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Understanding Trusts

Family trusts have received quite a bit of attention from our politicians over the years. You may remember the Bloc Quebecois attacking trusts as a “tax-shelter for the rich.” After that, the Auditor General criticized Revenue Canada (now the Canada Revenue Agency or CRA) for allowing gains on assets held in two trusts of a wealthy Canadian family to escape Canadian tax. In the 1999 Federal Budget, the tax on split income (or kiddie tax) was introduced, and in December 2002, these rules were tightened. As trusts are often used to hold investments for minors, the kiddie tax has a major impact on trust management.

Despite all the attention that trusts have received, it is important to keep in mind that they are not tax shelters. What they offer is greater flexibility in tax and financial planning. And you don’t have to be rich to enjoy the benefits of a trust — most Canadian trusts earn very little income.

In this bulletin we’ll explain what trusts are and how you might be able to use them to achieve your tax and financial goals. Armed with this information, you’ll be better able to assess whether using a trust can make sense for you. We’ll also discuss when the kiddie tax applies, and more importantly, where it doesn’t.

What is a trust?

The main advantage of a trust is that it allows you to separate the control and management of an asset from its ownership. This fact makes trusts a powerful tool. How is this accomplished? It all stems from the legal arrangement involved in setting up a trust. A trust is a legal relationship between three different parties. First, there's the settlor of the trust. This is the person who sets up the trust and contributes assets to it. The settlor also sets out instructions on how the assets are to be used or managed and who will benefit from the assets. These instructions are known as the trust agreement. The transfer of assets to the trust is known as the trust settlement.

The person (or group of persons) the individual appoints to control and manage the assets in the trust is known as the trustee(s). Sometimes the settlor will also be a trustee. Finally, there's the person, or group of persons, who will benefit from the assets owned by the trust. They are known as the beneficiaries. The trust agreement will either specifically name who the beneficiaries are or state that they will come from a certain group such as the children or grandchildren of the settlor (this can include individuals who are not even born at the time the trust is set up).

Therefore, a trust is formed when a settlor contributes property to the trust for the person he intends to benefit, or the beneficiaries. The trustees of the trust are appointed by the settlor to manage and control the trust's assets, according to the instructions set out by the settlor.

There is no requirement that the settlor, trustees and beneficiaries be different. In fact, an individual can be all three in the same trust. However, there can be adverse tax consequences if the settlor is a trustee or beneficiary—we'll discuss this later in the bulletin.

Types of trusts

Now that you understand the basic legal relationship involved in setting up a trust, it's easier to understand the different types of trusts and how they can be useful in tax and financial planning. First there are commercial trusts. These trusts are used for business and investment purposes—for example, most mutual funds in Canada are commercial trusts. In this bulletin, we'll be focusing on the other type of trusts which are known as personal trusts.

A personal trust is one where the beneficiaries do not pay for their interest in the trust—in other words, they receive their interest in the trust's assets as a gift. Personal trusts are set up in one of two ways. First, there are testamentary trusts, which are created on the death of an individual. A trustee of a testamentary trust (also known as an executor) will

control and manage the assets of the deceased's estate in accordance with the deceased's wishes as set out under the will. The second type of personal trust is called an inter-vivos trust, or "trust of the living." These trusts are set up during an individual's lifetime. Usually the purpose of setting up an inter-vivos trust is to transfer the benefit of owning assets to certain individuals, such as children, without actually passing control of the assets to them (for example, the settlor may not feel that the beneficiaries are ready for this responsibility). Inter-vivos trusts are particularly useful in accomplishing family tax and financial objectives.

There's one more feature associated with trusts that you should know about and it applies to both testamentary and inter-vivos trusts. It's related to the powers given to trustees to distribute trust assets. Trusts are said to be discretionary if the trustees decide who will receive distributions from the trust. Although the trust beneficiaries must be specified, the amount given to each beneficiary is left to the trustees' discretion. In a non-discretionary trust, the trustees must make distributions in accordance with the trust agreement. It is possible for a trust to be both discretionary and non-discretionary. This is due to the fact that distributions can be made from trust income or capital. For example, the distribution of trust income could be left to the trustees' discretion, while capital distributions to beneficiaries are fixed by the trust agreement.

