CIBC Wood Gundy

Trusts – An Introduction

Trusts can be highly effective wealth management vehicles, especially for income splitting, tax and estate planning purposes and wealth protection. A trust is an arrangement whereby a settlor transfers ownership of property to a trustee with instructions as to how the property should be managed for the benefit of beneficiaries. With a trust you can legally transfer ownership out of your own hands. However, you can still direct how trust assets are to be managed and distributed by clearly setting this out in the terms and conditions of your trust agreement.

In order for a trust to be created, the settlor must intend to create a trust, existing identifiable assets must be transferred to the trust and the beneficiaries must be readily determinable.

While reviewing this information, keep in mind that this general trust summary is only applicable to taxable personal trusts resident in Canada (although rules and applicability may differ in Quebec) and does not cover any laws or issues relevant to business planning, registered trusts or other trusts such as mutual fund trusts, foreign trusts or "untainted pre June 18, 1971" inter-vivos trusts. Also, the residence of the majority of controlling trustees generally determines the residence of the trust.

TYPES OF TRUSTS

There are two common types of trusts: inter-vivos ("living trusts") and testamentary trusts. An inter-vivos trust is set up during your lifetime and takes effect during your lifetime. A testamentary trust is generally set up in your Will and only arises as a consequence of your death. With inter-vivos trusts, taxes play a critical role. There may be immediate tax consequences when the trust is set up, income retained in the trust is generally taxed at the top individual tax rate and living trusts are subject to the government's income attribution rules (see below). Despite any potential limitations from a tax perspective, inter-vivos trusts may still be worth considering for reasons other than tax.

On the other hand, a testamentary trust only takes effect as a consequence of death, which means the assets belong to you during your lifetime and you do not have to relinquish control of your assets. A testamentary trust can be a powerful and flexible tax-planning tool allowing you to achieve family income splitting and long-term tax savings. A testamentary trust is taxed more favourably than an inter-vivos trust, because income retained in the trust is taxed at the same graduated rates that apply to individuals. It is also important to remember that the government's income attribution rules do not apply after death.

It should be noted that an inter-vivos trust cannot become a testamentary trust on the death of the settlor, but a testamentary trust, if "tainted," can become an inter-vivos trust.

THE ATTRIBUTION RULES

Before outlining possible trust strategies, it is important to understand the tax provisions that may apply when assets are transferred to other family members (or to a trust for the benefit of a family member). Assets are often transferred primarily for the purpose of income splitting. This is a strategy to achieve tax savings by shifting income to family members in a lower tax bracket. Unfortunately, the government has developed various attribution rules to limit this practice.

A Brief Summary Of Some Attribution Rules:

- If you transfer assets to your spouse or child under age 18, subsequent income earned on the assets is to be attributed back to you for tax purposes.
- Capital gains or losses realized by your spouse on the subsequent sale of transferred property are attributed back to you for tax purposes (unless transferred at fair market value).

The attribution rules continue to apply when assets are transferred to an inter-vivos trust for the benefit of a spouse or child under age 18. In other words, income paid out or designated by the trust to beneficiaries to be taxed in their hands, will be subject to the attribution rules.

It is also important to realize that if you transfer appreciating assets (such as stocks and bonds), either to a child or to a trust, the government deems that you have sold the assets at fair market value at the time of the transfer, so there may be a capital gain or loss for you to declare on your tax return.

There are some exceptions to the attribution rules, including:

- Capital gains realized by a child on the subsequent sale of transferred property
- Second-generation income, i.e., income earned on attributed income
- Outright gifts (not loans) to children over age 18
- Bona fide sale of property at fair market value

Also, the attribution rules do not apply after your death and relatives who are not resident in Canada are not subject to attribution on loans or gifts to family in Canada. If a trust is revocable (e.g., the settler can reclaim the assets or can change the beneficiaries), then all income and capital gains will be attributed back to the settlor. A trust may become revocable if the settlor appoints himself or herself as trustee or otherwise controls the trustee(s). (Appointing multiple trustees such that non-controlled trustees form the majority along with a majority rule clause may be a possible solution).

