BMO NESBITT BURNS

Trusts for Asset Protection and Tax Savings

Why Should I Consider Using A Trust?

A Trust is a special way of holding property which, if structured properly, can provide protection for your wealth and can also be used to reduce taxes. If you wish to transfer your wealth to your children but you have concerns about their ability to manage the wealth, or if you worry that your children may not protect and preserve the wealth beyond their lifetime (perhaps due to a spendthrift lifestyle or marital difficulties), using a Trust as a vehicle to transfer your wealth may be the solution.

Advantages Of Using A Trust

Trusts can provide protection for your wealth and tax advantages such as income splitting to reduce the aggregate taxes payable by you and members of your family. Without a Trust, your assets may be vulnerable to creditors, be depleted by spendthrift family members, and be subject to higher taxes. Generally, property held in a Trust for the benefit of others is not subject to probate tax (or probate fees depending on your province) upon your death since such property does not form part of your estate. Probate costs vary from province to province. In Ontario, using a Trust specifically for purposes of probate planning as part of your overall estate plan may translate into estate savings of approximately $15,000 for every $1 million held in the Trust.

A reduction in probate costs and income taxes, across generations, can be achieved by using a Trust. For example, your adult child and his or her children (your grandchildren) can receive income and capital distributions during your lifetime. Upon your death, your estate would not have to pay probate on the property held in that Trust and your child and grandchildren would continue to receive income and capital distributions. Upon the death of your adult child, the property still held in the Trust would not be subject to probate, a savings of probate tax for the estate of your child. Your grandchildren could continue to receive income and capital distributions from the Trust after the death of their parent, depending on the specific terms of the Trust you created.

A spousal Trust is often used to deal with more complex family structures, such as when your spouse is not the parent of your children. Such a structure is effective to ensure that your surviving spouse is able to maintain his or her standard of living and lifestyle after you are gone, while preserving (to the extent you dictate in the Trust document) the capital for the benefit of your own children. The spousal Trust is created to benefit your surviving spouse during his or her lifetime by way of mandatory income distributions and discretionary capital distributions. Upon your surviving spouse's death, your children would receive all the property, originally your wealth, remaining in the spousal Trust.

Trusts are often used for the benefit of a disabled beneficiary without jeopardizing that beneficiary's right to government disability benefits. It is also possible to create a Trust for a spendthrift beneficiary and structure it in such a way that it prevents the depletion of the Trust assets and provides protection from creditors.

How Do Trusts Work?

The term "Trust" symbolizes a relationship which is created when a person who initially owns property (the *Settlor* of the Trust) transfers possession and legal ownership of the property to someone else (the *Trustee* or *Trustees* of the Trust) to hold the property for the benefit of someone else (the *Beneficiary* or *Beneficiaries* of the Trust) according to certain terms. In order for a Trust to be validly created, there must be:

i) expressed (verbal or written) intention of the Settlor to permanently give up possession and control of the property and to create the Trust accompanied by delivery to the Trustees of the Trust property,

ii) a clear and precise description of the property to be held in the Trust, and

iii) a clear and precise description of who the Beneficiaries are.

These are referred to as the *Three Certainties*.

The Trust is not a legal entity, but is considered a separate taxpayer for income tax purposes. It is the Trustee who represents the Trust in that he or she has legal rights to the property. Therefore, only the Trustee can take actions on behalf of the Trust. The Trustee must act according to the intentions of the Settlor as expressed in the Trust document (commonly referred to as the *Trust Declaration*, *Trust Agreement* or *Trust Instrument*). It is the separation between legal and beneficial ownership that gives the Trust its flexibility in the control, management and distribution of Trust property.

Why Is The Trust Declaration Important?

A properly drafted Trust Declaration is a crucial part of an effective Trust structure. The Trust Declaration reflects the Settlor's intentions and outlines the powers granted to the Trustee. In particular, it contains instructions to the Trustee regarding how income and capital distributions are to be made, when and to whom. The Trust Declaration determines when the Trust will be terminated and who the ultimate Beneficiaries will be (perhaps other family members or charities).

In addition to the *Three Certainties*, a Trust must meet certain requirements in order to be valid. This means that the language used in the Trust Declaration – the terms of the Trust – must be considered carefully. For example, a Trust cannot exist indefinitely. Properly structured, a Trust can be used by a grandparent to provide for the distribution of his or her wealth to grandchildren who are not yet born. The choice of the Trustee must also be considered carefully. Among other requirements, the Trustee should possess sufficient knowledge regarding financial affairs including investments. He or she should not be in a position of conflict with any of the Beneficiaries' interests. In some circumstances it is appropriate to appoint a professional Trustee, namely, a corporate Trustee. This option is advantageous in that the corporate Trustee does not die leaving a void, and the corporate Trustee is not related to family members who are Beneficiaries, so this Trustee is truly independent, with no conflict of interest.

Tax Planning Advantages

There are two basic types of Trusts. A Trust that is created by an individual during his or her lifetime is an inter-vivos Trust. A Trust that is created upon

the death of an individual under the provisions of his or her Will or a Trust Declaration, such as Life Insurance Trust, is a testamentary Trust. Since the Trust is a taxpayer, it must file annual income tax returns. One important difference between the two types of Trusts is that the income earned and taxed within an inter-vivos Trust is taxed at the highest marginal tax rate (39% to 50% depending on the province), while income earned and taxed within a testamentary Trust is taxed at graduated tax rates, like any other individual taxpayer.
This means that testamentary trusts can be used as an income splitting vehicle to provide tax savings for Beneficiaries by reducing the tax payable on the investment income from the inheritance.

Using a testamentary Trust as part of your estate planning permits income splitting between the (testamentary) Trust and the Beneficiaries, with potential tax savings in excess of $10,000 per annum. The testamentary Trust can be used to split income between the Trust and a surviving spouse, children, grandchildren and any other Beneficiaries. The attribution rules that restrict the ability of inter-vivos Trusts to income split effectively, do not apply to testamentary Trusts. This means that your Will can create and fund a family Trust for each of your children and their family members. Your adult child could be appointed the Trustee, with authority to distribute income and capital to the Beneficiaries, on a discretionary basis. Inter-vivos Trusts can be used effectively in tax planning during your lifetime, particularly if the Trust terms provide for flexibility. For example, a Trust for minor children can provide a reduction of capital gains tax otherwise payable by the Trust, while a Trust for adult children can provide tax savings by way of transferring income to a Beneficiary whose tax bracket is lower than that of the contributor to the Trust and that of the Trust.
In addition, the recent low prescribed interest rates have created an opportunity to split other types of investment income among family members through the use of a prescribed rate loan to a family Trust.

For more information on this planning strategy, see our concept sheet entitled, *Reduce Your Taxes with a Prescribed Rate Loan*.

Conclusion

The asset protection and tax planning opportunities provided by Trusts makes them an attractive financial and estate planning tool. Trusts are extremely flexible and can be tailored to address specific needs.

Professional advise is essential when creating a Trust. Contact your BMO Nesbitt Burns Investment Advisor if you would like an introduction to a professional advisor, in order to understand the potential benefits of using a Trust in your family and financial structures.

Note: Some terms are capitalized for purposes of greater clarity in the context of this discussion only.

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