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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Living/family trusts

A living trust can be an effective wealth planning tool in the appropriate circumstances, facilitating strategies such as income splitting, business succession planning and charitable giving. This article provides a general overview of living trusts established in common-law provinces in Canada.

What is a trust?

An inter-vivos trust, also known as a living trust, is a trust created during a person's lifetime.

A trust is not a separate legal entity like a corporation, although it's treated as a separate taxpayer for tax purposes. A trust is a legal arrangement or relationship. An individual (known as the "settlor") creates the trust by entrusting some or all of their property to a person or persons of their choice (the "trustee"). The trustee holds legal title to the trust property and is obliged to hold the property for the benefit of one or more individuals or organizations usually specified by the settlor (the "beneficiary"). The trustee owes a fiduciary duty to the beneficiary. This means the trustee is required to act in the best interests of the "beneficial" owners of the trust property.

The terms of a trust are usually set out in writing in a trust document. The trustee is obliged to administer the trust in accordance with both the terms of the trust document and the governing laws that apply to the trust.

Creating a living trust

A living trust is created when the settlor transfers an asset or assets to a trustee for the benefit of their intended beneficiary. The trust actually comes into existence with the transfer of at least one asset to the trustee.

For a trust to be valid, three certainties must be met:

- 1) Certainty of Intention – there should be a clear intention to create a trust by the settlor;
- 2) Certainty of Subject Matter – there must be certainty as to what property is being held upon trust and the amount or share of the trust property that each beneficiary is to receive; and,
- 3) Certainty of Object – the beneficiary of the trust must be clearly identifiable by name or class.

A trust can be created informally, as demonstrated by the actions of the parties to the trust, or formally by signing a legal document referred to as a trust agreement. It's always

preferable that the establishment of the trust be documented. The trust agreement indicates the settlor, trustee(s), beneficiary(ies), the assets being transferred to the trustee, the powers and restrictions placed on the trustee, and how and when the trust income and capital are to be distributed to the beneficiary and to which beneficiary.

The instructions provided to the trustee can be very specific or more general depending on the settlor's underlying objectives.

Discretionary vs. non-discretionary trusts

A trust can be structured as discretionary or non-discretionary. A discretionary trust is a trust where the trustee is given discretion to make certain decisions. For example, a trustee may have the power to determine the timing and the amount of the distribution that a particular beneficiary will receive. A trustee may also have the power to determine whether the distribution to a beneficiary is made from income earned in the trust or capital of the trust. As well, a trustee may have the power to choose which beneficiary will receive a distribution from the trust.

A non-discretionary trust allows the trustee little or no latitude, and the trustee must simply follow the directions outlined in the trust agreement.

Parties to a living trust

Settlor

A settlor is the person who actually creates the trust by transferring property to a trustee to be held and administered for the benefit of the beneficiary. The settlor generally arranges to have the trust agreement drawn up and sets out the terms for how the trust assets are to be managed and used.

Contributor

A contributor is a person who transfers property to a trust for the benefit of the beneficiary. Often, the settlor is a contributor to the trust; however, a third party can also be a contributor. This article assumes the settlor is also the contributor to the trust.

Trustee

A trustee is a person or persons (or trust company) appointed initially by the settlor to manage and administer the property entrusted to them for the benefit of the beneficiary. A trustee's responsibilities are governed by the terms of the trust agreement and the governing law that applies to the trust. Typical trustee duties and obligations include:

- Carrying out the express terms of the trust arrangement;

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- Administering and investing the trust property in a manner that is consistent with the same degree of skill and care as that of a prudent person;
- Remaining impartial among the beneficiaries when making decisions that may impact one beneficiary at the expense of another;
- Keeping complete and accurate accounts relating to the trust property under their administration, including a record of income and capital receipts and disbursements. A trustee may also wish to maintain certain documents and records relating to the trust property, including bank and investment statements, cancelled cheques, invoices and receipts for expenses paid, trust tax returns, signed trustee resolutions, and loan and promissory note documents;
- Keeping the beneficiaries informed about the trust, for example, by providing them with investment or other financial statements relating to the trust property, or providing them with an update on any development relating to the trust; and
- Acting in the best interest of the beneficiaries and avoiding any conflict of interest.

These duties may be expanded or narrowed by the terms of the trust agreement, but, in most instances, cannot be eliminated completely.

