In-trust accounts

In-trust accounts are increasingly popular. They can provide a tax efficient opportunity to provide a savings plan for a child to help offset future education costs or a nest egg for a beneficiary when he or she reaches the age of majority. For the donor, they offer not just investment potential, but also the opportunity to split the capital gains portion of the total return on the investment with a minor. The following provides an overview of in-trust accounts.

What is an in-trust account?

An in-trust account is an "informal trust" you can create at a financial institution to invest funds on behalf of a minor. The account is set up as a trust because children under the age of majority cannot enter into binding financial contracts, nor can they accept a gift under a will. You or another adult is then responsible for investing funds for the child and signing the contract on the child's behalf.

Parents and other relatives frequently use in-trust accounts to save money for a child, often for tuition fees or for other purposes such as a down payment on a first home. An adult can open an in-trust account for a child so that the child can save birthday and holiday gifts, as well as Canada Child Tax Benefit payments. Inheritances not already governed by a formal testamentary trust created by a will can also be managed on behalf of beneficiaries through in-trust accounts.

Definitions

The following are some definitions of components required to set up a trust.

Donor – a person giving a gift or contributing an asset to the child.

Beneficiary – a person who benefits from the account's assets. The beneficiary of an in-trust account is usually a minor child or children related to the donor. The beneficiary and not the donor or trustee is the ultimate owner of the assets.

Asset – the money or any other property that the donor contributes.

Trustee – in a trust relationship, the assets must be managed on behalf of the beneficiaries. For an in-trust account, a trustee is appointed who

has the responsibility of doing this for the benefit of the child until he or she reaches the age of majority.

What is the difference between a formal and an informal trust?

An in-trust account is an informal trust because the investment contract with the in-trust account designation is the only document detailing the trust relationship. This is not a formal relationship, and often in-trust accounts may not be recognized in law without suitable supporting documentation. It's important that you ensure that the application establishing the in-trust account is completed properly.

For example, be sure the trustee and beneficiary are clearly identified. This supports the trust relationship and ensures the beneficial ownership of the account remains with the beneficiary. If you are the donor, you may wish to have a written document that clearly states that you are permanently giving the assets to the trust for the benefit of the named beneficiary. This will make your intentions clear in the event of any future legal or tax issues that may arise.

On the other hand, a formal trust is usually created by a legal document known as a deed of trust. It's a much more comprehensive process. The deed identifies the donor(s), trustee(s), beneficiary(ies) and assets of the trust. It specifies how the assets of the trust are to be administered, how long the trust is to continue, and indicates when and how the trust's assets are to be distributed to the beneficiary(ies). A testamentary trust is created upon the death of the testator. The supporting document for a testamentary trust is generally the will. Formal trusts can be simple or complex, but all generally require drafting by a lawyer.

Who pays the tax?

In *Joseph Blum v the Queen* (Tax Court of Canada, September 22, 1998), Joseph Blum, an 83 year-old Polish grandfather appealed a reassessment by the Canada Revenue Agency (CRA). The CRA had attributed capital gains income to Blum that had previously been taxed in the hands of his grandchildren. The shares in question were issued from his own companies in his name, but were held in trust for his three grandchildren. Mr Blum won his appeal, as it was determined that although there was no formal trust agreement, a trust had been established because all the certainties of a trust were present. The shares had been delivered into his name as trustee for trust property, the shares were the trust property, and there were three clearly identified beneficiaries.

Does a beneficiary always have to be specified?

Yes. If an account is designated as an in-trust account (i.e., there is no formal trust agreement) and there is no beneficiary named on the application form, one of the major criteria for establishing the trust relationship is missing. Without a beneficiary there is in fact no trust and therefore you would not be entitled to any of the associated benefits. AIM Trimark's application form identifies the trustee and the beneficiary. More than one trustee and more than one beneficiary may be specified on each account.

How is the in-trust account taxed?

In short, if you put money into an in-trust account for either a related minor child or a minor with whom you do not have an arm's length relationship, all income is attributed back to you. If you are a Canadian resident you would then include these amounts in income and pay the related taxes. Related children include children, grandchildren, nieces and nephews, among others. Income includes interest and dividends.

There are some exceptions. For example, the child pays the tax if the funds are provided solely from Child Tax Benefit payments or an inheritance. (The income is not attributed back to you.) Similarly, if the child contributes the money to the account, perhaps through a part-time or summer job, the income would also be taxed in the child's hands. It is the trustee's or trustees' responsibility to document the source of the funds in an in-trust account, as well as to account for the appropriate income tax treatment.

Capital gains, whether from distributions from the fund or from the sale of assets in the account, may, if the account is set up properly, be taxed in the hands of the child. For more information, see under the heading, "What are some of the tax advantages of in-trust accounts?"

What happens when assets other than cash are contributed to the account?

If you contribute or transfer assets to an in-trust account, you are deemed to have disposed of those assets at fair market value on the transaction date. If the market value of the asset is greater than its original cost, you may be subject to capital gains tax. The informal trust would then be deemed to have acquired the assets at the fair market value on the transfer date.

Capital gains, whether from distributions from the fund or sale of any assets in the account, may, depending on how the in-trust account is set up, be taxed in the hands of the child.

As a donor, can I get my money back?

No. In-trust accounts may be "informal" trusts as there is no trust deed, but they are still legal and valid trusts and the rules are very clear. Depositing funds into an in-trust account forever "divests, deprives and dispossesses" you of title to the deposited funds and vests the property irrevocably in the beneficiary's or beneficiaries' hands. If assets are indeed taken out of the

in-trust account, they must be used for the child's benefit. The trustee manages, but is not entitled to, the funds in the account.

