Tax Planning Involving Family Trusts

Trusts are often used in tax and estate planning because of the flexibility they offer over the control, management and distribution of appreciating assets. In an estate planning context, trusts can be used to provide control and protection of assets, reduce probate fees at death or serve as a Will substitute, and as a vehicle to transfer wealth to future generations. From a tax planning perspective, trusts can be used to facilitate income splitting by spreading income amongst family members who are taxed at lower marginal tax rates, thereby reducing the family's overall tax burden. In particular, the use of a discretionary family trust to reduce the after-tax cost of children's educational and other expenses is a common tax strategy and the focus of this publication.

The strategies contained in this publication may or may not be appropriate for you. As such, we recommend that you consult independent tax and legal professionals to determine whether these strategies would be appropriate for your particular situation and to ensure proper documentation and implementation.[1]

What is a Trust?

A trust, except in Quebec where a trust is the result of a legal act (see below), is a relationship amongst a trustee, the property managed by the trustee, and the beneficiary of the trust. The trust relationship is created when a person who initially owns certain property (the **settlor** of a trust created during lifetime or a testator of a Will) transfers possession and legal and beneficial ownership of the property, to someone else. The person who receives possession of the property, and the legal ownership, is the **trustee** of the trust. The person who receives the

[1] Note that there are significant differences between trusts created under Common Law and those created under Quebec's Civil Code. Although this publication outlines some of the main differences between the Common Law and the Civil Law in Quebec, Quebec residents are advised to obtain separate legal advice addressing the trust law under the Quebec Civil Code.

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beneficial ownership is the **beneficiary** of the trust. The trustee is given authority to manage the property according to the terms outlined in the trust agreement, for the benefit of the beneficiary. A trust is not a legal entity, but is considered a separate taxpayer for income tax purposes.

In common law provinces and territories, a trust is a relationship among the trustee, the property and the beneficiary. Therefore, in order for the trust to be validly created at law, the following **three certainties** must exist:

i) *Certainty of Intention – the clear intention to create a trust relationship, i.e., intent to transfer the property irrevocably to the trustee (for the benefit of the beneficiary);*

ii) *Certainty of Subject – the specific property transferred to the trustee to establish the trust must be clearly described so that it is identifiable; and*

iii) *Certainty of Object – the beneficiary or beneficiaries must be clearly and precisely described in a manner that allows the trustee to identify them and differentiate them from persons who are not beneficiaries.*

Unlike common law, under Quebec civil law a trust results from an act whereby a person (the settlor) transfers property from his/her ownership (i.e. patrimony) to another patrimony that he/she constitutes for a particular purpose and which a trustee undertakes, by his/her acceptance, to hold and administer. The acceptance of the trustee divests the settlor of the property and charges the trustee with the administration of the property under the term of trust. As patrimony is autonomous and distinct, the property transferred is not considered property of the settlor, trustee or beneficiary.

It is generally recommended that a written **trust agreement** (also referred to as a **trust declaration** or **trust indenture**) be drafted as a means of supporting the validity of the trust relationship, including proof of the existence of the three certainties required under common law, as noted above. In many situations involving an informal **"in-trust"** account established by a parent or grandparent for a minor child (who is unable to enter into a legal contract), the account opening document is the only formal agreement in existence. This document often lacks specified terms of trust other than to hold the property for a minor child; and as a result, the attainment of the age of majority, technically, entitles that child to the property in that trust account. In other words, the legal and tax implications of the relationship are unclear since there are no specified terms of trust beyond the default position at law that the property is to be managed by the settlor, while the child is still a minor. With an in-trust account, many unexpected tax and legal problems can occur (such as tax issues involving the income attribution rules) or disagreements may result over the child's access to the funds when he/she reaches the age of majority. Accordingly, in addition to the tax and legal problems created by the informal in-trust relationship, the many tax and estate benefits of a trust relationship may not be available because the lack of appropriate documentation may not support the existence of the three certainties necessary to create a valid trust. For these reasons, the comments in this publication are confined to a validly created formal trust arrangement.

Under Quebec civil law an "in-trust" account for minors does not legally exist, even if it is commonly referenced. In civil law, there is no deemed trust, as a trust must be created by contract or by operation of law. A minor does not have legal capacity and his/her parent or legal tutor (guardian) acts on his/her behalf as a representative until age 18. In Quebec, the settlor has the initial choice to appoint beneficiaries. Typically, beneficiaries are family members, relatives or other important persons to the settlor, corporations (constituted or to be constituted by one or any beneficiaries), or trusts for the benefit of one or any beneficiaries. The settlor could confer the right to appoint beneficiaries and determine their shares to the trustees or to a third person.

