What is a Trust?

In simple terms, a trust provides an intermediary between yourself and your intended heirs. A trust is a legal entity separate and apart from yourself or your estate that functions as a conduit to your beneficiaries. A conduit that, if you wish, you can control throughout your lifetime and even after your death.

While there are many names used to describe a trust, there are actually only two different types of trusts each with its own attributes and applications. This document is devoted to living trusts which as their name would suggest are created during your lifetime for the benefit of your chosen beneficiaries.

The second type of trust is called a testamentary trust. Unlike the living trust, a testamentary trust will only come into force at death as per the terms of your Will. The testamentary trust serves to distribute the estate’s income and capital to the beneficiaries in accordance with your wishes. Use of a testamentary trust can have significant tax benefits to the estate’s heirs. Such benefits are generally not available with a living trust. Ask your Investment Advisor for the RBC Dominion Securities publications, Estate Planning and Will Planning for more details.

Living/Family Trusts

A living trust is perhaps the most misunderstood planning tool utilized in financial planning. While often thought to only be appropriate for the very affluent, living trusts also called family or inter vivos trusts have many potential applications. In fact, the use of trusts is more commonplace than most realize. For example, an investor purchasing units of a mutual fund is actually investing their funds within a trust. Unfortunately, due to recent changes in tax law the use of living trusts for its tax planning merits has been significantly restricted. Today, trusts are more commonly considered when addressing estate planning concerns.

Although the use of a living trust will not be relevant to many individuals, there are effective uses for a trust that should be considered in certain circumstances. Potential situations where a living trust may be appropriate include: child/family support situations, business succession planning and charitable giving.

This document is intended to provide a general overview of the topic. Individuals interested in pursuing the use of a living trust should consult their legal and tax advisors to ensure that the use of this tool is appropriate for their circumstance.
Creating a Living Trust

A living trust is created when a person (called the settlor) transfers the title of assets such as cash or other investments to a trustee. The trust actually comes into existence with the signing of a legal document referred to as a trust agreement and the transfer of at least one asset to the trustee. The trust agreement indicates: what assets are to be 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 beneficiaries. The instructions provided to the trustee can be very specific or more general depending on the settlor’s underlying objectives.

While the roles of the settlor, trustee and beneficiaries are all different, the persons acting in these capacities can overlap. In other words, the settlor of a trust can also be the trustee and/or a beneficiary of the trust. In situations where a single individual acts as both trustee and settlor, they can not also be the sole beneficiary of the trust.

Role of the Trustee

A trustee’s responsibilities are directed by the terms of the trust agreement but there are specific obligations that a trustee must fulfill. Typical obligations include:
• the filing of an annual tax return;
• the distribution of income earned in the trust and perhaps capital to its beneficiaries;
• a legal obligation to act impartially with the trust’s beneficiaries; and
• properly investing and managing the trust’s assets.

Discretionary vs. Non-discretionary

A trust can also be structured as discretionary or non-discretionary. A discretionary trust provides the trustee with greater flexibility since he/she can choose to pay income or capital to beneficiaries at his/her discretion. For example, a trustee may wish to exercise their discretion and dip into the trust’s capital to maintain a beneficiary’s standard of living.

In a non-discretionary trust the trustee has little or no latitude, but must simply follow the directions outlined in the trust agreement.

Potential Uses of a Trust

The following summary of potential uses of a living trust is meant to outline some of its more common applications. There may be additional circumstances, not addressed in this document, that warrant the use of a trust.

Estate Freezing

An estate freeze should be considered if you own assets such as a business that you anticipate will significantly increase in value over the coming years. By implementing an estate freeze the asset’s value is “frozen” at its current value, for tax purposes, transferring all future growth to your beneficiaries. There are several methods of implementing an estate freeze, but most typically a corporation and trust are used in combination. Assets can be transferred directly to a trust to realize (i.e. crystallize) any capital gains that have accumulated to date. Future capital gains will be taxed in the hands of the intended beneficiaries. The estate freeze is normally structured to allow you to retain control of the transferred assets (assuming you are a trustee of the trust).

To Support Adult Children

If you have adult children that require on-going financial support, a trust may be used to provide this support in a more tax effective manner than providing it directly. If capital is gifted to a trust, the
Income earned on that capital will be taxable in the adult child’s hands while permitting the trustee to maintain control of the capital. For example, the trust could be established by a parent to support an adult child’s education expenses. Assuming the child is receiving little or no other income, trust income can be received virtually tax-free once the personal, tuition and education tax credits are applied. The use of a trust may be advantageous in comparison to gifting capital directly to a child as it will allow the gifting parent (the settlor) to retain control of the capital (assuming he/she is also the trustee). In order to evaluate the merit of this strategy one must compare the tax savings to the costs incurred to create and administer the trust.