Inter-vivos trusts

An inter-vivos trust is set up during the settlor's lifetime. For income tax purposes, it is deemed to be an individual. Consequently, the trust will calculate income, file a tax return and pay taxes in much the same way as you do. However, there are some important differences that you should be aware of:

- ◆ A trust is not allowed to claim personal tax credits.
- ◆ An inter-vivos trust generally pays tax on all income at the top Federal and provincial tax rate for individuals. There are no graduated rates for most inter-vivos trusts.
- ◆ If certain conditions are met, trust income can be allocated to the beneficiaries and taxed in their hands rather than the trust. Most of the tax benefits associated with an inter-vivos trust are achieved in this manner.

How can inter-vivos trusts be used?

When planning your financial affairs, it's often beneficial to transfer the ownership of an asset to others. Generally, you will make the transfer because

you want the recipient to receive the benefits from owning the asset. The transfer will be beneficial from a tax point of view, if the recipient pays less tax than you would on any income earned on the asset. Despite the tax benefits of transferring ownership, you might not be ready to give up control over the asset. This is where a trust comes in. You can transfer an asset to a trust and the asset will be held for the benefit of beneficiaries selected by you. The trustee, however, retains control over the asset. By acting as trustee or by appointing others you trust, you can ensure that the asset is managed in accordance with your wishes.

Some situations where a trust can be useful include:

Income splitting

One of the most common uses of an inter-vivos trust is to allow for family income splitting. In a typical situation, you may have a large amount of income while other family members are not fully utilizing personal tax credits and low marginal tax rates. Tax savings could arise if you could transfer beneficial ownership of your income producing assets to a trust. If the income in the trust is taxed in family members' hands, they'll pay less tax. Since a trust is used, control over the assets isn't given up. We'll discuss the set-up process a bit later—it's not quite as simple as it sounds.

The potential benefits from income splitting were reduced for some after 1999 with the introduction of the kiddie tax. Under these rules, the child will pay tax on the split income at top rates and the child can't claim personal credits to reduce the tax. Sources of income that will be subject to the tax include:

- ◆ Taxable dividends from private corporations received directly by a minor, or indirectly through a trust or partnership, and
- ◆ Business income from a partnership or trust, where the income is from services provided to, or in support of, a business carried on by certain relatives.

Effective January 1, 2003, the kiddie tax has been expanded to include interest, rental and other investment income where a trust or partnership provides property to, or in support of, a business carried on by certain relatives.

Despite the kiddie tax rules, you can still split interest income received from arm's length parties, capital gains and certain other forms of income with a minor. In addition, the kiddie tax does not apply to spouses/common-law partners and adult children (note that same-sex partners are treated as a spouse

for income tax purposes). For a full discussion of the kiddie tax rules, see our *Income Splitting* tax bulletin.

Estate freezes

Trusts can also be used in a common tax planning technique known as an estate freeze. Let's assume that you own shares of a company carrying on business. You're expecting the value of the corporation to rise rapidly in the future. As the value of the shares increases, the amount of tax which will be payable on your death will also increase. This is because you'll be deemed to dispose of your shares at fair market value when you die (unless you transfer them to your spouse). Under an estate freeze, you exchange beneficial ownership of your common shares for preferred shares with a fixed value. New common shares will be issued and held by a trust for your children. Future gains will accrue to them through the trust. In addition, where the property is qualifying farm or fishing property or shares of a qualifying small business corporation, gains allocated to the beneficiaries can be offset by their capital gains exemptions.

This plan effectively freezes the capital gain that will arise on your death based on today's value while allowing you or your trustees to retain control over the common shares. For more information, read our *Estate Planning* tax bulletin.

As a will substitute

With the introduction of rules for "alter-ego" trusts for 2000 and subsequent years, these trusts can be used as a will substitute which can result in probate tax savings. A trust will be an alter-ego trust where:

- ◆ The individual transferring assets to the trust is at least age 65,
- ◆ The income earned by the trust is payable to the individual during his or her lifetime, and
- ◆ No one but the individual can receive trust capital during the individual's lifetime.

