

An overview of trusts

The Income Tax Act enables beneficiaries to receive their entitlements in a manner consistent with the wishes of a settlor. Tax Treatment varies by type of trust.

This article reviews the nature of trusts, the procedure required to create them, and some of the variations for using them to reduce taxes.

What are the four elements of a trust?

A trust is not a legal entity (though it is required to file tax returns); rather it is the relationship among the four elements

Settlor

This is the original owner of the property who creates (or 'settles') the trust. A person who creates a trust by Will is called a 'testator'.

Trustee/s

The trustee is the new legal owner of the property, and must manage the property solely with a view toward the best interests of the beneficiary.

Beneficiary/ies

The beneficiary is the new beneficial owner of the property involved. The entitlements of beneficiaries need not be equal and provisions can be made for cessation or revocation of interests.

Property

Any property can be placed in trust, though usually it is some form of financial property. The property in an estate constitutes a testamentary trust.

Key characteristics of trusts

- While there can be only one settlor, there is no limit on the number of beneficiaries
- Likewise there is no limit on the number of trustees, though for practical reasons one trustee is usually sufficient, with perhaps 2 or 3 named in complex situations requiring specialized skills
- The settlor can also be a trustee and/or a beneficiary
- The settlor, trustees and beneficiaries can be individuals or corporations

How is a trust created?

There need not necessarily be a formal written trust document in all cases. Regardless of whether there is a formal document, the elements discussed above must be identified with sufficient certainty to cause the trust to come into being.



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Purpose of trusts

- Business planning purposes
- Creditor protection
- Protective care limited or restricted tax advantages
- Operation of law (such as an estate)

Trusts can be a key tool to use in estate and legacy planning. The people with the assets can control who gets those assets when they pass and lay out how and when those assets get used and transferred to heirs. The transfer may be postponed, the assets may be sprinkled over a period of time and the income directed to taking care of heirs vs. sending it directly to them.

Trusts can provide a much higher measure of privacy for the people setting them up and may even avoid probate taxes. Properly structured, they may serve to prevent legal battles between heirs or between executors, estate administrators and heirs.

One of the main distinctions is between trusts created during a person's lifetime ('inter vivos' trusts) and trusts created at death ('testamentary' trusts). There are little or no tax benefits available through the use of inter vivos trusts. The top marginal tax rate applicable to individuals applies to grandfathered inter vivos trusts and to certain testamentary trusts and estates effective 2016 and onwards.

Tax advantages of certain trusts and new rules

Effective from 2016 onwards, graduated tax rates and special treatment under some related tax rules that were available to testamentary trusts and grandfathered inter vivos trusts will only apply to graduated rate estates and qualified disability trusts. The tax advantages of testamentary trusts, or more specifically, graduated rate estates, have been limited to 36 months after the death of the individual where the estate arose as a consequence of the individual's death. They are then taxed at the top marginal tax rates from thereon. There can only be one graduated rate estate per deceased individual.

The principle tax advantage of a graduated rate estate or a qualified disability trust is that it is a separate taxpayer from its beneficiaries. While it cannot claim all the personal tax credits that may be available to real people, it is still able to take advantage of the marginal tax bracket system.

A qualified disability trust may only be set up for a disabled person. To qualify, the trust must:

1. be a testamentary trust,
2. be resident in Canada, and
3. have an electing beneficiary who is eligible for the Federal Disability Tax Credit, meaning the disability must be severe and prolonged. The trust can have multiple beneficiaries as long as one of them is an electing beneficiary. Keep in mind that an electing beneficiary can have only one qualified disability trust.

This trust would be set up in a will or life insurance trust. However, if for example, a parent wants to leave a portion of his/her estate and a life insurance policy for a qualified disabled child, either the estate or the life insurance trust may be a qualified disability trust, but not both. The same holds true for a grandparent and parent each wanting to leave a trust for that disabled child. Only one of those trusts will be eligible for graduated income tax rates. Furthermore, the eligibility is different than for discretionary trusts or "Henson" trusts set up in Ontario to plan around the Ontario Disability Support Program.

Trusts and Taxation

The trust is taxed in the province where the trustee is located, more specifically, where the central management and control of the trust is usually located. This is driven by *Fundy Settlement v. Canada* 2012 DTC 5063, 2012 Sec 14. Other factors which help determine which laws apply to a particular trust include:

- the residence of the settlor,
- whether there is land or real property in the trust and where that is located; and
- whether the terms of the trust include an intention to be governed by particular laws.

If the trust is eligible for graduated tax rates which vary by province, then the income taxes paid may be far lower than if the trust is taxed at the highest marginal tax rate which could approach 50+%. That could mean more out of every dollar earned may be available to beneficiaries rather than the government.

Especially if a beneficiary is in the top tax bracket and receives income from a direct estate distribution (rather than via a trust), almost half that income would go to the government in taxes. By comparison, a testamentary trust will pay less tax on every dollar earned up to about the highest bracket for individuals. Even at more modest levels, if the combined income of the trust and beneficiaries exceeds even the lowest tax bracket threshold, the door is open for an opportunity to save taxes.

Long-term tax savings

Most trusts are deemed to dispose of their property every 21 years for the fair market value of that property. The terms of the trust may permit the trustee to transfer capital property with unrealized capital gains to capital beneficiaries prior to the 21st year. The capital beneficiaries receiving this property will then be liable for any tax resulting from the subsequent sale of that property at their marginal tax rates which may be lower than the top rates applicable to the trust. This deemed disposition of trust property effectively limits the deferral of tax on appreciable property. It should not be confused with the rule against perpetuities. That rule deals with the validity of a trust and how long a property can be held in a trust before it vests with the beneficiaries. The tax rule doesn't require the windup of a trust. The trust may continue beyond 21 years. Some provinces have abolished the rule against perpetuities or removed it from operation.

Tax optimization strategies

Income splitting

The main strategy is effected by the settling of the trust itself: the creation of a new taxpayer being the trust. During the 36 month period while the graduated rate estate holds the deceased's assets, the estate can pay the tax at graduated rates. Part or all of the income can be split between the estate and beneficiaries for income tax purposes. Taxes may be saved by beneficiaries from this declaration for the first 36 months.

Spousal trusts

What happens when the surviving spouse dies? "Tax-free spousal rollovers of capital property may be extended to one or more spousal trusts, sometimes referred to as life interest trusts.

Legislation passed in 2016 offers a choice on who pays the tax on the life interest trust's income. It could be the trust who holds the assets or the primary beneficiary spouse only where, among other criteria, the Graduated Rate Estate of the primary beneficiary spouse and the life interest trust jointly elect to have the rules apply. This

effectively allows the estate the option to have a mismatch apply where there are non-tax reasons to do so. A mismatch may occur where the beneficiaries of the deceased spouse's estate are different from the residual beneficiaries of the life interest trust.

Family with Special Needs

You may consider creating a trust to hold investments for the benefit of a child or parent with a physical or mental disability. If the trustee makes a preferred beneficiary election, the income can be retained in the trust but taxed in the hands of the lower income beneficiary. This reduces taxes while allowing the trustee to control the investments.

Administration cost

Creating a testamentary trust can be as simple as executing a valid Will. On the other hand, the more complex the needs, the more costly it will likely be to explore alternatives and draft the necessary documentation.

Similarly, ongoing costs can be substantial but will generally be proportionate to the tax savings and other benefits gained. In fact, experience has shown that in the simplest of situations, they can be as little as the cost of filing an annual tax return.

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