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FINANCIAL ADVISORY SUPPORT

Taxation of In-Trust Accounts

Who pays the tax?

When you receive your T5, T3 or other tax reporting slips for your in-trust account, you may ask who is required to report the income and capital gains on the slips for tax purposes. This article discusses these as well as general tax issues related to in-trust accounts.

For the purposes of this article, we have assumed that all individuals are residents of Canada in a province other than Quebec. In addition, we have not discussed any complications that may arise if any of the individuals involved are U.S. persons (U.S. citizens or green card holders) or residents of a country other than Canada.

The discussion in this article is not valid for residents of Quebec since an in-trust account in Quebec may not be considered a trust and the assets in the in-trust account may be considered to belong to the account holder. Quebec Civil Code stipulates that a trust only results from the following elements: an act whereby a person, the settlor, transfers property from his patrimony (1); to another patrimony constituted by him (2); which he appropriates to a particular purpose (3); and which a trustee undertakes, by his acceptance, to hold and administer (4). This means that to have a valid trust in Quebec it has to be a formally documented trust that has all the four elements above. Therefore, for Quebec purposes, all income/losses and capital gains/losses of the in-trust account are reported by the account holder. If the assets in the in-trust account were transferred by someone other than the in-trust account holder then the attribution rules should be considered.

Who pays the tax?

The answer depends on your intentions and actions and how the arrangement is really viewed by Canada Revenue Agency (CRA). CRA has said that for tax purposes, no distinction is made between a formal trust and an informal trust except that it is typically more difficult to establish whether an informal trust is in fact a valid trust.

If the nature of the arrangement is such that no trust is established and the facts, including the manner in which you handle the account, indicate that no actual transfer of property has been made to your child/grandchild or other related minor, the income from the in-trust account will remain your income.

If the in-trust account represents an actual transfer of property to your child/grandchild or other related minor at the time the property is deposited to the account, such that you are acting solely as the child's agent or guardian of his/her property, the income from the account will be that of the child, subject to the application of the attribution rules.

If there is neither a trust nor a gift, the income is taxed in your hands since there has been no transfer of property.

Therefore, to determine the taxation of your in-trust account, you must determine which scenario your situation falls under: (1) the account is yours but you have segregated it for a specific purpose or for a specific person(s); (2) you gifted the money to a specific person(s) and you are acting as that person's (those persons') agent or guardian of the property; or (3) you have established a trust for the benefit of a specific person(s).

In the first scenario, the taxation is simple. Since the account belongs to you, you will continue to be taxed on all income and capital gains reported on the T3 or T5 slips.

The second scenario is a little more complicated. Here you are arguing that the funds in the account were gifted to a related minor, but you are acting as their agent or guardian of property since they do not have the legal capacity to enter into legally binding contracts such as purchasing financial instruments. However, in most provinces, a parent cannot automatically act as a child's guardian of property; although, it may be acceptable to act as guardian of property where the funds are below a certain threshold (varies by province). In addition, a minor cannot enter into an agency relationship. If this argument is successfully made, then any income and capital gains belong to the child, but of course are subject to the attribution rules for gifts to related minors. The attribution rules are discussed later on.

In the third scenario, you must first determine whether your in-trust account is a trust under law. The existence of a trust is determined by the relationship between the settlor, the trustees and the beneficiaries. In the case of an in-trust account, the relationship may not be defined by a formal written document, but rather determined by the applicable trust legislation and common law. Under common law, a trust exists when there are three certainties: (1) certainty of intention to establish a trust, (2) certainty of beneficiaries and (3) certainty of trust property. The attempt to establish a trust will fail unless it is certain that you intended to bring a trust relationship into existence and both the property and the beneficiaries or other objects of the trust are described with adequate certainty. Whether the three certainties are present or not is a question of fact in each particular case; therefore, the best evidence of this is a written trust document, which minimizes the risk of anyone arguing differently. The certainty of intention is established where it is clear that a trust relationship was intended as opposed to some other relationship such as an agency or just earmarking assets for a particular use with no real transfer of beneficial ownership. The property must be clearly identifiable in order for the certainty of property to exist. And finally, the beneficiaries must be identifiable. Where you open an in-trust account for your children or grandchildren, in absence of a formal trust document, the certainty of intention to establish a trust is a difficult one to prove.

For income tax purposes, if it is determined that a trust exists, the trust is treated as a separate person and the taxable income, including gains, of the trust is generally determined in the same way as any other individual. However, a trust is not entitled to claim any of the personal tax credits (e.g. basic personal exemption or spousal amount) and will also be subject to the tax rules for trusts. Any income/losses and capital gains/losses earned in your in-trust account will be taxed in the trust unless the income or capital gains are paid or made payable to the beneficiaries. The trust is taxable at the highest marginal tax rate since it is an inter vivos trust (created during the lifetime of the settlor). Therefore, it may make more sense to ensure that all income and capital gains are paid or made payable to the beneficiaries. Any income and capital gains paid or made payable to the beneficiaries may be taxed in their hands **subject to the attribution rules discussed in the next section.**

Attribution

Where you transfer or loan property to a related minor child, any income or loss from the property in the taxation year is deemed to be your income or loss. An exception is made for a minor who turns 18 before the end of the year or for loans at commercial interest rates or the CRA prescribed rate. Where the transfer or loan is made instead to a trust for the benefit of the related minor child, the income earned by the trust on the property that would otherwise be reported by the minor is deemed to be your income. However, attribution of taxable capital gains and allowable capital losses does not apply to attribute such gains and losses from a related minor child, whether or not the arrangement constitutes a trust.