SOME EFFECTIVE USES OF INTER VIVOS TRUSTS

- Provide support for any dependants
- Provide support for infirm dependant without compromising government benefits
- Provide for any obligations, e.g., on divorce
- If applicable, prevent inclusion of assets under Family Law Act in the event of a beneficiary's marital breakdown
- Provide creditor protection in certain circumstances
- Provide centralized control of investment or business interests
- Estate freeze with a family business (create retirement income while passing future capital gains to next generation).
- Minimize disputes among heirs as a Will is more likely to be contested (e.g., claiming that the testator lacked mental capacity to draft the Will or undue influence on the testator).
- To avoid probate costs (cost/benefit analysis needed; probate may not be applicable in Quebec)
- Ensure confidentiality as trust agreement is a private document whereas a Will is a public document after probate

TAX PLANNING WITH TESTAMENTARY TRUSTS

If you have substantial capital to leave to your children at death, it may be appropriate for you to distribute it to them outright, however, this may mean that they will be missing out on a major tax-planning opportunity. For instance, if you have adult children in a high tax bracket and you leave them substantial capital in an outright distribution through your Will, any income they earn on that capital will be taxed at their high tax rate. If, on the other hand, you direct the capital to testamentary trusts for them and their children, any future income can be designated to them, or to their children, or to the trusts, at each of their respective tax rates. This strategy may be particularly attractive to adult children who wish to fund their own children's school, camp, hobby and other expenses in a tax-efficient manner.

Testamentary trusts can also serve as appropriate vehicles if you wish to have assets managed for minor children or other dependants. A testamentary trust can provide for education funding, especially if there are significant age differences among children. For example, if you have already paid university expenses for older children, and there are younger children who have not yet had the chance to enjoy the same benefit, an unfair situation could arise. That is, if you passed away before the younger children reached university age, they would have to use some of their inheritance to fund their education. A testamentary education trust could be designed to effectively equalize the situation.

You might also consider a testamentary trust if you wish to provide lifetime income for your spouse after your death but maintain capital for other beneficiaries at your spouse's death. It should be noted, however, that provincial family-law legislation may allow your spouse to overturn this type of arrangement. For instance, in Ontario, your spouse has up to six months after your death to choose to receive an equalization payment under the Family Law Act rather than accept the terms of your Will.

If you have a spouse and three children, you could actually establish four testamentary trusts, one for each child and one for your spouse. Each child's trust could include that child's children as potential beneficiaries. Income distributed to beneficiaries could be taxed at their respective tax rates, or, if the appropriate designation is made, the income could be taxed in the trust as if it were an individual. (Multiple trusts of a common settlor for common beneficiaries will be combined for tax purposes.) Professional advice and guidance is mandatory because of the complexity and changeability of our tax laws, and the care required in properly drafting these trusts into your Will.

Other Uses Of Testamentary Trusts

- Provide support for any dependants
- Provide support for infirm dependant without compromising government benefits.
- Provide for any obligations
- If applicable, prevent inclusion of assets under Family Law Act in the event of a beneficiary's marital breakdown
- Provide creditor protection in certain circumstances
- Provide centralized control of investment or business interests

QUALIFYING SPOUSAL TRUSTS

A qualifying spousal trust can be an inter-vivos trust or a testamentary trust. In order to qualify as a spousal trust, the settlor must be a Canadian resident for an inter-vivos trust; and the testator must be a resident of Canada immediately before death for a testamentary trust created by Will. During the beneficiary spouse's lifetime, he or she must be entitled to receive all of the income, and no one else may be entitled to any portion of the capital. Also, the settlor can transfer eligible assets to the trust without immediate tax consequences (i.e. the transfer can be on a tax-deferred basis at the settlor's adjusted cost base). The settlor can elect to recognize capital gains on selected assets if this provides a tax advantage, for example, to utilize a capital loss carry forward. However, on the death of the beneficiary spouse, there will be a deemed disposition of trust assets at fair market value with all the attendant tax consequences (taxable in the trust only). Subsequent deemed dispositions occur every 21 years thereafter under the rules for non-qualifying trusts.

If before the death of the beneficiary spouse, an asset is transferred to a beneficiary other than the spouse, the trust may become a tainted spousal trust and acquire the asset at fair market value.

As mentioned above, professional legal advice will be required to properly analyze the impact of provincial family-law legislation on individual situations.

ALTER EGO AND JOINT PARTNER TRUST

Both the alter ego and joint partner trust are inter-vivos trusts created on or after January 1, 2000 and the settlor(s) must be at least 65 years old. Until the death of the settlor of an alter ego trust or the settlors of a joint partner trust, only the settlor or the settlors are entitled to receive income and capital of the trust. Like the spousal trust, the settlor(s) can transfer capital property into an alter ego or joint partner trust on a tax-deferred basis. In case of an alter ego trust, there will be deemed disposition of trust property at fair market value upon death of the settlor. In the case a joint partner trust, deemed disposition occurs upon death of the latter of the settlor and the settlor's spouse. The settlor can elect out of the tax-free rollover treatment and realize capital gains/losses upon transfer of property into the trust. The 21-year deemed disposition rule is not applicable until after the death of the settlor of an alter ego trust or both settlors of a joint partner trust.

