

THE STRATEGIC USE OF TRUSTS

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For many families, trusts can play an integral role in the planning process. There are a variety of reasons why transferring property to a trust may be beneficial to you and your family. Let's briefly highlight how a trust works, some common uses of trusts for planning, along with new reporting requirements for Canadian trusts beginning in 2023.



What is a trust?

A trust is a relationship where someone (the “settlor”) transfers legal ownership of property to someone else (the “trustee”) whose role it is to manage the property for the benefit of the beneficiaries. If you are the settlor, although you legally transfer ownership, you can specify how you’d like trust assets to be managed, invested and ultimately distributed in the terms and conditions of the trust document or will.

There are three requirements to create a trust:

- You (as the settlor) must intend to create a trust;
- You must transfer existing identifiable assets to the trust; and
- It must be easy to determine who the beneficiaries are both initially and at any point in the future while the trust exists.¹

Types of trusts

For tax purposes, there are two main types of trusts:

- An inter-vivos trust that is both created and takes effect during the settlor’s lifetime.
- A testamentary trust, which only comes into effect as a consequence of death. It is typically created by will or beneficiary designation or declaration.

¹ The rules differ under the Quebec Civil Code. Under civil law, a trust is defined as a patrimony constituted by a settlor who transfers property from his patrimony to another autonomous and distinct patrimony that is allocated for a particular purpose and is entrusted to one or more trustees to administer. Acceptance of the administration of the trust by the trustee is sufficient to make certain the rights of the beneficiary. In order to be validly constituted, an independent trustee must be in office, and must be a person who is neither the settlor nor one of the beneficiaries.

In addition, a trust can be either discretionary (for which the trustees decide if and when to pay income and capital, and to whom to pay it), or non-discretionary (for which the trust document outlines when to pay income and capital, and to whom to pay it.)

Certain types of trusts are known as “life-interest trusts.” A life-interest trust is a trust that provides for one or more beneficiaries during their lifetime, and a residual beneficiary after their death. The most common life-interest trusts are those that provide for an individual and/or the individual's spouse or partner² during their lifetime(s), and then the property in the trust remaining at death (of the survivor) is left to other beneficiaries, such as children or a charity.

Three common types of life-interest trusts for tax purposes are:

Alter Ego Trust: The individual (age 65 and over) who establishes and contributes to the trust is the only life interest beneficiary.

Joint Spousal or Partner Trust: The individual(s) (age 65 and over) who establishes and contributes to the trust and their spouse or partner are the only life interest beneficiaries.

Spousal or Partner Trust: The spouse or partner of the individual who establishes and contributes to the trust is the only life interest beneficiary.

For these trusts, there are limits on who gets the income and capital during the life interest.



Tax Implications

If you transfer capital property (such as stocks and bonds) to a trust, for tax purposes you generally are treated as if you have sold the assets at fair market value at the time of the transfer. This generally results in tax payable on any capital gain with some exceptions.³ If you realize a capital loss, however, it may be denied under the superficial loss rules.⁴

The trustee may distribute income and capital to beneficiaries as the trust document permits. If income is paid (or payable) to a beneficiary in the year it is earned, it can be deducted from the income of the trust and then becomes taxable to the beneficiary. Income retained in the trust is generally taxable at the highest marginal tax rate.

Strategic uses of trusts

There are many reasons that you may decide to set up a trust. Each of these requires a cost—benefit analysis and may not be appropriate in all circumstances.

Inheritance Protection

You may have a spouse or partner whom you wish to provide for after your death but also want the remainder of your estate to be passed to your children after the death of your spouse or partner. If your children are from a previous relationship, you may want to use a life-interest trust to preserve the inheritance for those children. You could, for example, set up a spousal or partner trust in your will that specifies that income from the assets in your estate, or a portion of the assets, will be available to provide for the needs of your surviving spouse or partner during their lifetime, but that the remaining estate assets will ultimately go to your children upon your spouse's or partner's death. This can also be done with a trust set up during your lifetime.

² In this article, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the Income Tax Act, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

³ Some exceptions apply for transfers to certain trusts such as an alter ego trust, a joint spousal or partner trust or a spousal or partner trust.

⁴ These rules apply if property that you dispose of is reacquired within 30 days and is still held on the 30th day by you or an affiliated person. This includes a trust that has you or your spouse or partner as a majority beneficiary.



Trusts for minors

Trusts are frequently used for gifts or bequests to minor beneficiaries, who have not yet reached the age of majority (which is 18 or 19 years of age, depending on the province or territory of residence.) Since a minor cannot legally manage the funds, it's often desirable to appoint someone to manage the funds on behalf of the child until the child reaches the age of majority, or at a later, more appropriate age.

Control distributions to beneficiaries

Another benefit of using a trust is that your trustee can maintain control over both the timing and amount of distributions to your beneficiaries. For example, you may establish a testamentary trust in your will that specifies that half of a child's inheritance would be distributed when they reach age 30 and the other half is distributed at age 40. This level of control could be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves. You could even provide trustees with the flexibility to allow for changes in the amount and timing of distributions, or perhaps even which beneficiary to pay to, based on future circumstances.

Dependents with a disability

In many provinces, it is possible to set up a trust to provide support for dependents living with a disability, without compromising government benefits. This may occur, for instance, where a trust gives complete discretion to trustees as to the timing and amount of distributions. These are commonly referred to as "Henson Trusts".⁵ Other trusts may be set up for a limited amount of assets, possibly from either an inheritance or proceeds of a life insurance policy, without impacting government benefits.