In addition to formalizing the legal requirements, a trust agreement governs the management of the trust property

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while it is held in the trust and the distribution of the trust property and/or income therefrom to the beneficiaries of the trust during its existence and upon its termination. Under trust law, a distinction exists between the income and capital of a trust and consequently, the beneficiaries can be entitled to receive distributions of either the annual income from the trust property (**income beneficiaries**) or the trust property itself (**capital beneficiaries**) or both. In trust law, unlike tax law, income does not include capital gains so it is not uncommon for the trust agreement to specifically define trust income as income for tax purposes for consistency. Finally, it is important to note that under trust law, income that is accumulated in the trust (rather than paid out on a current basis or made payable to the beneficiaries) will become capital of the trust in the following year.

Choice of Trustees

Since the settlor (or testator upon death) of a trust relinquishes the ownership and control of the trust property to the trustee(s) for the benefit of the beneficiaries, the choice of who to select as trustee(s) is critical. Under common law, the trustee does not have a beneficial interest in the trust but instead has legal interest in the trust and therefore, has authority to act on the trust property. It is the trustee who legally represents the trust and has legal ownership and control of the trust property, subject to the terms of the trust outlined in the trust agreement. The trustee has a fiduciary duty to the beneficial owners (i.e., the beneficiaries) to give effect to the intentions of the settlor/testator and to act in a manner that benefits the beneficiaries. This again underscores the importance of a formal and clearly written trust document. It is this separation between legal and beneficial ownership that gives the trust its flexibility in the control, management and distribution of the trust property.

In Quebec, civil law has specific rules governing the choice of trustee. The trustee must be a person (who is not a minor and not incapable) or a legal entity authorized by law. In the case where a settlor or a beneficiary is a trustee, he/she must act jointly with a trustee who is neither settlor nor beneficiary (commonly known as the "independent trustee"). The trustee has the control and exclusive administration of the trust patrimony according to the terms outlined in the trust deed or the law by default.

However, in both common and civil law, discretionary powers outlined in the trust agreement provide authority to the trustee to use discretion with respect to any, some, or all of the decisions regarding distribution of income, distribution of capital, timelines, termination of the trust and distribution to the various categories of beneficiaries. Authority to exercise discretion provides the trustee with significant choice or flexibility in making decisions involving the trust property, within whatever parameters were provided for in the governing trust agreement.

Among other requirements, the trustee should possess sufficient knowledge regarding financial matters, including investment management. He or she should not be in a position of conflict with any of the beneficiaries' interests. Certain tax rules may restrict the choice of trustee. For example, negative tax implications can arise if the settlor (or anyone who has subsequently contributed property to the trust) is in a position to control the trust as a trustee. Depending on the terms of the specific trust and the expected length of time of its existence, the age of the trustees appointed is important, to the extent that adequate provision for (younger) replacement trustees is not provided. In some circumstances, it may be appropriate to consider the appointment of a corporate trustee – depending on the complexity and size of the trust – to deal with any potential conflicts of interest or trustee succession. Finally, it is important to note that the trustees' fiduciary duty to the beneficiaries (as previously discussed) to always act in the best interests of the beneficiaries is held at a high standard at law. This fiduciary duty must govern the trustee's behaviour in conjunction with the expressed intentions outlined by the settlor or testator, as reflected in the trust agreement.

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Types of Trusts

There are generally two types of trusts, **inter-vivos** and **testamentary** trusts. Inter-vivos trusts are created during one's lifetime and are commonly used for control, protection and tax planning purposes; often to implement income-splitting strategies. A common example of an inter-vivos trust is a discretionary family trust, which is the focus of the tax strategies described subsequently. Other common types of inter-vivos trusts include **alter-ego** and **joint partner** trusts, which are used in estate planning as Will substitutes and for incapacity planning, as well as probate fee minimization. Please see our BMO Financial Group publications entitled *Alter-Ego and Joint Partner Trusts* for more information on these types of inter-vivos trusts. Additionally, a **Henson** trust can be created during one's lifetime or in one's Will. This is a discretionary trust that may be used effectively in some provinces to preserve provincial government benefits for disabled family members. For more information, please see our BMO Financial Group publication entitled *Planning with Trusts for an Adult Person with a Disability*.

While an inter-vivos trust is created during one's lifetime, a testamentary trust is created upon the death of an individual, pursuant to the terms outlined in the deceased's Will. In this case, the settlor of the trust is the deceased, typically referred to as the **testator** (or **testatrix**) and the **executor** (or **executrix**) of the Will is often named as the trustee of the trust; although it is possible to select different persons to act as trustees instead.