The tax benefit provided by an alter-ego trust is due to the fact that you can transfer your assets to the trust at their tax cost. On your death, the trust will be deemed to have disposed of the property at fair market value, as would be the case if you held the assets personally. However, as the assets in the alter-ego trust are outside of your general estate, these assets may not be subject to provincial probate taxes.

As a non-tax benefit, since an alter-ego trust is not a will, the property distribution instructions that will apply on your death will generally not be subject to the usual rules for a will. In particular, your wishes may be more difficult for others to contest and there may be more privacy.

In addition to the alter-ego trust, the tax rules also allow for a joint partner trust. This trust is basically a variation of an alter-ego trust, except that you and your spouse/common-law partner can participate together. There is one significant downside associated with an alter-ego trust or a joint partner trust—the use of one of these trusts may preclude taking advantage of the rules we discuss later for testamentary trusts.

Providing for a family member with special needs

In some cases, you may be willing to transfer ownership of assets to a family member, but that person is not competent to hold them. For example, if your child is mentally infirm, you'll likely want to provide for your child by transferring assets to them. However, you'll want to maintain control over the assets transferred. In this situation, a trust can be ideal. A trust will ensure that the assets are properly managed for the benefit of your child while allowing the benefits of ownership to flow through to them. Also, depending on the nature of the trust and the province in question, holding assets in trust may increase benefits available to the child that are subject to income or net worth tests.

Trusts for charitable giving

A trust can also be a useful tool for charitable giving. Assume that you want to leave a substantial gift to charity and you have made a provision for such a gift under your will. This kind of bequest will count as a charitable donation for the year of death and the immediately preceding year. However, if the gift is large, your executors may not be able to utilize the entire non-refundable tax credit from the gift. Alternatively, you could make the gift during your lifetime and claim the credit over five years. But, what if you need the income from the property? A charitable remainder trust could allow you an immediate tax credit while allowing you to receive income from the gifted property during your lifetime. The capital of the trust would be passed on to the charity on your death. Note, however, that the donation eligible for a credit is discounted based on your life expectancy.

Setting up an inter-vivos trust

Since inter-vivos trusts pay tax at the top personal tax rates, there's often little advantage in having an inter-vivos trust pay tax on income. Tax savings arise if the trust's income is taxed in the hands of low-income family members. But before this can happen, there are conditions that you'll have to meet.

First, for income to be taxed in the hands of a beneficiary (referred to as an income allocation), the income must be paid to the beneficiary or become payable to them during the taxation year of the trust. You'll have to deal with this issue on an ongoing basis and we'll discuss it in the "*Things to Consider Annually*" section of the bulletin.

Secondly, the income paid or payable to the beneficiaries must not be subject to what is known as the "income attribution rules." Whether these rules apply or not will depend mainly on how your trust is set up. The attribution rules can potentially apply whenever you gift property or make a loan at little or no interest to a family member. This includes loans and gifts made through the use of a trust. The most important rules are as follows:

- ◆ If you make a loan (at rates less than the interest rate prescribed by the government) or gift property to a trust for the benefit of your spouse, any income or capital gains from the transferred property allocated to the spouse will be taxed in your hands.
- ◆ If you make a loan or gift property to a minor child or a trust for a minor child, income from the funds allocated to the child will be taxed in your hands. In this case, a minor child includes a son, daughter, niece or nephew under 18 or some other minor with whom you do not deal at arm's length. Note, however, that capital gains arising from the property will be taxed in the hands of the child.
- ◆ If you gift property to a trust and you are a trust beneficiary, all income and capital gains of the trust (as well as income losses and capital losses) will be taxed in your hands. This rule will also apply if you gift property to a trust and you can later control who will receive trust property or you can control when the property is disposed of. Consequently, you should never transfer income-producing property to a trust and be a controlling trustee or beneficiary, if income splitting is desired. Trusts subject to these rules are often called reversionary trusts.
- ◆ If you make a loan to a trust benefiting an adult child or other adult relative, income from the funds may be attributed to you, if the purpose of the loan was to reduce taxes. Capital gains, however, will not be attributed to you.
- ◆ If you make a low interest (or interest-free) loan or transfer property to a corporation, and a trust for other family members is a shareholder, then you could be deemed to earn interest on the loan or transfer. An important point—this rule doesn't apply if your corporation is a "small business corporation" (SBC). Generally, an SBC is a Canadian-controlled private corporation (CCPC)

in which at least 90% of the assets (on a fair market value basis) are used in operating an active business in Canada.

