The Navigator

Wealth Management

RBC Wealth Management Services

Living / family trusts

A living trust can be an effective wealth planning tool in 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. The following topics will be addressed:

- What is a trust?
- Creating a living trust
- Parties to a trust
- Potential uses of a trust
- Taxation of trust income
- Assets held in a trust
- Winding up a trust

Please contact us for more information about the topics discussed in this article.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax 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 legal advisor before acting on any of the information in this article.

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 is 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 people of their choice (the trustee(s)). 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 (the beneficiary), usually specified by the settlor. The trustee owes a fiduciary duty to the beneficiary. This means

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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 of the jurisdiction in which the trust is resident.

Creating a living trust

A living trust is created when the settlor transfers the title of specific 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 Property** – 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 Beneficiary** – 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 is 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 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 beneficiary and/or their entitlements to the trust fund are not fixed, but are determined by the criteria set out by the settlor in the trust agreement. Discretionary trusts can be discretionary in two respects. First, the trustee usually has the power to determine which beneficiary (from within the class) will receive payments of income or capital from the trust. Second, the trustee can select the amount of trust property that the beneficiary receives. Although most discretionary trusts allow both types of discretion, either can be allowed on its own.

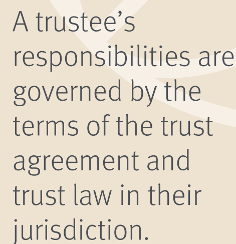
It is possible for a trust to have a fixed number of beneficiaries and for the trustee to have discretion as to how much each beneficiary receives. Alternatively, it is possible to have a class of beneficiaries from whom they could select members. Most well-drafted trust agreements give the trustee the power to add or exclude beneficiaries from the class; this gives the trustee greater flexibility to deal with changes in circumstances, especially changes in the tax laws of the applicable jurisdiction.

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 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



A trustee's responsibilities are governed by the terms of the trust agreement and trust law in their jurisdiction.

arranges to have the terms of the trust drawn up according to their wishes.

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 that the settlor is also the contributor to the trust.

Trustee

A trustee's responsibilities are governed by the terms of the trust agreement and trust law in their jurisdiction. Typical obligations include the duty to:

- Carry out the express terms of the trust arrangement
- Defend the trust
- Prudently invest trust assets
- Remain impartial among the beneficiaries
- Account for their actions and keep the beneficiaries informed about the trust
- Remain loyal
- Not delegate their duties unless specifically allowed by the trust agreement or governing legislation
- Not profit from the trust
- Not be in a conflict of interest position
- Administer the trust in the best interest of the beneficiaries

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 beneficiary can be an income beneficiary, a capital beneficiary, or both. It is important to note that what may be considered to be income for tax purposes may not be considered to be income for trust law purposes. The trust agreement should specify what is considered to be income and capital. If the trust document is silent on this issue, the trustee will need to seek 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 are fulfilling their fiduciary duties and acting in the best interest of all beneficiaries of the trust.

Potential uses of a trust

Some of the potential uses of a living trust are outlined below. 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 value over the coming years may want to consider implementing an estate freeze to lock in the current value of the business and transfer the anticipated growth to other taxpayers. An estate freeze typically involves exchanging the

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owner's common shares for cash, and/or promissory note and preferred shares. As the preferred shares will not grow in value, this effectively freezes the value of the old common shares to their present market value without triggering tax. The company then issues new common shares, commonly to a trust, for the benefit of the beneficiary(ies) who are usually 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 the "Estate Freeze" article.

To provide support for adult children

A trust may be used to provide for adult children that 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 be received tax-free. 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.

To provide support for disabled children or elderly parents

Support for a disabled child or elderly parent, who cannot manage their own financial affairs can be provided by a trust. 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 "Henson Trust" article.

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 is 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 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 on to charity at death. This strategy is well suited for older individuals in a high tax bracket. Ask your RBC advisor for a copy of the guidebook entitled "Charitable Giving", which discusses the use of charitable remainder trusts and other ways to include charitable giving as part of your wealth 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 when determining probate fees.

To maintain privacy

A living trust can be used as a discrete means of transferring assets outside of the Will. While a Will becomes a public document when filed with the courts for probate, the trust remains private. 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

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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 provide a significant tax savings for the parent or grandparent, and potentially the whole family.

Taxation of trust income

A living trust is considered to be a separate taxpayer, distinct from the settlor and the trust's beneficiary. The trust may be required to pay income tax on income and capital gains earned in the trust. A living trust is subject to tax at the highest marginal rate in its province of residence on every dollar of income earned.

Assets transferred to the trust

When the settlor transfers non-cash assets to the trust, a tax liability may result. In general, the assets are treated as if they have been sold at fair market value. Any unrealized capital gains or losses are deemed to be realized by the settlor and should be declared on the settlor'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 our article on "Alter Ego and Joint Partner Trusts".

Income and capital gains earned and retained in the trust

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. The income and capital gains earned and retained in the trust are taxed at the top individual marginal tax rate for the trust's province of residence. The trust is not entitled to claim personal tax credits. There is no tax advantage to retaining income in the trust.

Income and capital gains paid or made payable to a beneficiary

Subject to the attribution rules discussed below, 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 "paid" to the beneficiary 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 the 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.

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 Income Tax Act (ITA).

The attribution rules require income or capital gains earned on property

With proper planning, ideally at least one year in advance of the 21-year anniversary, steps may be taken to defer the tax on the deemed disposition.

transferred by gift or low-interest or no-interest loan to the 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 stocks could be considered. Income 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 can also be avoided if the funds are loaned to a properly structured trust at the Canada Revenue Agency'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 allocated by the trust 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) 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. If the super attribution rules apply, all income and capital gains earned on the transferred property will be taxed in the settlor'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 the trust's assets be declared every 21 years. This is referred to as the 21-year deemed disposition rule. At this point in time, the trust must report all accumulated gains on its tax return as if it actually sold the assets. If the trust holds real estate or business assets, this may involve valuators 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 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

The trust agreement should be reviewed to determine what the trustee can or cannot do with regards to investing.

before. With proper planning, ideally at least one year in advance of the 21-year anniversary, steps may be taken to defer the tax on 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 trust

If the trust is properly structured, income payable to a beneficiary of a trust is generally included in the beneficiary's income. 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. In general, in kind capital distributions can generally be made on a tax-deferred basis.

This rule is subject to certain exceptions. For example, capital distributions to a non-resident beneficiary must be done at fair market value, triggering a taxable disposition in the trust. Also, if the super attribution rules apply to a trust, capital must be distributed to a beneficiary at fair market value.

Assets held in a trust

Almost any type of asset can be transferred to a trust. Investments such as stocks and bonds are the most 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 entitled "Trustee Investment Powers" for more information on the investment powers of a trustee.

Winding up a 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 trust

There are many reasons for establishing a living trust. Regardless of the reasons, it is essential that the trust be properly structured to achieve one's goals. Because of the complexity that comes along with trust law and taxation, it is important to consult a professional legal advisor to determine if a living trust would be advantageous in the particular circumstance.

Please contact us for more information about the topics discussed in this article.

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