Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Taxation of in-trust accounts

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

When you receive the 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 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 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 his patrimony; (2) to another patrimony constituted by him; (3) which he appropriates to a particular purpose; (4) and which a trustee undertakes, by his acceptance, to hold and administer. This means that 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 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 the Canada Revenue Agency (the “CRA”). For tax purposes, there is no distinction made between a formal trust and an informal trust. However, it is typically more difficult to establish whether an informal trust is in fact a valid trust.

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;
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 have established a trust for the benefit of a specific person.

The account belongs to you

If there is no indication of an actual transfer of beneficial ownership of the assets to a trust or another person, you will continue to own the assets in the account. 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. Simply put, if there is neither a trust nor a gift, the income is taxed in your hands since there has been no transfer of property.

You are acting as agent or guardian of property

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

There are two important factual issues that must be addressed in order to successfully make this argument. First, in most provinces, a parent cannot 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 cannot enter into an agency relationship, and therefore it would be difficult to argue that the child or disabled individual initiated the agency.

For tax purposes, there is no distinction made between a formal trust and an informal trust.

If this argument is successfully made, then any income and capital gains belong to that person. However, keep in mind that there are attribution rules that may apply to attribute income earned on a gift made to a minor back to the donor of the gift.

You have set up a trust

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.** 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.
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 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. 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 will be subject to the tax rules for trusts. 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 marginal tax rate. 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

Income attribution rules have the effect of deeming income or 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.

Attribution rules, as they apply to minor children, only apply to interest and dividend income and do not apply to capital gains and losses. Once the minor turns 18, these attribution rules no longer apply to gratuitous transfers but instead only apply to interest and dividend income earned from interest-free or low-interest loans. Similarly, where a gratuitous transfer or interest-free or low-interest loan is made to a trust for the benefit of the related minor child, the interest and dividend income earned by the trust on the property that would otherwise be reported by the minor is deemed to be your income.

In addition to the attribution rules noted above, the Income Tax Act contains additional attribution provisions which apply to trusts and we refer to as the "super attribution" rules. These rules may apply if a Canadian resident trust holds property on condition that:

- 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 cannot 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 is not usually possible to have multiple trustees with in-trust accounts.

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 the type of arrangement you have and whether the super attribution rules ever applied to the trust if in fact you do have a trust arrangement.

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

It is important to note that if 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, attribution would not apply. In these cases, all income (interest, dividends and capital gains) earned on these funds are taxed in the beneficiary's hands.

Filing requirements

If there is truly a trust arrangement, the trustee needs to ensure that an annual tax return is filed for the trust, if required. The trustee also needs to provide T3 tax slips to the beneficiaries for any income that was paid or made payable to them. The beneficiaries will use the T3 slips to file their personal tax returns. 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 the type of arrangement you have and whether the super attribution rules ever applied to the 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 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 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, there will be no disposition for tax purposes when legal ownership of the property is transferred. For a tax disposition to occur, there would need to be 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 so 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 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. In other words, the rollover is not available where super attribution applies and the settlor/contributor is alive at the time of the transfer.

Summary

In summary, determining which taxpayer is responsible for reporting the income from an in-trust account depends upon the ownership arrangement. Once the correct arrangement is determined, it is also prudent to determine whether any attribution rules apply to the income earned in the in-trust account.

This article may contain several 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.

Wealth Management