Below, we set out situations where the attribution rules should not pose a problem.

Avoiding Attribution — Rules of Thumb

If you follow the rules of thumb listed below, the attribution rules should not be a concern:

Select your settlor and settlement property carefully.

A gift must be made by a settlor to create a trust. Therefore, the settlor and the property used for the gift should be selected carefully. An ideal settlor is a family member who won't be involved in trust management and won't be a beneficiary. If a beneficiary is infirm or disabled, the settlor should be a parent or grandparent of that beneficiary. The gift should be easily segregated and should not produce income, such as a gold coin. The concern is that attribution can arise if the gift becomes intermingled with the income-producing property.

Borrow funds from a third party to purchase income-producing property. If the trust borrows money from a third party to purchase income-producing assets such as shares of your small business corporation, attribution can be avoided. In this case, you didn't make a loan to the trust.

Make sure the income producing property isn't purchased from you. Even if a loan is obtained from a third party, attribution can still apply if the asset is purchased from you. In the case of a family-owned business corporation, this is easily accomplished by having the trust purchase new shares directly from the corporation, rather than purchasing existing shares from you. You do need to ensure that the trust acquires these shares at their fair market value.

Hold growth assets in a trust for minors. In some cases, it is possible to make a transfer directly to a trust without attribution. Let's say you gift money to a trust set up for the benefit of minor children. If the trust invests in assets which will produce capital gains, such as Canadian equity mutual funds, there will be no income to attribute. Remember that capital gains earned by a trust will only be attributed to you if your spouse is a beneficiary and is allocated the gain or the trust is a reversionary trust.

Things to consider annually

You've set up your trust so that the attribution rules won't apply and the income-producing property is in place. What's next? As we discussed earlier, income splitting is accomplished by having trust income taxed in the hands of the beneficiaries of the trust. For this to happen there are conditions to be met. There are two ways to meet these conditions under tax law.

Preferred beneficiary election

The first method is using what is called a preferred beneficiary election. If one of the beneficiaries of the trust is mentally or physically infirm or disabled, you can elect to allocate income to that beneficiary while retaining the income in the trust. This election recognizes that it would be imprudent to turn trust assets over to a beneficiary who is infirm. We won't discuss the rule in much detail other than to highlight one point—the trust settlor must be the spouse, parent or grandparent of the infirm beneficiary. Without this, no election is possible.

Income paid or payable

Most trusts will have to use the second method — pay out the trust income or make it payable to beneficiaries. For a non-discretionary trust this is an easy task. Income and capital gains generally become payable under the terms of the trust. In the case of minor children, the trustees are entitled to retain the child's share of income earned by the trust while the child is a minor.

Unfortunately, things are a bit more complicated for discretionary trusts. You'll have to do more work to have the trust's income taxed in the hands of low-income beneficiaries. There are two basic steps.

First, the trustees must exercise discretion and decide who will be entitled to the trust's income for the year. This generally takes the form of a trustees' resolution. In the resolution, the trustees declare that the trust's income and capital gains will be payable to certain beneficiaries. The declaration could be in terms of fixed amounts or percentages of income (including capital gains). An important point—trustees must exercise their discretion during the year.

A second step is required as a resolution alone doesn't cause income to become payable. The declared amounts must be paid or made payable by issuing promissory notes.

With this two-step operation, one thing becomes clear—to have income taxed in the hands of your family, you have to give them the income. But what if your beneficiaries are minor children—do you have to give them the income?

The answer is yes, but not necessarily directly or right away. There are alternatives which meet the “paid or payable” test while ensuring that some control is retained over income allocated. The most effective of these alternatives are discussed briefly in the box below.

