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From my perspective ...

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Thinking through the decision to purchase joint-last-to-die policies.

Joint last-to-die ("JLTD") policies on two spouses or partners are not for everyone. In fact, JLTD policies may not be appropriate in many cases.

Why do people think a JLTD policy is the correct choice?

From a numbers perspective: The rate of return on the death benefit and cash value of a permanent JLTD policy is usually better than on a single life policy on either insured life.

From a practical perspective: The life insurance proceeds are assumed to be required at the second death. When the surviving spouse dies, the funds can help pay the ultimate tax liability on accrued capital gains and RRSP/RRIF balances1, and fund bequests to heirs. However, if funds are required at the first death, a JLTD policy may not meet the client's objectives and may subject them to significant financial risks.

In what situations would liquidity be needed at the first death?

Examples of when life insurance proceeds are usually required at the first death include:

Situation	Considerations
Succession of a family business to a child/children when the business owner dies	• When the business owner dies, significant money may be needed to: ◦ pay taxes on the business being transferred, ◦ keep the business running, and/or ◦ provide funds to the surviving spouse and children who are not inheriting the business.
Surviving spouse is not the parent of the deceased's children	• Life insurance proceeds can either fund the bequest to the deceased spouse's children or pay tax on the assets being gifted to the children, as well as provide for the surviving spouse.
Intend to use the policy as collateral for a loan from a third-party lender	• A lender may not provide a loan secured by a JLTD policy since life insurance proceeds are not available at the first death to repay the loan. • If a loan is provided, it is often a demand loan which means the lender may demand repayment when the first spouse dies even though there are no life insurance proceeds to repay the loan. • If there are no liquid assets to repay the loan, the policy may need to be surrendered. There may be tax consequences to do so.
Policy owner is not a US citizen, but the spouse is a US citizen	• A single life policy owned by the non-US citizen spouse may avoid various US tax issues (estate and income tax) when the owner's spouse and children are US citizens. • With a JLTD policy, if the non-US citizen spouse owns the policy and dies before the US citizen spouse, there may be US tax implications to the new owner of the policy

[1] The spousal rollover of registered assets and assets with accrued capital gains means that if assets are left to the surviving spouse or partner (or a qualifying spousal trust for assets with accrued capital gains), the tax is deferred until the earlier of the assets being sold (or distributed in the case of an RRSP or RRIF) or the death of the surviving spouse.

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What happens when a spouse/partner becomes an ex-spouse/partner?

According to Statistics Canada, 37.9% and 41.3% of marriages end in divorce before their 30th and 50th wedding anniversary, respectively.[2]

The most overlooked and underestimated concern with a JLTD policy are the financial complications that arise if the spouses are no longer together at the time of the first death.

- **When the first life dies** there may be a significant need for cash to cover the financial obligations of the deceased spouse including taxes on assets, as well as bequests to heirs and dependents (including a new spouse). A JLTD policy does not provide this liquidity if the ex-spouse is still alive.
- **If the policy owner dies before the surviving ex-spouse** (or is a shareholder of a corporation that owns the policy when the shareholder dies), there may be significant tax consequences.

What are the tax consequences with a JLTD policy when the owner / shareholder dies before the surviving ex-spouse?

Although most advisors recognize the need for life insurance proceeds when the first spouse dies, especially when the spouses are no longer together, many fail to address with their clients the tax consequences associated with a JLTD policy when the other life insured under the policy (the ex-spouse) is still alive. This applies to JLTD polices that are owned personally or owned by the deceased's corporation.

Personally owned JLTD policy at death

If the spouse who owns the JLTD policy dies before the other life insured under the policy (the ex-spouse), since the policy is still in existence and proceeds are not received, the JLTD policy is disposed of at death by the spouse who owned the policy. Unless the owner's current spouse/partner is the successor owner, under the Income Tax Act (Canada), the policy is deemed disposed of at its cash surrender value ("CSV").

If the policy is not transferred to the current spouse/partner as successor owner, and the policy goes into the deceased's estate or directly to the deceased's children (or the ex-spouse), the policy is deemed to be sold at its CSV. To the extent the CSV exceeds the policy's adjusted cost basis, the deceased policy owner is taxed on the policy gain.

Example: CSV of $1 million on a personally owned JLTD policy on an insured and an ex-spouse

- If the policy owner bequests to their children a JLTD policy with a CSV of $1 million that has no adjusted cost basis, the deceased is deemed to realize a policy gain of $1 million.
- At the highest marginal tax rate of 50%, the deceased policy owner will be subject to tax of $500,000 on the policy gain on the policy. This will need to be paid from assets in the deceased's estate.

[2] Statistics Canada. Table 39-10-0029-01 30- and 50-year total divorce rates per 1,000 marriages, DOI: https://doi.org/10.25318/3910002901-eng

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Death of the shareholder of a corporately owned JLTD policy

Although the JLTD policy is not transferred at the death of an insured life who owns shares of the corporation, the value of the corporation immediately before death, for the purposes of calculating the value of the deceased's shares, includes the CSV of the JLTD policy. This means that:

- If the shareholder dies before the other life insured under the policy (the ex-spouse) and owns 100% of the corporation, and
- The shareholder does not leave the shares to a current spouse/partner (or a qualifying spousal trust), then.
- The value of the deceased's shares will include the CSV of the JLTD policy when calculating the capital gain on the shares.

Example: CSV of $1 million on a corporately owned JLTD policy on an insured shareholder and an ex-spouse

- The deceased shareholder owns 100% of the shares of the corporation that owns the JLTD policy.
- Assuming the shareholder dies before the other life insured under the policy (the ex-spouse) and does not leave the shares to a current spouse/partner, the deceased shareholder's capital gain on the shares will include the $1 million CSV, increasing the taxes on death on the shares by approximately $250,000.
- Because life insurance proceeds are not paid to the corporation at the first death, there will be no addition to the corporation's capital dividend account at that time.
- As a result, planning after death (also known as post-mortem planning) cannot be used to reduce or eliminate the tax liability associated with the inclusion of the $1 million CSV in the value of the deceased's shares. This will result in the capital gains tax on the CSV.

Can planning reduce these tax risks?

Planning can reduce these tax risks, but it should be implemented before or shortly after the JLTD policy is acquired.

- With a personally owned JLTD policy, a properly drafted and set-up family trust may be the solution.
- With a corporate-owned JLTD policy, a share reorganization, the creation of additional classes of shares, and a proper ownership structure is often recommended.

The cost and complexity of this type of planning often prevents clients from implementing these solutions. Even with these tax planning solutions in place, clients could still face significant financial risk if life insurance proceeds are required at the first death.

Concluding comments on JLTD policies

There are cases where JLTD policies make sense. However, there are many more cases where the actual risks associated with JLTD policies have not been considered. A thorough assessment of the risks would result in

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fewer JLTD policies and more single life policies being recommended to meet the life insurance needs of spouses/partners.

It is important that advisors fully explain the risks and quantify the actual amounts at stake to their clients. If a client decides to proceed with a JLTD policy, advisors should document conversations indicating that their clients understand the risks of a JLTD policy.

About Bryan McNulty

Bryan McNulty is a tax and estate lawyer with more than 20 years of experience. Prior to joining Equitable Life®, Bryan's experience included working at a major accounting firm, a law firm, and a major life insurance company. His expertise is tax and estate planning for high-net-worth clients and business owners. Bryan is available to meet with advisors and their clients on large cases.

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