Keeping Estate Assets Out of the Hands of a Beneficiary's Creditors:

The Power of Discretionary Trusts – Part 1

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September 2022

Ideally, the estate planning process will enable clients to personally benefit the people most important to them by providing the intended beneficiaries with bequests once the client passes away. However, if a beneficiary is bankrupt when the client's gift comes to fruition, the bequest may not achieve the desired effect, leading to the question of how we may be able to assist our clients in planning around this scenario.

It is well-established in law that an inheritance received by a bankrupt beneficiary will fall into the pool of property available to satisfy the beneficiary's creditors: see *Watson Estate, Re*, 1927 CarswellOnt 28, [1927] 4 DLR 626, 61 OLR 173 (Ont SC). Technically speaking, under subsection 99(1) of the *Bankruptcy and Insolvency Act*, RSA 1985, c. B-3 [the "*BIA"*], any bequest given directly to a beneficiary who is bankrupt and has not yet been discharged from bankruptcy will become "after-acquired property", meaning that it becomes available to the trustee in bankruptcy to apply against the person's liabilities. Moreover, a bankrupt beneficiary may not handle an inheritance received prior to being discharged from bankruptcy, since section 71 of the *BIA* stipulates that the ability to dispose of the bankrupt's property, and otherwise deal with that person's property, passes to and vests in that individual's trustee under the *BIA*.

Despite the foregoing, it is possible to prevent a bequest from falling into the hands of a beneficiary's creditors through careful estate planning. The safest instrument to use to ensure that a client's estate goes directly to the chosen beneficiaries is a discretionary trust.

Using Discretionary Trusts

Typically, discretionary trusts are associated with controlling bequests left by a testator to disabled beneficiaries. However, discretionary trusts can also be useful for protecting bequests left to "spendthrift" beneficiaries. To keep a bequest from being used to satisfy a beneficiary's creditors, a discretionary trust ought to have at least two elements:

1) The beneficiary should only be given a <u>potential</u> life interest in the trust property; and

2) That potential life interest ought to be subject to the absolute discretion of the trustee.

With respect to the first element, a beneficiary only ought to receive a potential life interest in either the income generated by the trust property or the property itself to ensure that the bequest is not "available" to satisfy the beneficiary's debts in bankruptcy. At most, the beneficiary should only have a hope of acquiring a benefit under the trust until the trustee actually exercises their discretion to distribute to the beneficiary. If the beneficiary is found to have either a vested or contingent interest in the bequest, either at the present time or in the future, that bequest may satisfy the definition of property subject to the *BIA* under section 2. A life interest also ought to be provided to ensure that the trust does not lapse.[1]

The second element, making the potential life interest completely subject to the discretion of the trustee, again ensures that the beneficiary does not have a tangible property interest in either the trust property or related income and can prevent the beneficiary's discharge from bankruptcy being made conditional on payment of any funds from the trust.

For clients who want a discretionary trust clause to have more of a protective element by, for example, requiring the trustee to ensure that the potential beneficiary is not reckless with money, or to redirect the trust property if the beneficiary goes bankrupt, the will-drafter ought to take care to ensure that the trust does not run afoul of the anti-deprivation rule, which we will review in next month's Solicitor's Tip.

[1] This point is made by Frank Bennett in a 2009 article, "The Effects of Bankruptcy on Estate Planning," 61 C.B.R. (5th) 163. See heading 2. Wills, (e) Spendthrift Trusts.