Income Paid or Payable: Dealing with Minors

Set up an “In Trust” Account for the Minor. Under this alternative, the child’s parent would set up a bank or investment account on behalf of the child. Income paid out by the trust would be deposited in this account. The payment of income and the income earned on the amounts deposited will be taxed in the hands of the child. Remember however that the money does belong to the child and will have to be turned over once the child reaches the age of majority. There may also be restrictions over disbursements which can be made from the account and investments which can be held under Federal and provincial law. You should seek advice from your BDO advisor in conjunction with your lawyer.

Make Payments to Third Parties. The CRA has stated that certain payments made by the trustees to third parties for the benefit of a beneficiary will be treated as a payment of income to the beneficiary. These payments include tuition fees, medical expenses or other expenses incurred for a minor beneficiary’s benefit. For example, the trustees could pay for a child’s private school tuition using trust income and the payment amount will be taxed in the hands of the child.

Pay Income in Kind. A payment of income need not be made in cash. It may be possible to transfer title to assets other than cash into the name of a minor. The asset selected could have terms which would make liquidation difficult. For example, where a trust receives a stock dividend consisting of shares redeemable only at the option of the corporation, title to these shares could be transferred to a minor. The child would not receive liquid proceeds until the corporate directors authorize a redemption.

Testamentary trusts

The second type of personal trust we’ll discuss is a testamentary trust. A testamentary trust is a trust that’s created on the death of an individual, under the terms of the deceased’s will. It’s taxed much in the same way as an inter-vivos trust, with two major and beneficial exceptions.

First, rather than paying tax at the top rate, testamentary trusts calculate tax using the marginal rates available to individuals. Let’s say you set up an

inter-vivos trust for a child with no income. The trust earns about \$72,000 of income. In this case, the least amount of tax will be paid if the trust allocates all of the income to the child (an inter-vivos trust pays top-rate tax). The child will pay tax at approximately 21% on the first \$36,000 or so of income and perhaps 31% on the rest (depending on the province). Now, let’s see what would happen if the trust is a testamentary trust. In this case, the least amount of tax is payable if about 1/2 of the income is taxed in the hands of the individual. This is due to the fact that the trust and the individual will both pay tax on \$36,000 of income at approximately 21%. In this case, a testamentary trust doubles the income splitting potential provided by a trust.

The second difference is that a testamentary trust can have a non-calendar taxation year. This is beneficial where income is paid or payable to a beneficiary. The income becomes taxable to the beneficiary in the calendar year in which the trust’s taxation year ends. For example, assume that a testamentary trust has a January 31st year-end. If a dividend is received by the trust in February 2009, that income will be included in the trust’s January 2010 taxation year. If the income is paid or becomes payable to a beneficiary during the fiscal year ending January 31, 2010, the beneficiary will report the income on their 2010 tax return. Consequently, the beneficiary could receive the cash from the dividend in February 2009, but not have to pay tax on the income until April 2011.

How can a testamentary trust be used?

A testamentary trust can be used for most of the same purposes as an inter-vivos trust. Popular uses include income splitting and providing for a minor or infirm heir. For income splitting, a testamentary trust is even more powerful. There are a couple of reasons why.

First, the income attribution rules discussed earlier are generally not a concern — the rules generally don’t apply to transfers made on death. Also, depending on the identity of the deceased and other factors, where a minor child is a beneficiary, the kiddie tax may also not apply.

Second, additional marginal tax rates become available. It is possible to set up more than one testamentary trust. If you provide for multiple trusts under your will, each trust will be entitled to its own set of marginal rates. A word of caution is in order, however. You can’t create an unlimited number of trusts for the same beneficiaries. If you do, the CRA will deem the trusts with common beneficiaries to be one trust.

For example, let’s say you have three children who will receive your assets on your death. If you

create three trusts and each child is a beneficiary of all three trusts, then all three trusts will be taxed as one trust. But if you set up one trust for each child with each child as sole beneficiary, then the three trusts will be taxed separately, increasing the potential for income splitting.