Testamentary trusts currently provide greater tax advantages than inter-vivos trusts. As a result, they are often used to bequeath growth assets to a surviving spouse on a tax-deferred roll-over basis (a **spousal testamentary trust**) or to children or grandchildren in a **testamentary family trust**, or to both a surviving spouse and other family members (sometimes referred to as a **tainted spousal trust**). These testamentary trusts are excellent vehicles to use in bequeathing larger estates because of the ability (subject to proposed legislation outlined below) to split income between the trust and its beneficiary (or multiple beneficiaries in the current and/or successive generations) as well as to provide for control "beyond the grave". This protection and control of wealth may be particularly appealing in a blended family scenario or whenever it is desirable to protect a child's inheritance by establishing a trust to provide for a residual inheritance for the child of a prior marriage, following the death of the surviving spouse. For more information on estate planning involving testamentary trusts, please see our BMO Financial Group publication entitled *Trusts for Asset Protection and Tax Savings.*

How Are Trusts Taxed?

As noted previously, trusts are not considered legal entities but they are taxed as separate entities for Canadian tax purposes, as individuals.

The tax residency of a trust is generally determined by where the majority of the trustees reside. Therefore, it is important to keep the current (and future) tax residency of possible trustees in mind when establishing the trust. Significantly, recent case law has established that the "mind and management" test, which is used in the determination of corporate tax residency, is also relevant in determining the residency of a trust for tax purposes.

A trust is considered a separate (individual) taxpayer and is subject to income tax on an annual basis on any income earned on the trust assets that was not allocated and paid or made payable to the trust beneficiaries. In general, any income retained by an inter-vivos trust (i.e., a trust created during lifetime) is subject to tax at the top personal marginal tax rates; whereas any income retained by a testamentary trust (i.e., a trust created at death) is currently subject to the same marginal tax rates as an individual. In either case, a trust is not eligible for the basic personal exemption of approximately $11,000. Note, however, that legislative amendments originating from the 2014 Federal Budget will restrict the tax benefits of testamentary trusts resulting from the graduated marginal tax rates, beginning

in 2016, with no 'grandfathering' for existing testamentary trusts and limited exceptions, such as testamentary trusts whose beneficiaries are eligible for the disability tax credit. Specifically, beginning in 2016, any income retained in any existing and future testamentary trusts will generally be subject to the top marginal tax rates, similar to the treatment accorded to inter-vivos trusts.

Alternatively, income that is paid/payable by the trust and allocated to its income beneficiaries will create a deduction within the (testamentary or inter-vivos) trust to reduce or eliminate its taxable income. The income distributed to the income beneficiaries of the trust retains its character for Canadian tax purposes and is taxable to the beneficiary at his/her marginal tax rates (subject to the possible application of the attribution rules – discussed below) which opens up the possibility of income splitting. As such, the trust can become an effective conduit in that the dividend gross-up and tax credit (applicable to Canadian dividends) and the 50% income inclusion rate on capital gains allocated by a trust to its beneficiaries will also be accorded similar treatment to a Canadian-resident beneficiary. Losses realized in the trust (both net and non-capital) can be applied to offset income retained within the trust, but cannot be allocated to the beneficiary.

The 21-year Tax Rule

In order to prevent the indefinite deferral of capital gains on property retained by a trust, Canadian tax law deems the trust to have sold all of its property at fair market value (and to re-acquire it at the same amount) on each 21st anniversary of the creation of the trust (with some exceptions, such as spousal, alter-ego or joint-partner trusts). Capital gains that are unrealized will therefore become taxable to the trust, however it may be possible to allocate these deemed gains to capital beneficiaries depending on the terms of the trust. Because of this rule, many trusts will contemplate a termination date prior to the first 21st anniversary, but there is no requirement for a trust to be terminated within this period. Often the terms of the trust are drafted to provide flexibility so that the potential capital gains tax can be deferred. For example, the trustees could be given discretion to distribute all, or some, of the capital property to beneficiaries before 21 years have elapsed. In most cases, this distribution of capital property (to a Canadian beneficiary) can occur at the trust's tax cost, avoiding any immediate tax consequences to the trust or the beneficiary. The beneficiary will then own the property outright (which is not always desirable depending on the scenario), generally at the tax cost base of the property to the trust, such that the beneficiary will be subject to tax on the accrued gains when he/she ultimately disposes of the property (or at death).

Income Attribution Rules

Under Canada's marginal tax rate system the more you earn, the more you pay in income tax on incremental dollars earned. With this in mind, it can make sense to spread income among family members who are taxed at lower marginal tax rates in order to reduce your family's overall tax burden. Trusts are often used to facilitate this type of planning to achieve tax savings through income splitting, particularly where minor children are involved. However, it is important to take into account the income attribution rules in implementing any income splitting strategies since these rules can prevent income splitting in many situations, particularly where there has been a transfer to a spouse or minor child for the purposes of earning investment income. If these rules apply, the taxation of the investment income will "attribute" back to the transferor regardless of the legal ownership of the investment which produces the associated investment income.