Alter ego trust and joint partner trust have the following advantages:

- Minimize or eliminate probate
- Alternative to Will and Power of Attorney
- Avoid challenges of provisions of Will
- Creditor protection

TAX CREDITS

Generally, a trust is treated as an individual for tax purposes but is not allowed to claim any personal tax credits (with the exception of the dividend tax credit which is available to a trust).

PAYMENTS TO BENEFICIARIES

A trust is subject to tax on any taxable income (including capital gains) although it is allowed to pay income out to beneficiaries (if trust agreement permits). Any income paid out or designated as taxable to a beneficiary is deductible from the trust's income subject to eligibility, e.g., interest or dividend income to income beneficiaries and realized capital gains to capital beneficiaries. The income would then be taxable in the hands of the beneficiary. The trust also has the option of having the income taxable in the trust even though it is paid out to a beneficiary. This may provide a tax advantage if the trust's tax rate is lower than that of the beneficiary or to allow the trust to utilize a capital loss (in most cases, capital losses cannot be flowed through to beneficiaries as they are losses of the trust).

Also:

- Generally, a distribution from a trust resident in Canada to a Canadian resident retains its nature, e.g., Canadian dividends remain Canadian dividends, capital gains remain capital gains, etc.
- A trust can be discretionary (the trustees decide when income should be paid and to whom) or non-discretionary (the trust agreement outlines for the trustees when income should be paid and to whom).

EXPENSES

Expenses incurred by a trust are deductible only by the trust and cannot be flowed through to beneficiaries.

DEEMED DISPOSITIONS

Generally, the Income Tax Act requires a deemed disposition of all assets in a trust every 21 years with special rules for qualifying spousal trusts, alter ego trusts and joint partner trusts. In the case of qualifying spousal trusts, the first deemed disposition may be postponed until the death of the beneficiary spouse, and subsequent deemed dispositions are subject to rules for non-qualifying trusts. In the case of alter ego and joint partner trusts, the 21-year deemed disposition is not applicable until after the death of the settlor or both the spouse and his/her partner.

If a trust receives assets through a transfer from another trust, the receiving trust will be subject to a deemed disposition on the day that the transferring trust would have been subject to the provision. This is meant to discourage transfers between trusts in order to avoid the deemed disposition rule.

The deemed disposition rules may be avoided if the income and capital beneficiary is the same person. In this case, the trust (if trust agreement permits) can distribute the underlying asset to the beneficiary, tax-free, with the beneficiary assuming the trust's adjusted cost base. A taxable capital gain or loss would only occur on actual sale of the asset or on the death of the beneficiary.

CREDITOR PROTECTION

Generally, the assets of an irrevocable discretionary trust may be protected from creditors if certain conditions are met. Creditor protection may be challenged if, among other tests:

- The transfer of the assets to the trust was intended to defraud creditors, or
- The transfer of the assets to the trust occurred less than one year before any claim, or
- The transfer of the assets to the trust occurred less than five years before any claim insolvent if you cannot meet obligations once due or liabilities exceed assets).

Creditor protection may also be challenged in situations other than those described above. You should also be aware that certain types of creditors (e.g., tax authorities, dependants and former spouses) have preferred rights which may allow them access to funds, and special rules may apply in the case of bankruptcy.

Also:

- "Irrevocable" refers to the impossibility of the transferor ever reclaiming or resuming control of the assets transferred to the trust.
- "Discretionary" refers to the trustee's right to determine when and how much income or capital to pay to which beneficiary, completely at the trustee's discretion. (If a particular beneficiary is facing creditor issues, there is no requirement for the trustee to pay anything to that beneficiary).

Obviously, to the extent the trust itself has liabilities, assets within the trust will not be protected from creditors of the trust. A properly drafted trust agreement is an essential part of trust planning. We strongly urge you to consult your tax and legal advisors for help in this area. Your tax and legal advisors should be in a position to analyze your particular family situation, prepare a comprehensive analysis including the costs and benefits, and help you to incorporate all of the clauses and provisions that are suitable to your circumstances and personal objectives.

Given the complexities involved and the care required to properly draft these trusts, professional advice is recommended before any action is taken.

www.woodgundy.com

03/12

0264-12