In addition to these attribution rules noted, the Income Tax Act contains a “super attribution” section that applies where property in a trust is held on the condition that it may either revert back to the contributor or pass to persons to be determined by the contributor at a time after the creation of the trust; or that during the lifetime of the contributor, the property shall not be disposed of except with the contributor’s consent or in accordance with his/her direction. If any of these conditions are present, then any income/losses and capital gains/losses earned by the trust on the property transferred are deemed to be those of the contributor while the contributor is alive and resident in Canada, regardless of the age of the beneficiaries. This condition may exist in cases where the trust is a revocable trust or where the contributor is the sole trustee of the trust or the controlling trustee of the trust. A perfect example of this is where a parent contributes money to an in-trust account for his/her children and he/she is the sole trustee of the in-trust account. This situation may be avoided if one parent contributes the funds to the in-trust account and the other parent is the trustee of the account. Another way to potentially avoid these rules is to have the contributor be one of three trustees but with no controlling powers. This is not usually possible with in-trust accounts.

An exception to these attribution rules applies where the funds in the in-trust account came from the minor beneficiary through such sources as the Child Tax Benefit, the Universal Child Care Benefit, his/her own employment income, gifts from non-resident individuals or an inheritance. In these cases, all income (interest, dividends and capital gains) earned on these funds are taxed in the beneficiary’s hands.

Filing requirements

Trustees are generally required to file a T3 Trust Income Tax and Information Return (T3) annually with respect to each trust of which they are the trustees. You have to file a T3 return if income from the trust property is subject to tax, and in the tax year, the trust

- has tax payable;
- is a Canadian resident and has either disposed of or is deemed to have disposed of a capital property or has a taxable capital gain;
- is a non-resident throughout the year and has a taxable capital gain or has disposed of taxable Canadian property;
- is a deemed resident trust;
- holds property which is subject to the super attribution rules discussed;
- has provided a benefit of more than \$100 to a beneficiary for upkeep, maintenance or taxes for property maintained for the beneficiary's use; or
- receives from the trust property any income, gain or profit that is allocated to one or more beneficiaries and the trust has
 - total income from all sources of more than \$500;
 - income of more than \$100 allocated to any single beneficiary;
 - made a distribution of capital to one or more beneficiaries; or
 - allocated any portion of the income to a non-resident beneficiary.

Therefore, where an in-trust account is considered a trust and the trust has earned income of more than \$500, has earned any capital gains from the disposition of property or has allocated income of more than \$100 to any one beneficiary, then a T3 return is necessary.

Where the attribution rules apply (but not the super attribution rules) to income because the beneficiaries are related minors, then the trustee has two options: (1) the income can be taxed in the trust at the highest marginal tax rate; or (2) the income can be paid or made payable to the beneficiaries and taxed in the hands of the contributor at his/her marginal tax rate. If the beneficiaries are no longer minors, then the income can be allocated to the beneficiaries and taxed in their hands at their marginal tax rate.

Any capital gains earned by the trust can be allocated (paid or made payable) to the beneficiaries and taxed in their hands since the attribution rules will not apply to this type of income, even if the beneficiaries are minors.

However, if the super attribution rules apply, then income and capital gains earned by the trust are taxed in the contributor's hands, regardless of whether the income and capital gains are allocated to the beneficiaries or not and regardless of the age of the beneficiaries. In either case a T3 return will be required.

Some institutions that have set up in-trust accounts have informed their clients that a T3 return is not necessary as long as there is only one beneficiary. However, CRA has responded stating that trustees of trusts are generally required to file a T3 return annually with respect to each trust of which they are the trustees in accordance with certain provisions of the Income Tax Act. In particular, the trustee is required to file a T3 return in any year where the trust has disposed of capital property, regardless of the number of beneficiaries of the trust.

Transfer of assets to beneficiaries

Once the beneficiaries reach the age of majority, you may want to transfer the assets in the in-trust account to them. The tax implications of doing this again depend on the type of arrangement you have and whether the super attribution rules ever applied to your trust if in fact you do have a trust arrangement.

Where you have determined that the assets in the in-trust account belong to you but they have been set aside for a specific person and now you want to transfer the assets to that person, you will have a disposition at fair market value (FMV) at the time you gift those assets to the intended beneficiary. Their adjusted cost base (ACB) will be equal to that FMV.

If instead it is determined that you are acting as an agent for the true beneficial owner of the assets in the in-trust account or you are acting as the guardian of property for that individual, at the time the legal ownership is transferred to him/her, there will be no disposition for tax purposes because these assets were always his/hers. For a tax disposition to occur, you need a change in both legal and beneficial ownership. In this scenario there is only a change in legal title, but no change in beneficial ownership (i.e. the assets in the in-trust account will transfer to the beneficiary at cost).

Where it is determined that the arrangement is a trust relationship and the super attribution rules did not apply to the arrangement, then the assets in the in-trust account can be transferred to the beneficiaries at cost unless the trustee elects to transfer them at FMV. On the other hand, if the super attribution rules ever applied to the trust arrangement, the assets in the in-trust account must be transferred at FMV. In other words, the rollover is not available in scenarios where the super attribution rules have ever applied to the trust.

Summary

In summary, deciding who has to report the income from your in-trust account involves first determining what the arrangement represents. The taxation follows from this decision and the application of the attribution rules.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with your independent legal or tax advisor.



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