In the context of income splitting involving family trusts, the first attribution rule to consider is the "reversionary trust" rule which is the most severe of the attribution rules since it can attribute all income (including capital gains) to the settlor of the trust. In general, this rule will apply if property of the trust may revert back to the settlor (or a subsequent contributor to the trust) or if the settlor/contributor has control over the distribution

of the trust property. For these reasons, it is generally advisable that the settlor/contributor(s) are not (nor will ever become) a beneficiary of the trust and that they are not a trustee, or if they are a trustee then they are only one of at least three trustees and do not have veto power. Strict adherence to these recommendations is necessary because of the severity of this attribution rule, which can attribute all of the trust's income from the property transferred (or property substituted for it) back to the settlor or contributor, regardless of the age or relationship to the beneficiaries.

Another important attribution rule involves the transfer or gift of property to a spouse or related minor child (i.e. a child under the age of 18) either directly or indirectly (eg. through a trust). In the case of a spouse, any investment income earned on the transferred property will attribute back to the transferor spouse, whereas in the case of a minor child, interest and dividend income (but not capital gains) will attribute back to the parent (or other related transferors, such as a grandparent, aunt or uncle). If a trust is used to indirectly benefit a spouse or minor child, this rule will apply to the trust income that is allocated (i.e., paid/payable) to the spouse or child beneficiary. However, since capital gains allocated to minor children are not attributed under this rule, a significant planning opportunity is available if a trust structures its investments to achieve primarily capital appreciation.

In general, the attribution rules will not apply when the transactions involving related parties are structured on "arm's length" terms, such as when a transfer of property is made in return for equal fair market value consideration, including consideration consisting of a loan carrying an interest rate at least equal to the Canada Revenue Agency's (CRA) current prescribed interest rate. Similarly, the attribution rules will generally not apply on gifts or transfers to adult children (i.e., aged 18 or over). However, where the transfer constitutes a loan for low or no interest (versus a gift) and it can be determined that one of the main purposes of the (direct or indirect) loan was to facilitate income splitting, attribution can apply even if the child is an adult.

Finally, it is important to note that similar **corporate attribution** rules can apply when a corporation is used to indirectly benefit a spouse or minor child. In addition, another important anti-avoidance rule to be aware of involving income splitting with minor children is the **kiddie-tax** provision which was introduced in 2000. Prior to the introduction of this provision, it was common for a minor child to hold shares in a private family business (typically through a family trust structure as part of an **estate freeze**) and receive dividends on these shares. Once allocated from the trust, these dividends from the private company could be taxed in the child's hands with little or no taxation assuming the child had limited, if any other sources of income. However, the kiddie-tax rules now cause affected dividends from a related private corporation to be automatically taxed to the child at top marginal rates, regardless of the child's level of income from other sources. Although the introduction of these rules significantly restricted this common planning technique, the use of family trusts to hold shares of private family business corporations for the benefit of related children may still be beneficial – for example, as a means of "multiplying" the lifetime capital gains exemption (now $813,600 in 2015) on a future sale of the shares of a qualifying small business corporation or to facilitate income splitting by sprinkling dividends to children aged 18 or over who otherwise have limited income (eg. children in school). For more information on tax and estate planning involving a family business, ask your BMO financial professional for a copy of our publications *Transferring Your Business to the Next Generation* and *Tax Planning for the Family Business.*

Income Splitting Using an Inter-Vivos Family Trust – Example Scenario

As noted earlier, the flexibility of trusts make them ideal vehicles for use in implementing various tax and estate planning strategies. While this flexibility and the control

and protection of assets offered by a discretionary family trust are concepts explored in some of our other BMO Financial Group publications (such as *Trusts for Asset Protection and Tax Savings* and *Planning for the Family Vacation Property*), it is the potential income tax benefits that can be achieved by using an inter-vivos discretionary family trust to split investment income that is the focus of this publication. To illustrate the potential tax benefits, consider the following example scenario involving the Jones family:

- John and Mary Jones have been happily married for many years and have three children, Sally, who is 19 and attending university and twins, Todd and Rod, who are both 16 and in private school. Each is a resident of Canada for tax purposes (and is not a U.S. or dual citizen).
- John is an executive who pays tax at the top marginal rate. Mary has a modest income from a part-time job, but their three children have no income.
- In addition to many significant family expenses, from his after-tax income John is paying $10,000 annually for each of Todd and Rod's private school tuition and $20,000 annually for Sally's university costs (beyond the portion of her costs that are covered from the payments to Sally from her RESP).
- As a result of cashing in stock options and a recent bonus payment, John has $800,000 in excess cash (after-tax) to invest. He is seeking to invest the funds in a conservative portfolio that returns an aggregate of 5% – i.e., $40,000/year (assuming a breakdown of $4,000 in realized capital gains and $36,000 in interest income).