Beneficiary

A beneficiary is a person entitled to the use and enjoyment of the trust property. A trust agreement may name specific beneficiaries, or identify a class of beneficiaries, such as the children or grandchildren of the settlor (this may allow the settlor to include a person who may not be born at the time the trust is created). A beneficiary can be an income beneficiary, a capital beneficiary, or both. It's important to note that what may be considered income for tax purposes may not be considered income for trust law purposes. The trust agreement should specify what is considered income and capital. If the trust document is silent on this issue, the trustee will need to seek qualified legal advice.

Overlapping roles

While the roles of the settlor, contributor, trustee and beneficiary are all different, the people acting in these

capacities can overlap. In other words, the settlor of a trust can also be a trustee and/or a beneficiary of the trust. Some combinations of overlapping roles can have tax or legal implications. For example, the attribution rules (discussed later on) may apply where the settlor is the sole trustee of the trust or a capital beneficiary of the trust. In such a case, the income and capital gains earned in the trust may be taxable to the settlor as opposed to the trust or another beneficiary. Also, while a trustee can be a beneficiary of a trust, they may want to take extra care to ensure they're fulfilling their fiduciary duties and acting in the best interest of all beneficiaries of the trust.

Potential uses of a living trust

Some of the potential uses of a living trust are outlined in the following sections. There may be additional circumstances, not addressed in this article, that warrant the use of a trust.

To implement an estate freeze

A business owner who anticipates a significant increase in the value of their business over the coming years and who may be looking to transfer ownership of the business may wish to consider implementing an estate freeze. An estate freeze allows a business owner to lock in the current value of the business and transfer the future growth of the business, and its associated tax liability, to other taxpayers. An estate freeze typically involves exchanging the business owner's common shares for preferred shares that have a fixed value equal to the fair market value (FMV) of the shares exchanged. New common shares are issued, commonly to a trust, for the benefit of other taxpayers, who are often the business owner's children or other family members. Any growth of the business will accrue to the common shares held in the trust. For more information about the estate freeze strategy, ask your RBC advisor for an article on this topic.

To provide support for adult children

A trust may be used to provide for adult children who require ongoing financial support in a tax-effective manner. If capital is gifted to a properly structured trust, the income earned on that capital may be taxable in the adult child's hands (if paid or made payable to the child) while the trustee maintains control of the capital. Assuming the child is receiving little or no other income, the trust income may not be subject to tax in their hands. In addition, the use of a trust may be more advantageous than gifting capital directly to a child, as it can allow the settlor to retain some control of the capital through the terms of the trust. In order to evaluate the merit of this strategy, consider whether the tax savings outweigh the costs incurred to create and administer the trust.

If a person wishes to give a portion of their estate to charity, but requires the assets to support their current lifestyle, a trust can be created to achieve this objective as well as provide them with a tax break today.

To provide support for a disabled child or an elderly parent

A trust can be established to provide support for a disabled child or elderly parent, who cannot manage their own financial affairs. This trust may also help protect a disabled beneficiary's entitlement to provincial or territorial disability related benefits. For more information on a living trust for a disabled beneficiary, ask your RBC advisor for the article on Henson trusts.

To donate to charity

If a person wishes to give a portion of their estate to charity, but requires the assets to support their current lifestyle, a trust can be created to achieve this objective as well as provide them with a tax break today. A charitable remainder trust, as it's commonly referred to, is created by donating a residual interest in a trust to charity. The settlor of the trust may qualify for a non-refundable donation tax credit upon the trust's creation. The trust is structured to provide the settlor with income for their lifetime and to have the capital pass to a charity upon their death. This strategy is well-suited for a person who has charitable intentions and is looking to transfer their wealth in a tax-efficient manner. Ask your RBC advisor for a copy of the article titled, "Leaving a legacy" that discusses the use of charitable remainder trusts and other ways to include charitable giving as part of your estate planning.

To reduce probate fees

Assets that are transferred to a properly structured living trust will no longer be the settlor's property, so those assets would not be included in their estate on death and subject to probate fees.