What are some of the tax advantages of in-trust accounts?

Contributions made to an in-trust account are not tax deductible. However, the opportunity for income splitting of capital gains may create some tax-planning opportunities. This is especially true when you are saving for a minor for educational or other purposes.

If you contribute to an in-trust account for a minor and the investments provide primarily capital gains, the child pays the tax. As the child would normally be in a lower tax bracket than you, you would have effectively achieved income splitting. You could continue with this strategy until the child turns 18. At that point all capital gains and income would be taxed in the hands of the child, whether or not the plan is transferred into the child's name or remains in-trust.

Investments that have capital growth as their primary investment objective are ideal for an income splitting strategy. In addition, capital gains are generally taxed more favourably than investment income. For this strategy to work, care must be taken to ensure that the in-trust account complies with the applicable tax rules. The provisions of the Income Tax Act (Canada) state that both income as well as capital gains earned by a trust may in some situations be attributed back to the donor. This can happen if the terms of the trust are such that the property may only be disposed of with the consent of, or in accordance with, the direction of the donor. The CRA has generally interpreted this to mean that the provision will apply if the donor is also the trustee of the account. This would apply regardless of the relationship between the donor and beneficiary.

There are various other pitfalls that may prove to be a trap for the unwary. We recommend that you discuss any proposed arrangements carefully with your financial planner and tax consultant.

What happens to income on income?

Income on income, also known as secondary income or second-generation income, is income earned on the first-generation income that is retained in the account. First-generation income has already been taxed in the hands

No turning back

In *Koons v Quibbell*[1] a second wife set up two trusts for her late husband's grandchildren as they were left out of his will. They were to receive the trust proceeds at age 18. The first grandchild to turn 18 received his account, but before the second grandchild turned 18 the second wife cashed in her plan and used the funds for her own family. The court awarded the grandchild with the amount of the account plus interest, on the grounds that the trust account had been set up properly, thereby making the gift to the grandchild irrevocable.

[1](1998) 21 E.T.R. (2d) 66 (SASK)(QB)

of the donor so any income earned on these taxed earnings will become income of the child, without further attribution.

Meticulous records have to be kept to track this secondary income. The easiest way to do this is by moving first-generation income into a separate account that then earns future or secondary income that is not subject to attribution.

AIM Trimark's Customizing Service enables unitholders to transfer distributions from one fund or account to another. If an existing account derives income solely from the old Family Allowance Benefit or the Child Tax Benefit programs, these "taxed" distributions could be transferred to this existing account, which is not subject to the attribution rules.

What happens when the child reaches the age of majority?

When the child reaches the age of majority of 18 or 19, depending on the province, he or she may take control of the funds. Beneficial ownership of the account has always resided with the child. Although the trustee has managed the money, the informal trust may be dissolved when the beneficiary reaches the age of majority. AIM Trimark will not give the child access to the funds automatically – we will await instructions from the trustee(s). It is important to note that the child is legally entitled to demand that the trustee(s) distribute the trust proceeds to him or her, regardless of the child's intentions for the money. The child could take legal action against the trustee(s) if the trustee(s) decline to transfer the assets to the child.

For accounts in Quebec, once the beneficiary reaches the age of 18, instructions can only be taken from the beneficiary.

Assuming the account has been set up properly, there should be no capital gains implications to changing the registration from an in-trust account to the beneficiary's name because there has not been a disposition of any assets in the account. All future income and capital gains transactions will then be taxed in the hands of the now-adult beneficiary, and the donor will no longer face any tax implications.

Who's in control?

In *Lampron v Lampron*[2], the court determined that the value of three in-trust accounts had to be included in the total of net family property of the wife, for the purposes of calculating the equalization payment. The reason for this was that the parents were both the donors and the trustees of the accounts. This resulted in the trusts not being irrevocable and therefore the funds remained in the control of the parents. The end result was that the wife received a lesser equalization payment than she would have, had the accounts had a separate donor and trustee.

[2] 2004 A.C.W.S.J. 315

What happens if the donor or trustee dies before the beneficiary reaches the age of majority?

If the donor dies, attribution ceases and all future income earned in the account will be taxed in the child's hands. If the trustee dies, then the trustee's executor will turn to the will to see if a replacement trustee has been named. If a replacement trustee is not named, then the account could remain in the name of the estate until the beneficiary attains the age of majority.

It is possible to set up the in-trust account with joint trustees. Upon the death of one trustee, the surviving trustee will continue to manage the account.

What happens if the beneficiary dies before reaching the age of majority?

If the minor child dies, the assets in the trust will be distributed according to provincial laws dealing with intestacy (no will) because minors in most cases are not legally entitled to draw a will.

Are there any risks in contributing or transferring assets to an in-trust account?

As discussed above, if the account is not set up properly, the CRA may challenge the income-splitting arrangement. This may result in capital gains as well as income being attributed back to the donor.

If assets are transferred to an in-trust account in order to avoid creditors or to avoid the division of assets upon marriage breakdown, this could be seen as being a fraudulent conveyance. An improper transfer of this kind may result in a court order demanding that the funds be removed from the in-trust account.

Choose the best option for you

In-trust accounts can offer investment potential along with the opportunity for income-splitting with a minor. The savings can offset future education costs or provide a nest egg for the beneficiary when he or she reaches the age of majority. Nevertheless, every family and individual is unique, so it is important that you talk with your advisor, lawyer and/or tax advisor to find out the options that are best in your situation. Once you have your plan in place, don't forget to review it from time to time, or as your circumstances change.

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