Planning Options:

1. Status Quo – John invests personally

John opens an investment account in his own name and invests the $800,000. He will receive taxable income of $38,000/year consisting of interest income of $36,000 plus $2,000 of taxable capital gains (i.e., the 50% taxable portion of the $4,000 capital gains). Assuming a top personal tax rate of 45%, John will pay personal income tax of $17,100 (i.e., $38,000 x 45%) on this income. As a result, to cover the $40,000 aggregate education costs, John will need to access significant additional resources beyond the income from this investment account.

2(A) Family Trust – Without Loan

Assume that John has spoken to his lawyer and accountant and decides to proceed with a discretionary inter-vivos family trust. As outlined in the formal trust agreement drafted by his lawyer, he settles the trust with a gold coin (i.e., a non-income producing asset to avoid any attribution of income on the settlement property) and establishes his wife and three children as discretionary income and capital beneficiaries. John is careful to exclude himself as a beneficiary of the trust and also establishes Mary as the sole trustee of the trust in order to avoid application of the reversionary trust attribution rule previously discussed (although if properly drafted, it may be possible for John to be one of at least three trustees).

John then gifts the $800,000 cash to the trust, which is then invested by the trustee(s) to return the desired $36,000 of interest income and $4,000 of capital gains.

In order to fund Sally's remaining university costs, $20,000 of the interest income is allocated and paid from the trust to Sally by the trustee(s). Assuming that the total of the $20,000 interest income and any taxable Educational Assistance Payments from her RESP do not exceed the aggregate tax savings derived from her basic personal tax credit ($11,327 in 2015) and her tuition and education tax credits, Sally's tax liability will be small or perhaps nil.

To partially cover the twins' private school fees, the trustees are able to allocate and distribute the $4,000 of capital gains realized by the trust (i.e. $1,000 of taxable capital gains to each child) which should not result in any personal tax payable by the twins because of their basic personal tax credit. However, to the extent that any of the remaining $16,000 of interest income (of $36,000) is allocated and paid or made payable to the twins (or to John's spouse, Mary), this interest income will be attributed back to John and taxed in his hands because of the income

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attribution rules. As such, the income attribution rules will defeat any income splitting goals on this excess, at least until the twins turn 18 years old.

2(B) Family Trust – With Prescribed Rate Loan

This alternative is similar to the previous scenario above involving the creation of a family trust, except that instead of John *gifting* the $800,000 cash to the trust, John will establish a prescribed rate loan for $800,000 to the trust. As noted above and in our BMO Financial Group concept sheet entitled *Reduce Your Taxes with a Prescribed Rate Loan*, the attribution rules on investment income can be avoided by properly implementing a prescribed rate loan strategy.

This simple, yet effective income-splitting strategy involves transferring income-generating assets (ideally cash) to a lower-income family member (directly or indirectly through a trust structure) and taking back a loan equal to the fair market value of the assets transferred at the CRA's prescribed interest rate in effect at the time of the loan. Given the current low CRA prescribed rates, implementation of this strategy now presents a very compelling opportunity. For loans made in the third quarter of 2015, the rate necessary to avoid the income attribution rules is only 1% – this continues to be an all-time low for CRA's prescribed rate. Most importantly, if structured properly the prescribed rate in effect at the time of the loan will continue to apply until the loan is repaid, regardless of future changes to the prescribed rates. For loans made after September 30, 2015 (ie. the end of the third quarter of 2015) the CRA's prescribed rate at the time of the loan will apply over the duration of the loan.

To implement this strategy, an interest-bearing loan is made from the person in the higher marginal tax bracket to a family member (or to the trustee of a trust with family beneficiaries) in a lower tax bracket for the purpose of investing. To avoid the income attribution rules there are a number of requirements that must be met. For example, interest must be charged at a rate at least equal to the CRA's prescribed rate in effect at the time the loan is made. Interest is charged annually at this rate and must be paid by the following January 30th each year. In order for there to be a net benefit, the annual realized rate of return on the borrowed funds must exceed the annual interest rate charged on the loan, which is included in the income of the transferor and should be deductible to the transferee family member (or family trust), if used for investment purposes. By locking in this strategy at the current low rate, long-term benefits of income-splitting can be achieved to the extent future investment returns exceed this current low 1% threshold.