While the income of most trusts is taxed at the highest personal marginal tax rate, there is an exception for a qualified disability trust (QDT), which is instead subject to graduated progressive tax rates. In order to be a QDT, the trust must arise as a consequence of death, and at least one beneficiary must be eligible for the disability tax credit. This may permit a larger amount of after-tax income to be accumulated within the QDT.

Income splitting

If you are in a high tax bracket and want to benefit family members who pay tax at lower rates, you could loan funds at (or above) the government's current prescribed rate of interest⁶ to an inter vivos trust with family members (such as your (grand)children) as beneficiaries. If the loan is structured and operated properly, income that is paid from the trust to the children, or payable on their behalf for expenses such as private education, summer camps, and recreational programs, can be taxed in the (grand) children's hands at their lower tax rates. This can mean significant annual family tax savings where income can be earned above the prescribed rate of interest.

The net effect of implementing a prescribed rate loan to a trust could be to have only interest income at the prescribed rate taxed in the hands of the higher-income family member, while any investment income earned by the trust (net of the interest paid at the prescribed rate) may be taxed in the hands of the trust beneficiaries.

⁵ The "Henson Trust" is named after an Ontario Appeal Court decision (Ontario Ministry of Community & Social Services vs. Henson (1989), 36 ETR 192 (Ont. CA)) involving a father who established a fully discretionary trust for his daughter. The Ontario Ministry of Community and Social Services tried to look through the trust such that she would be disqualified from certain asset-tested government benefits. The Court ruled that the assets were not to be considered hers. In early 2019, the validity of the Henson trust was upheld by the Supreme Court of Canada in the [S.A. v. Metro Vancouver Housing Corp](#) case. Consult a legal advisor, as some provinces and territories may not recognize Henson trusts for purposes of government benefits.

⁶ From January 1, 2023 to March 31, 2023, the prescribed rate is 4%. At times the prescribed rate has been as low as 1%.

Privacy

A trust may provide confidentiality on your death. Generally a trust agreement is a private document, while probating a will in most provinces and territories is a public process with the nature and value of assets generally available for anyone to review. Various trusts, such as a life-interest trust, set up during your lifetime, can be used as a will substitute⁷ to provide privacy instead of having your property pass through your will, which is generally public.

Probate/Estate administration tax

Depending on your province, setting up a trust during your lifetime and transferring your assets into the trust while you are alive may result in reduced probate fees or estate administration taxes, since assets placed into these trusts are generally not included in the estate value. Alter-ego and joint partner trusts are often used for probate planning since transfers to these trusts are not taxable if the transferor is at least 65 years of age.

Minimize disputes among heirs

An inter vivos trust may assist in minimizing disputes among heirs. A will may be contested on the basis that the testator lacked mental capacity to make the will or undue influence was exerted on the testator. This is less likely to occur with a trust set up during your lifetime when you directed and carried out the trust settlement.

Estate Freeze

An estate freeze allows an owner-manager to pass the company's future growth to one or more children, other family members, or even third parties while maintaining a degree of control over the company, and limiting capital gains tax that will be payable on death by the owner-manager. New common shares would be issued to the family members (or others), who would then be entitled to the future growth of the company. Where younger family members are involved, you may want to establish a family trust. Instead of having the children receive the property directly at the time of the freeze, a trust would subscribe for the common shares and hold the shares for the benefit of the family members.



⁷ Note that it's still generally advisable to have a will to cover off any residual assets or personal effects that have not been transferred to the life-interest trust.

Matching incentive trust

A matching incentive trust can be used to motivate the behaviour of a beneficiary. This trust is generally designed to provide distributions to a beneficiary when they engage in desired behaviours, such as attending post-secondary education or engaging in employment or self-employment. For example, the trust may specify that in order for the beneficiary to receive \$50,000 of income annually from the trust, they must demonstrate that they earned at least \$50,000 of income on their own that year.

Offshore inheritance trusts

Offshore inheritance trusts can provide a significant opportunity for tax savings if a foreign family member is planning on leaving assets by way of a gift or inheritance to a Canadian resident. For example, suppose you live in Canada and expect to receive substantial funds from a parent who has always resided outside Canada. It may be possible for your parent to transfer the assets into a foreign trust without Canadian tax being levied on the trust assets or income. If the trust is located in a low (or zero) tax jurisdiction, there may be no tax anywhere on the annual income or growth of the inheritance. The transfer must be made directly from your parent to the trust; if you receive the funds first and then transfer them into an offshore inheritance trust, the tax-free benefits will not apply.



New trust reporting rules

Starting for trusts with a taxation year ending on December 31, 2023 or later, most Canadian trusts will be required to file a tax return, even if they have no taxable income. In previous years, generally only trusts with tax payable or certain transactions, such as dispositions of capital property or distributions to beneficiaries, were required to file. In addition, beginning for those tax returns, most trusts⁸ will be required to report additional information, including the identity of the trustees, beneficiaries and settlors, as well as any other person who has the ability to control or override trustee decisions.⁹ Trusts that fail to report required information may face significant penalties.¹⁰

In summary

Since trust and tax laws are very complex, advice should be obtained from legal and tax professionals prior to implementing any of the trust strategies outlined above.

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⁸ Certain trusts are exempt from these rules. For example, QDTs and trusts holding less than \$50,000 in deposits, government debt and listed securities are also exempt from the rules.

⁹ Quebec has indicated that it intends to follow these new federal reporting requirements.

¹⁰ Further information on these new trust reporting rules can be found in or report "Enhanced Trust Reporting Rules" which can be found online at https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/enhanced-trust-reporting-en.pdf.

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