Disabled Children or Elderly Parents

A trust can be established to provide support for disabled children or elderly parents who can not manage their own financial affairs. If the capital is gifted to the trust, the income and capital gains earned on the trust’s assets will be taxed in the beneficiary’s hands (if they are over the age of 18). Assets of the trust can be distributed to the beneficiaries at any point in the future.

Charitable Remainder Trusts

If you wish to give a portion of your estate to charity, but require the assets to support your current lifestyle, a trust can be created to achieve this objective as well as provide 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. As the settlor of the trust, you can qualify for a nonrefundable tax credit upon the trust’s creation. This strategy is well suited for older individuals in a high tax bracket. Generally, the trust is established to provide the settlor with income for their lifetime and the capital passes to the charity at death.

To Reduce Probate Fees

Since assets that are transferred to a living trust are no longer the property of the settlor, the assets are not included as part of the settlor’s estate when determining probate fees. In addition to reducing probate fees, the trust can be used as a discrete means of transferring assets outside a Will. While your Will becomes a public document when filed with the courts for probate, the trust remains a private entity.

Taxation of Trust Income

The living trust is considered to be a separate taxpayer, distinct from the settlor and the trust’s beneficiaries. Income earned on the trust’s assets is taxed, generally, in the same way as an individual. There are three situations where a tax liability can arise:
1. on the transfer of assets into the trust;
2. on income retained in the trust; and
3. on income received by the beneficiaries.

Assets Transferred to the Trust

Upon the settlor’s transfer of non-cash assets to the trust, a tax liability may result. Generally, when assets are transferred to a trust, they are treated as if they have been sold at their fair market value. This requirement is known as the “deemed disposition rules” of the Income Tax Act. Therefore, if the fair market value of the transferred assets is greater than the original cost, a capital gain will be triggered. This capital gain would be declared on the settlor’s tax return.

Income Retained in the Trust

Since a trust is treated as a separate legal entity, it must file an annual tax return as if it were an individual. All income earned on the trust’s capital is declared on its tax return with a deduction claimed for any income or capital gains that have been paid to the beneficiaries during its fiscal year. The income retained within the trust is taxed at the top marginal tax rate for individuals (50% or more, in most provinces). Thus, there is no tax advantage to retaining income in the trust.

Income Paid to Beneficiaries

The income distributed from a trust retains its character upon receipt by the trust’s beneficiaries. This means that dividend income from Canadian corporations will be subject to the dividend tax credit, only 75% of realized capital gains are taxable and interest income will be taxed at the beneficiary’s marginal tax rate.

In the past, trusts were frequently used as a means of transferring income from a family member...
in a high tax bracket to a member in a low tax bracket, called income splitting. Today, the ability to income split with family members has been significantly restricted due to the “income attribution rules” of the Income Tax Act. The attribution rules require income that is earned on capital transferred by gift or loan to the trust be “attributed” (i.e. taxed) back to the settlor. These rules are applied when a gift or loan is made to the trust and income is distributed to a spouse or minor child. If the settlor lends capital to the trust, attribution will also apply to adult children.

While the use of a living trust as a means of income splitting has been significantly restricted, there are still opportunities:

- Unlike dividend and interest income, capital gains distributed from the trust to a minor child are taxable in the child’s hands. Thus growth-oriented investments such as stocks could be considered.
- Income distributed to adult children or other adult family members (except a spouse) would be taxable in the beneficiaries’ hands.

Although income splitting can still be achieved within a trust, these opportunities are also available without the trust structure. Thus, income splitting should not be the sole purpose for a trust’s creation.

Investments Held in a Trust

Although the trustee may be restricted in the types of investments that can be held in a trust, he/she is responsible for the actual selection of appropriate investments. The trustee can choose to hold the trust’s investments directly through an investment dealer such as RBC Dominion Securities or with a trust company. It is also possible to utilize both a trust and investment dealer to meet the trustee’s needs. A trust administration account can be set up with the trust company and the investments can be purchased through the investment dealer.

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 (other than depreciable property) be declared every 21 years.

Evaluating the Merits of a Trust

While there are several opportunities where a living trust may have application, your decision to create a trust must be based on an evaluation of the net benefit of creating this structure. A trust is expensive to create with set-up costs ranging from one to five thousand dollars and annual fees of approximately five hundred dollars. Although a trust can yield potential tax savings, the underlying objective for trust creation will likely be the need to retain control of capital.

Conclusion

Although the planning opportunities for living trusts are limited, the most effective uses remain within the realm of estate planning. Individuals considering the use of a living trust should consult their tax advisor to determine if its use would be advantageous to their particular circumstances.

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