Based on this scenario, John will earn $8,000 interest income (ie. $800,000 x 1%) on the prescribed rate loan which is included in his taxable income. The trust can then allocate and distribute the interest income realized in excess of the interest cost to any of its beneficiaries (including Mary) without invoking the attribution rules which would otherwise apply in the absence of the prescribed rate loan.

As noted in the following summary, because of the ability to split all types of investment income with all of the trust's beneficiaries, the prescribed rate loan strategy can optimize the income tax savings by accessing the personal tax credits and lower marginal tax rates of other family members (including Mary, if beneficial) while still maintaining the desired control and flexibility inherent in the trust structure. In other situations involving different types of investments, the benefits of a low income taxpayer earning eligible dividend income can be quite substantial because of the power of the dividend tax credit at low income levels. For more information, please see our BMO Financial Group publication entitled *Eligible Dividend Income.*

Summary

	1. Status Quo	2. Family Trust	
		(A) Without Prescribed Rate Loan	(B) With Prescribed Rate Loan
Total income (a)	$40,000	$40,000	$40,000
Tax to John on loan interest (b)	–	–	$3,600[4]
Tax on interest income (c)	$16,200	$7,200[1],[2]	– [1],[5]
Tax on Capital Gains income (d)	$900	– [3]	– [3]
Total Tax (b)+(c)+(d) = (e)	$17,100	$7,200	$3,600
Total after tax Income (a)-(e)	**$22,900**	**$32,800**	**$36,400**

[1] $20,000 assumed received tax free by Sally due to personal and tuition/education tax credits
[2] $36,000 interest less $20,000 to Sally = $16,000 attributed and taxable to John at assumed rate of 45%
[3] Assumed sheltered by the twin's basic personal tax credits
[4] $800,000 x 1% = $8,000 loan interest x 45% (based on CRA prescribed rate for 3rd Quarter 2015)
[5] $36,000 interest income less $8,000 loan interest expense less $20,000 allocated to Sally = $8,000 which is assumed sheltered by the twin's remaining basic personal tax credits

In addition to the income splitting benefits, there may be other benefits to a prescribed rate loan strategy. In particular, by loaning funds instead of gifting funds to the family trust, John has the ability to receive this capital back at any time (subject to the specific terms of the loan agreement drafted), or the loan could be forgiven upon his death. However, there may be other scenarios where a gift is preferable (eg. if John may be exposed to creditors in the future) and if Mary is listed as a beneficiary of the trust, some access to the income and capital may still be available without the loan. Finally, it should be noted that if assets other than cash (such as an investment portfolio) are gifted or loaned to the trust, there is a resultant transfer at fair market value, which may trigger capital gains subject to immediate taxation (or capital losses which may be denied as 'superficial losses' for tax purposes).

Although the previous example focussed on the income splitting benefits of parents shifting investment income to their children, a similar strategy involving a trust established by grandparents for their children and/or grandchildren could be employed.

Other Considerations

While the use of a family trust can facilitate an income splitting strategy and provide control and protection over family assets, a trust structure may not be appropriate for every family. Some other considerations in establishing a family trust include:

- The additional complexity and administrative tasks and costs associated with establishing and maintaining a family trust structure, such as:

- The legal fees involved in retaining a trusts and estates lawyer to provide advice and draft the trust agreement;
- The annual costs of maintaining the trust, including legal and accounting (bookkeeping) fees and tax return preparation; and
- Annual trustee fees that may be charged by the trustee(s) unless waived.

Given these costs, unless there are valuable non-tax reasons for establishing a trust structure, it is generally suggested that a trust should not be established with less than $500,000 of capital.

- Possible immediate taxation of accrued capital gains on any assets gifted, loaned or otherwise transferred to a family trust (other than an alter-ego, joint partner or spousal trust).
- The 21-year rule described previously, which generally limits the deferral of taxation of capital gains earned by the trust, subject to possible planning strategies.
- The various income attribution and kiddie-tax rules described previously which can restrict or limit the tax planning available for minor children and spouses, particularly when the trust is established without proper planning or is implemented or documented poorly. In particular, the tax planning objectives associated with the family trust can be defeated if proper documentation and record-keeping procedures are not followed in the ongoing management of the trust, including the use of the trust funds. The CRA has been active in the last several years in reviewing family trust structures for various deficiencies, as outlined in greater detail in a subsequent section.
- The additional upkeep associated with the prescribed rate loan strategy, including the requirement to ensure payment of the loan interest by January 30 of each year.
- The settlor's/contributor's loss of the future access to the assets gifted/transferred to the trust or the future growth on any assets loaned to the trust, by virtue of the irrevocable nature of the trust.
- The additional coordination required to combine the tax and estate planning strategies involving a family trust with the broader planning strategies envisioned in the individual's Will and comprehensive estate plan for other assets.
- The additional responsibilities and limitations associated with a trust structure versus a direct gift – i.e., even if a trust is created for the benefit of an adult child who is also the sole trustee, the entitlement as a trust beneficiary differs from direct ownership of assets and is subject to the specific terms of the trust agreement. Therefore it is important that your family members understand and accept these limitations and that the trustee(s) of the trust are chosen wisely and with foresight to appoint appropriate successors, when required.