To maintain privacy

A living trust can be used as a discrete means of transferring assets outside of the Will. In general, your Will governs the distribution of any assets that form part of your estate on death. If your Will needs to be probated, it becomes a public document. Anyone can obtain a copy of your probated Will from the court. This may disclose your testamentary intentions and the value of your estate. A trust document that governs the administration of the trust property is private and will not be subject to

public scrutiny. Only the settlor, the trustee(s) and the beneficiary(ies) will know about the transferred assets.

To income split

A living trust can provide a mechanism for splitting income between higher-income and lower-income family members to minimize a family's overall tax burden.

A parent or grandparent can establish a family trust for the benefit of low-income family members and fund the trust by way of a gift or loan. Subject to the attribution rules discussed later on, income and capital gains earned in a properly structured trust that are allocated to a beneficiary can be taxed in the beneficiary's hands at their marginal tax rate. If the beneficiary has no other source of income, they may pay little or no tax. This could potentially provide significant tax savings for the parent or grandparent, and the whole family.

Taxation of a living trust

Trust reporting requirements

For Canadian income tax purposes, a trust is considered to be a separate taxpayer, distinct from the settlor and the trust's beneficiary. Under the Income Tax Act (ITA), as well as the Canada Revenue Agency's (CRA) current administrative position, a trust needs to file a tax return (known as a T3 return) in certain circumstances. For more information, ask your RBC advisor for a copy of the article on trust reporting requirements.

Assets transferred to a living trust

When a settlor or contributor transfers non-cash assets to a living trust, a tax liability may result. In general, the assets are treated as if they've been sold at FMV. Any unrealized capital gains or losses are deemed to be realized by the settlor or contributor and should be declared on the settlor's or contributor's tax return. There are instances where these rules may not apply, such as in the case of an alter ego or joint partner trust. For more information, ask your RBC advisor for an article on alter ego and joint partner trusts.

Taxation of income and capital gains earned but not paid or made payable to a beneficiary

As mentioned, since a trust is treated as a separate taxpayer, it must file an annual tax return as if it were an individual. If the trust is properly structured, all income and capital gains earned on the trust's capital are declared on its tax return with a deduction claimed for any income or capital gains that have been paid or made payable to the beneficiary during the year. Any income or capital gains earned in the trust and not paid or made payable to a beneficiary is taxed in the trust at the top individual marginal tax rate for the trust's province or

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territory of residence. The trust is not entitled to claim a personal tax credit.

Taxation of income and capital gains paid or made payable to a beneficiary

Subject to the attribution rules discussed in the following section, if the trust is properly structured, income or capital gains paid or made payable to a Canadian resident beneficiary are included in the beneficiary's tax return and subject to tax at the beneficiary's marginal tax rate.

Income or capital gains are considered "paid" to the beneficiary if they are physically paid to the beneficiary or used to pay for expenses that directly benefit only the beneficiary such as private school tuition, lessons, camp and childcare expenses.

Income or capital gains "made payable" are not paid out to the beneficiary but are retained in the trust. These funds are legally owed to the beneficiary and supported by a promissory note to substantiate that the beneficiary can enforce payment of these amounts.

Income or capital gains allocated to a Canadian resident beneficiary from the trust retain their character. This means that interest, dividends and capital gains earned in the trust will be taxed as if the beneficiary earned these types of income personally.

A trustee should seek advice from a qualified tax and legal advisor as to their ability to pay or make payable income or capital gains to a beneficiary of a trust, as well as the steps they need to take to do so, in accordance with the trust terms.

The attribution rules

Trusts are frequently used as a means of income splitting. This strategy involves transferring income from a family member in a higher tax bracket to a member in a lower tax bracket. The ability to income split with family members can be significantly restricted due to the "attribution rules" in the ITA.

The attribution rules require that income or capital gains earned on property transferred by gift or low-interest or no-interest loan to a trust be attributed back (i.e. taxed) to the transferor in certain situations. These rules may apply when a gift or low-interest or no-interest loan is

made to the trust and income (and capital gains in the case of a spouse) earned on that property is allocated to a spouse or related minor child beneficiary. If the transferor lends capital to the trust with no interest or low interest, attribution may also apply to income allocated to an adult child beneficiary.

In spite of the attribution rules, there are still opportunities to use a living trust for income splitting. Unlike dividend and interest income, capital gains distributed from a properly structured trust to a related minor child are taxable in the child's hands. In this case, growth-oriented investments such as growth stocks could be considered. If a trust is funded by way of gift and is properly structured, both income and capital gains distributed from the living trust to adult children or other adult family members (except a spouse) may be taxable in the beneficiaries' hands.

