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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Taxation of in-trust accounts

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When you receive the T5, T3 or other tax reporting slips for your in-trust account, you may ask who's required to report the income and capital gains earned in the in-trust account for tax purposes. This article discusses the taxation of such income, as well as general tax issues related to these 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 tax 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: (1) an act whereby a person, the settlor, transfers property from their patrimony; (2) to another patrimony constituted by them; (3) which they appropriate to a particular purpose; (4) and which a trustee undertakes, by their acceptance, to hold and administer. This means in order to have a valid trust in Quebec, there needs to be formal trust documentation that has all of 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 contributed 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 viewed by the Canada Revenue Agency (CRA). 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've segregated it for a specific purpose or for a specific person;
2. You gifted the money to a specific person or that person became entitled to funds (for example, through an inheritance or insurance proceeds), and you are acting as that person's agent or guardian of the property; or
3. You've established a trust for the benefit of a specific person.

The account belongs to you

If there's no indication of an actual transfer of beneficial ownership of the assets to a trust or another person, you'll continue to own the assets in the account. Since the account belongs to you, you'll continue to be taxed on all income and capital gains earned in the account. Simply put, if there's neither a trust nor a gift, the income is taxed in your hands since there's been no transfer of property and the property belongs to you.

You're acting as agent or guardian of property

The second scenario is a little more complicated. In this case, you're arguing that the funds in the account were gifted to someone or that person became entitled to the funds (for example, through an inheritance), and you're acting as their agent or guardian of property. This is likely the case for a minor or a mentally incapacitated individual since they don't have the legal capacity to enter into legally binding contracts to manage the assets.

There are two important factual issues that must be addressed to successfully make this argument. First, in most provinces, a parent can't automatically act as a child's guardian of property, except in circumstances related to small amounts of money (the threshold varies by province). A parent may require a court order to be appointed as guardian of property for the child. Second, a minor or mentally incapacitated individual can't enter into an agency relationship, and therefore, it would be difficult to argue that the child or mentally incapacitated individual initiated the agency.

If the agency relationship can be proven, any income or capital gains would be taxable to the child or individual with the disability subject to attribution rules (discussed later in the article).

If there's no indication of an actual transfer of beneficial ownership of the assets to a trust or another person, you'll continue to own the assets in the account. Since the account belongs to you, you'll continue to be taxed on all income and capital gains earned in the account.

You have set up a trust

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.** The certainty of intention is established where it's 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.
2. **Certainty of beneficiaries.** The beneficiaries must be identifiable.
3. **Certainty of trust property.** The property must be clearly identifiable.

The attempt to establish a trust will fail unless it's 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. 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, there's no distinction made between a formal trust and an informal trust. However, it's typically more difficult to establish whether an informal trust is, in fact, a valid trust. If a trust exists, the trust is treated as a separate taxpayer and will be subject to the tax rules for trusts. Generally, any income/losses and capital gains/losses earned in the in-trust account will be taxed in the trust unless the income or capital gains are paid or made payable to the beneficiaries. Income taxed in the trust is taxable at the highest personal marginal tax rate. Therefore, to minimize taxation, it may make 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

The income attribution rules have the effect of deeming income/losses from property transferred to certain related people back to you. Generally, income attribution rules apply if you gratuitously transfer property (i.e. gifts) to a related minor or make an interest-free or low-interest loan (less than the CRA prescribed rate) to a related individual, and one of the purposes of the loan is to reduce taxes.

Where property is transferred to minors, only income (e.g. interest and dividends), and not capital gains/losses, are attributed back to the transferor. Once the minor turns 18 years of age, these attribution rules no longer apply to income earned on gratuitous transfers. The attribution rules continue to apply to income earned from interest-free or low-interest loans. The attribution rules work in a similar manner, where a gratuitous transfer or interest-free or low-interest loan is made to a trust for the benefit of a related individual.

Attribution doesn't apply in the case where the funds in the in-trust account came from the minor beneficiary through such sources as the Canada Child Benefit, their own employment income, gifts from non-resident individuals or an inheritance.

In addition to the attribution rules noted earlier, there are additional attribution rules which apply to trusts, often referred to as the "super attribution" rules. These rules may apply if a Canadian resident trust holds property on condition that (in simplified terms):

- The property may revert back to the person who contributed it;
- The person who contributed the property has the power to determine who receives it after the trust is created; or
- The trust property can't be disposed of without the contributor's consent.

If the super attribution rules are triggered, 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. A perfect example of this is where a parent contributes money to an in-trust account for their children and they are 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. However, it's not usually possible to have multiple trustees with in-trust accounts.

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It's important to note that although the super attribution rules may not apply, the other attribution rules (income earned on gifts to minors or no-interest or low-interest loans) may still apply.

Filing requirements

If there's truly a trust arrangement, the trustee needs to ensure that an annual tax return is filed for the trust, if required. Where the trust is properly structured and income and capital gains are taxable to the beneficiaries, the trustee also needs to provide T3 tax slips to the beneficiaries. The beneficiaries will use the T3 slips to file their personal tax returns. For more information on trust reporting requirements, ask your RBC advisor for an article on this topic.

The trustee should also keep accurate records and document any trust transactions.

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 this transfer depend on which scenario described earlier applies to your in-trust account.

Where you've determined that the assets in the in-trust account belong to you, but they've 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 transfer those assets to the intended beneficiary. The adjusted cost base (ACB) of the property for the beneficiary will be equal to that FMV.

Alternatively, if it's determined that you're acting as an agent for the true beneficial owner of the assets in the in-trust account or you're acting as the guardian of property for that individual, there is no disposition for tax purposes when you transfer legal ownership of the property to the beneficial owner. For a tax disposition to occur, there needs to be a change in beneficial ownership. In this scenario, there's only a change in legal title, but no change in beneficial ownership, so the assets in the in-trust account will transfer to the beneficial owner at cost.

Where it's determined that the arrangement is a trust relationship and the super attribution rules did not apply to the arrangement, the assets in the in-trust account can generally 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 and the settlor/contributor of the assets is alive at the time of the transfer, the assets in the in-trust account must be transferred at FMV. The assets will also need to be transferred at FMV if the beneficiaries are non-residents of Canada.

Summary

Determining who's responsible for reporting the income and capital gains from an in-trust account depends upon the ownership arrangement. Further, you'll need to determine whether any attribution rules apply. Due to this complexity, it's important for you to work with a qualified tax advisor to ensure you understand the tax implications of the arrangement and satisfy your tax filing obligations.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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