As it can be very difficult to vary or amend the terms of a trust subsequent to its creation and the changes may invoke adverse tax consequences, it is very important to engage qualified tax and legal professionals to establish and implement your family trust to ensure sufficient flexibility to meet your family's desired planning goals and objectives.

Trust Administration – Paid or Payable

As demonstrated in the Jones family example, a discretionary family trust can be an effective income-splitting vehicle if it is implemented and administered properly. In this regard, subject to the specific terms of the trust agreement and the potential application of the income attribution rules, it is possible to allocate the annual income generated in the trust to its income beneficiaries to achieve a reduction (or elimination) of the trust's taxable income and to include a corresponding amount of income in the hands of the beneficiaries, ideally those in lower marginal tax brackets. In order for this to

occur, however, the income of the trust must be considered **paid or payable** to the beneficiary. In the case of a discretionary inter-vivos trust, to the extent that the trust's income is not paid or made payable to its beneficiaries before the end of the trust's taxation year (December 31), the income will be taxed in the trust at the highest marginal tax rates.

To be considered paid, the income must actually be distributed before the year-end; whereas to be considered payable, the beneficiary must be entitled to enforce payment (before the end of the year). Typically, the trustees would exercise their discretion under the terms of the trust to allocate the trust's income to its beneficiaries and notify each beneficiary (or the legal guardian where the beneficiary is a minor and the trust indenture so permits) prior to the end of the trust's December 31 taxation year. In order to formally document the allocation, the trustees would prepare a written resolution and issue a promissory note to the beneficiaries as evidence of the debt created. In many situations, it is not possible to determine the amount of the trust's income before December 31, as such it will be important that a trustee resolution be prepared by year-end to note the intention to allocate the desired portion of the trust's actual income and notify the beneficiary accordingly. Subsequently, after year-end, the exact amount of the allocation can be formalized and the promissory note should be delivered as soon as possible thereafter. The income allocated will then be deducted in the trust's income tax return and tax slips will be issued to the beneficiaries to report this income, which are due within 90 days after the trust's year-end (i.e., March 31 for inter-vivos trusts in non-leap years).

CRA's Administrative Policy

In many situations involving discretionary (family) trusts for beneficiaries who are minors, the trustees may prefer not to make payments of the trust's income directly to the minor child. Instead, the trustees may prefer to make the payments to the minor child's parent or legal guardian to reimburse an expenditure made by them for the child's benefit or directly to a third party for goods or services provided for the benefit of the child. With regard to indirect payments, where an amount of the trust's income is paid to another person for the benefit of a beneficiary, the CRA has previously commented that it will generally consider the amount to be taxable to the beneficiary provided the payment is made with the beneficiary's direction or concurrence (or in the case of a child, the child's parent or legal guardian). Specifically, the CRA provided some guidance on indirect payments made by trusts for minor beneficiaries in *Income Tax Technical News # 11*. Although the CRA has now archived and cancelled (as of September 30, 2012) this and other older interpretive publications in its recent modernization of its technical content, some direction may be available from the administrative policies that were previously outlined in this CRA document. In particular, the policies outlined therein suggested that an indirect payment would be deductible from the trust's income and included in the beneficiaries' income (in the absence of the application of the attribution rules) where:

1) The trustee exercised his or her discretion pursuant to the terms of the trust indenture or Will to make the amount of the trust's income payable to the child in the year before the payment was made;

2) The trustee initiated the steps to make the payment, the trustee notified the parent of the exercise of the discretion, and the parent directed the trustee to pay the amount to the appropriate person before the payment was made; or the payment was made pursuant to the parent's request and direction, the parent was advised of the exercise of discretion and payment of the amount either before or after the payment was made; and

3) It is reasonable to consider that the payment was made in respect of an expenditure for the child's benefit (i.e., amounts paid for the support, maintenance, care, education, enjoyment and advancement of the child, including the child's necessaries of life).

This CRA document further recommended that the first two criteria above should be evidenced in writing and that receipts be obtained to support third party expenditures or reimbursements. To the extent that the third criterion is not met, the amount would generally not be deductible to the trust. However, the amounts may still be included in the income of the person who received or enjoyed the benefit of the payment.