The attribution rules may not apply if the funds are loaned to a properly structured trust at the CRA's prescribed rate. The trust must pay interest on the loaned funds annually to the lender. The lender must declare the interest received as income on their tax return. The benefit of this prescribed rate loan strategy is that there is no attribution on any income or capital gains that are earned in the trust and allocated to the beneficiary(ies). Although the lender must pay tax on the interest income received at their marginal tax rate, the tax savings on the income allocated to the beneficiary(ies) should ideally compensate for this.

In addition to these attribution rules noted previously, the ITA contains a set of "super attribution rules" that apply specifically to trusts. These rules may apply where the person who transfers property to the trust (e.g. settlor or contributor) retains control over that property or where that property can revert back to the settlor. Examples of situations where these rules might apply include where the trust is a revocable trust or where the settlor is the sole trustee or the controlling trustee of the trust or is a capital beneficiary of the trust. If the super attribution rules apply, all income and capital gains earned on the transferred property will be taxed in the settlor's or contributor's hands at their marginal tax rate.

The attribution rules should be discussed with a qualified tax advisor prior to setting up a living trust.

Deemed disposition of trust assets

In order to prevent the indefinite deferral of capital gains accumulated in a trust, the tax laws require that unrealized gains on a living trust's assets generally be declared every 21 years. This is referred to as the 21-year deemed disposition rule. Please note that certain living trusts, such as an alter ego, joint partner trust or spousal trust, are

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exempt from the 21-year deemed disposition rule. On the trust's 21st anniversary, it's deemed to dispose of its assets at FMV, triggering any gains (or losses) that have accrued on its assets. The trust assets are treated as if they've been sold, even though there was not an actual sale. If the trust holds real estate or business assets, this may involve valuers to establish a proper value. Any gains realized as a result of this deemed disposition are taxed in the trust at the highest marginal tax rate in the trust's province or territory of residence. These gains cannot be allocated to the beneficiary to be taxed in their hands.

Even though a trust must pretend to dispose of everything and pay the tax, it does not mean the trust must be wound up. Once the tax is paid, the trust continues to operate as it did before.

With proper planning, steps may be taken to defer the tax that may result from the deemed disposition. Speak to a qualified tax and/or legal advisor regarding the planning that may be available.

Tax treatment of distributions from a living trust

From an income tax perspective, distributions of income will be taxable in the beneficiary's hands, subject to the attribution and super attribution rules. Distributions of capital are generally received tax-free by the beneficiary. The trustee may be able to choose to make the capital distribution in cash or in-kind. From an income tax perspective, if the trustee makes the distribution in-kind to a Canadian resident beneficiary, this can generally be done on a tax-deferred basis unless the super attribution rules applied to the trust at any time. If the super attribution rules apply, the capital will generally need to be distributed to a beneficiary at FMV, unless the beneficiary is the contributor to the trust or the contributor's spouse, or if the contributor has passed away. Capital distributions to a non-resident beneficiary must also be done at FMV, triggering a taxable disposition in the trust.

Assets held in a living trust

Almost any type of asset can be transferred to a trust. Investments such as stocks and bonds are commonly held assets in a living trust. The settlor of the trust may choose to place restrictions on the types of assets that are held in a trust.

The power to invest trust assets is usually set out in the trust agreement. The trust agreement should be reviewed to determine what the trustee can or cannot do with regards to investing. Where the trust agreement is silent with respect to the trustee's investment powers, the trustee must rely on the statutory investment powers that govern the trust. Ask your RBC advisor for a copy of the article on trustee investment powers for more information on this topic.

Winding up a living trust

The power of the trustee to wind up the trust depends on the terms of the trust. Trust agreements may provide that the trust be wound up prior to its 21st anniversary in order to avoid the deemed disposition. If the trust agreement does not deal with the wind-up, the trustee may need to seek court approval if they wish to wind up the trust.

Evaluating the merits of a living trust

There are many reasons for establishing a living trust. Regardless of the reasons, it's essential that the trust be properly structured to achieve one's goals. Because of the tax and legal complexities associated with trusts, it's important to consult a qualified legal advisor to determine if a living trust would be advantageous in the particular circumstance.

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