The downside of using multiple trusts is the loss of flexibility. You'll have to make a decision before death on how your estate will be split between the three trusts. This may outweigh the tax savings in some situations. If one of the three heirs in our example is dependent on you for support, you may want your estate to pass to a single trust. The trustees would have the responsibility of providing for the dependent child during his or her lifetime. Only those assets not required for the care of this child would be made available to the others.

Setting up and administering a testamentary trust

There is only one major difference between the administration of a testamentary and inter-vivos trust — how the trust is set up. As we discussed earlier, an inter-vivos trust is often created on a gift of non-income producing property. The income-producing property is usually acquired later using a loan. Setting up a testamentary trust is much more direct. In your will, you would insert instructions that certain properties will be held in trust for named beneficiaries. The naming of trustees and the rules governing trust administration would also be set out in your will. In terms of annual administration, testamentary trusts operate in the same way as inter-vivos trusts. If the trust is discretionary and income splitting with beneficiaries is beneficial, your trustees will still have to pay out income or make it payable to the low-income beneficiaries in the same manner as inter-vivos trusts.

The 21-year rule

One issue we haven't discussed yet is how long your trust can be used. From a legal point of view, a trust would normally have a defined dissolution date. From a practical point of view, however, the terms of dissolution can be drafted in such a way to effectively give a trust an unlimited life. With this possibility in mind, deemed disposition rules for trusts were introduced to prevent an indefinite capital gains deferral. Remember that individuals are deemed to dispose of property on death and a trust with an indefinite life could bypass this rule.

Generally, a trust is deemed to dispose of its capital property every 21 years. An exception to this rule exists if you create a trust for your spouse.

Provided that the income of the trust is payable to your spouse and no one but your spouse is entitled to the capital of the trust during their lifetime, the trust will be a spousal trust. As such, the deemed disposition of the trust's assets will not occur until your spouse's death.

Similarly, if you are age 65, an alter-ego trust will have its first deemed disposition on your death (for a joint partner trust, the disposition will arise on the death of the second partner). If a spousal, alter-ego or joint partner trust continues after that, it will be subject to regular deemed dispositions every 21 years.

Managing your trust

The first step on the way to good trust management is a well-drafted trust agreement. A well-drafted agreement will make the trustees' job easier, while also helping to ensure that conflicts will not develop in the future.

A trustee's job is made easier because the trust agreement can open up options for the trustee which would not otherwise be allowed under general law. The administration of trusts is governed by provincial trustee legislation. These rules impose restrictions on the conduct of trustees. In many cases, you'll want your trustees to follow the rules. For example, most provinces state that trustees must act in an impartial manner. But there are other provisions that you may not want your trustees to be bound by. A good example is the set of rules which governs trust investments. Many provincial trustee acts contain a list of investments that can be held by a trust. Although the investments tend to be of very high quality, they are also very low risk investments which may yield low rates of return. Although these lists are being expanded these days to allow for a wider variety of investments such as mutual funds, you'll probably still want to authorize additional investments. For example, if your goal is to split income from a family-owned corporation, your trust agreement will have to allow your trustees to hold these shares.

Long-term flexibility should also be built into your trust agreement. You may have a particular plan in mind that can be built into your trust agreement fairly easily.

But what happens if future events unfold in a way you didn't anticipate? A good trust agreement will also deal with the "what ifs." For example, let's say you provide for a testamentary trust for your children in your will. You would like each of your children to go to college or university before they receive their inheritances. Consequently, you state in

your will that the bulk of your estate should be held in trust until your children reach 25. What would happen if one of your children is not mature enough at age 25 to manage his or her inheritance? Since you may not be alive at that point to amend your will, this may be an example of a “what if” you’ll want to deal with in your will.

Your BDO advisor and your lawyer can help you draft a trust agreement or trust provisions in your will that can help the trustees deal with the unexpected. Remember that if your agreement or will is silent on an issue, your trustees will be bound by trustee laws.

The result may not be what you intended. A well-drafted agreement can save a great deal of money and preserve family harmony.

Conclusion

Trusts are a very powerful tool for tax and financial planning. However, there are many traps and pitfalls for the unwary. Your BDO advisor can help you decide whether a trust is right for you.

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