Provided the expenditure clearly benefits the child, many varied expenses could qualify such as education, camps, sporting activities, arts programs, clothing and medical and dental expenses, and the child's share of grocery bills and vacation costs. However, to the extent that the parent may receive a tax benefit from an expenditure made on behalf of the child, it may be preferable for the parent to incur these specific types of expenses personally in order to preserve the parent's access to any tax credit or deduction otherwise available.

In light of the above commentary, some best practices to document and support third party payments include:

- Establishing separate bank and investment accounts for the family trust and each beneficiary.
- Establishing a streamlined process to review and document expenditures, such as requiring the submission of receipts or invoices to the trustee to detail the nature and purpose of the parents' expenditures on behalf of the child or implementing a formal written request by the parent or legal guardian to the trustee for direct payment to a third party for expenses to be incurred on the child's behalf. These requests should be formally approved and documented by the trustee(s) who would then authorize a cheque from the trust in the current year as reimbursement or direct payment to the third party, as applicable.
- Regular trustee meetings to formalize trustee distributions and resolutions. This should include a meeting prior to the end of the year to review all distributions to-date and to prepare a trustee resolution to declare a final income distribution – evidenced by either a cheque for the distribution or a promissory note in the name of the beneficiary – and informing the beneficiary (or parent / legal guardian) accordingly.
- Consultation with legal and tax counsel as necessary.

Recent CRA Audit Activity

Over the last several years, the CRA has increased its scrutiny of domestic trusts to ensure that they have been established and managed properly, and that the trustees are sufficiently aware and compliant of the relevant tax laws. In particular, some areas of concern are as follows:

- Proper establishment of the trust, including appropriate documentation, implementation (i.e. proof of the three certainties) and evidence of the settlement property.
- Proper allocation of trust income to ensure it is actually paid or payable as evidenced by the appropriate trustee resolution before the trust's year-end. This documentation should include proof of payment or a **legally enforceable** promissory note and adherence to CRA's administrative policies governing third party payments.
- Proper documentation to support that the trust funds are not being used to benefit the trustee/parent for their personal use; but rather that the child (beneficiary) is the one benefitting exclusively from the trust expenditures.
- Monitoring the 21-year anniversary date(s) of the trust and ensuring appropriate recognition of accrued capital gains on this anniversary.
- Reviewing prescribed rate loan arrangements with trusts to ensure proper documentation and implementation (including the required interest payment by January 30th each year).
- Reviewing the appropriate provincial or international tax residency of a trust in light of recent case law concerning the mind and management of the trust; especially where the trustees are not exercising their authority and may be unduly influenced by others.

Continued

Final Thoughts – Investment Choices for Family Trusts

As noted previously, a trust is generally treated as a conduit, such that any income of the trust that is allocated to the beneficiaries will retain its character in the hands of the (Canadian) beneficiaries. On the other hand, any income retained in an inter-vivos trust will be taxable to the trust similar to an individual – albeit at the top marginal tax rate and without the benefit of the basic personal tax credit. As such, the principles followed when investing for an individual are generally applicable for a trust investor; however the terms of the specific trust (in light of any investment restrictions imposed by the relevant provincial trustee legislation) must be considered. Quite often, a more conservative investment mandate may be appropriate, depending on the purpose of the trust, the attributes of its beneficiaries and the investment time horizon.

Often the beneficiaries of a family trust are minor children such that the attribution rules can apply on interest and dividend income allocated to the child beneficiaries (unless the prescribed rate loan strategy has been employed). Where attribution is a concern, investments which return capital gains – which are generally not subject to attribution when received by minor children – are typically contemplated. In other cases where the attribution rules do not apply – such as when the child is at least 18 years old or a prescribed rate loan is used – a strategy of allocating and distributing dividend income from Canadian public companies to children in school can be quite effective because of the power of the dividend tax credit, particularly to beneficiaries in lower marginal tax brackets.

Conclusion

A formal trust can be used in many tax and estate planning contexts to provide tax savings, control and protection, and as a vehicle to transfer wealth to future generations. From a Canadian tax perspective, an inter-vivos family trust can facilitate income-splitting to lower the overall family tax burden through the funding of family expenses, such as children's educational costs in excess of RESP limits. As a result, the use of a discretionary family trust should be considered as a tax-efficient planning strategy for parents (or grandparents) who wish to provide assistance to other family members facing significant expenditures.

The commentary provided herein is neither a comprehensive review of the subject matter covered nor a substitute for specific professional tax and legal advice. The strategies contained in this publication may or may not be appropriate for you. As such, we encourage you to consult with independent tax and legal professionals to confirm the anticipated implications to your particular situation in light of the current income tax and other relevant legislation and CRA's current assessing practices, when developing and implementing any strategies.

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