capital, from an investment perspective Ling should discuss with her investment advisor the types of investment tools he or she might use when investing on behalf of the trust. For instance, if the investment advisor wishes to utilize mutual funds, those funds might have a return or capital component where a small portion of capital is distributed as income. If so, Ling may wish to address this in her Will so the return of capital component can be paid to Kai, as opposed to being re-capitalized.

(v) Even handed rule

One of the fundamental rules of trust law is that the trustee must consider the needs of both the life tenant and residual beneficiary when making decisions. However, in Ling’s case her primary goal is to provide for Kai. Ling should consider including a clause stating that the trustee is not bound by the even hand rule to ensure that in investing the funds of the trust and in administering the trust Kai is the primary concern.

Ling has a lot to consider. Once she has decided whether an annuity or trust is the right solution for her she should speak with her investment and legal professionals to ensure the right terms are in her Will to protect Kai in the future.

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