MACKENZIE
Investments

Strategies for Trusts in Tax and Estate Planning

Trusts can be a powerful tool in tax and estate planning

Investor Guide

What's inside

Traditionally, families distributed assets between generations by will or by gift.

In many Canadian families or family-owned businesses, a simple and straightforward transfer of assets is still very effective; but the complexities of today's society are bringing issues of asset control, protection, or tax reduction that can often be better addressed by the use of a formal trust.

Trusts can be a powerful tool in tax and estate planning

Trusts can help families or individuals achieve many tax or non-tax objectives. You and your financial, tax and legal advisors can work together to determine where one or a number of trust options will assist with financial, estate and tax planning needs. Some of the reasons trusts are being set up today include:

- Control and protection for minor children or special needs dependents
- Protection for family members who are not seen to be financially knowledgeable
- Income-splitting to lower the family tax burden
- Protection from claims against family law or marital regime claims
- Confidentiality
- Probate tax minimization
- Specific retirement and estate planning goals
- Charitable giving

The basics

A trust is a relationship that exists when a trustee holds property for the benefit of others (called the "beneficiaries"). Setting up a trust involves changing the legal ownership from the original owner (called the "settlor") to the new legal owner (called the "trustee"). Trustees can be one or more individuals, including the settlor. Under current laws, a trust is not a separate person and therefore does not own the assets in the trust. Ownership is by the trustee, so this is a very important role. There are rules that outline the duties and responsibilities of a trustee that need to be considered when choosing who will act. These are outlined in the section called "The law".

The importance of the trust document

When you set up a trust, you as the settlor make decisions about how it will be operated. You decide who the trustee(s) will be and how much power the trustee will have, as well as how long the trust will last. A legal expert will work with you to draw up the trust document and ensure that all aspects of the operation of the trust are clear and follow all trust and other applicable laws. The terms that establish a trust may be set out in your last will and testament or the terms of the trust can be set out in a freestanding trust declaration or trust agreement.

The law

A trustee is obliged to make decisions and administer the trust in the best interests of the beneficiaries. Each province and territory has its own Trustee Act that sets out the powers of a trustee. Although the official trust document can generally expand or in some cases, reduce the authority of a trustee, generally a trustee must:

- deal with different beneficiaries or different groups of beneficiaries fairly, without giving preferential treatment to one beneficiary over another. This is known as the "Even Hand" rule.
- deal with the assets in the trust in a way that is in the best interests of the beneficiaries, even if the trustee would not normally do the same if the same option was available for his or her own assets. This is known as the "Good Faith" or "Loyalty" rule.
- take full responsibility for the obligations of the trustee role. This is known as the "Duty Not to Delegate", which means that the trustee cannot allow anyone else to make decisions about the trust, unless the trust document specifically allows this. Delegation of complex tasks such as investing trust assets to an investment professional is a common practice today.

The investment rules

One of the most important duties of the trustee is making investment decisions to ensure the trust meets its set objectives. The trustee must invest trust property to generate interest and dividends for beneficiaries designated to receive income ("income beneficiaries") or generate capital gains for beneficiaries intended to receive capital ("capital beneficiaries") or a combination of both income and capital gains for beneficiaries who have full benefit of the trust. Most provinces have specific legislation, referred to most commonly as "prudent investor" rules, which provide guidelines for trustees and their financial advisors to use when investing trust property. A legal advisor will be able to clarify how these rules work in a specific province.

Settlement of a trust

As a general rule, capital property is transferred to a trust at fair market value. Therefore, as settlor of the trust, you will pay tax on the accrued gains upon transfer of the property to a trust (or the estate in the case of a testamentary trust). The trust will acquire the assets at a cost equal to the fair market value. There are exceptions to this general rule such as for qualifying spousal trusts, and alter ego and joint partner trusts.

As you can see, the role of the trustee is vital. Your trustee should be chosen with great care because the success of the trust arrangement will depend on the level of competence of the trustee, and the relationship that the trustee will be able to build and maintain with the beneficiaries. The trustee will require, in many instances, the assistance of an investment advisor for asset allocation, as well as legal and/or accounting professionals.

Computation of income

For tax purposes, the Income Tax Act (Canada) treats a trust as if it were a separate taxpayer. This means that although the trustee holds title to the trust assets, taxable income earned in the trust can be taxed either within the trust or in the hands of the beneficiaries. An essential feature of a trust is that income earned by the trust retains its character as it flows through to the beneficiaries. Interest, dividends, foreign income and net capital gains can be taxed in the hands of the beneficiaries or taxed in the trust and paid to the beneficiary as an after-tax distribution.

Tax rates used for a trust depend on the circumstances under which the trust is set up (see the chart on page 8), and the location (residency) of the trust. Generally the trust is considered to be resident in the jurisdiction where the trustee lives, or where the majority of the trustees live.

However, according to the Supreme Court of Canada, the residence of a trust may also be determined by the location in which central or substantial management and control is exercised.

Asset allocation in a testamentary trust for minors

Mark is the trustee of a trust his late father set up to benefit Mark's two young children. Mark's father wanted $100,000 of his estate to be held in a trust for Mark's children for university tuition and to meet any needs that Mark, as trustee, felt were justified. The trust will continue until the last of the two children reaches the age of 35. Michelle, Mark's daughter, is 5 years old and Christopher, Mark's son, is 8. This means that the trust will exist for 30 years. Michelle and Christopher are joint beneficiaries and will be able to receive income and capital from the trust.

Mark and his financial advisor establish a portfolio of mutual funds that will best suit the needs of the trust. Mark and his advisor select mutual funds to provide primarily growth potential and some income because the children are so young and do not need income.

As the children grow income needs may increase, so Mark and his advisor discuss adding an income-generating fund to the portfolio at that future time.

As the trust will exist for 30 years, Mark and his advisor will have to pay attention to any unrealized capital gains in the trust before the 21st anniversary of the trust to ensure that no unanticipated tax will be payable. See the section entitled "The 21-year rule".

Tax reporting

The trustee is responsible for accurate tax reporting. A tax return called a T3 Trust return is used to calculate tax payable annually on any income that is not paid or payable to beneficiaries. Income for the trust is calculated but reduced by any amounts that are to be taxed in the hands of the beneficiaries. Capital losses or non-capital losses realized by the trust can only be used by the trust; they cannot be allocated to a beneficiary under current tax rules. Trustees have the discretion to elect to have income and/or capital gains distributed by the trust to beneficiaries taxed as though it had been retained by the trust.

In the case of a disabled beneficiary, there is available a special tax election that can be used to reduce tax on income, called the "preferred beneficiary election" (refer to Trusts for Individuals with Disabilities).

Income beneficiaries receive a T3 "Statement of Trust Income Allocations and Designations" from the trustee no later than 90 days after the end of the taxation year. This income is then included in the beneficiary's personal tax return, and a copy of the form should be attached to the return.

Inter vivos trust

A trust established during the lifetime of the settlor is known as an "inter vivos" trust. Income that is not distributed to the beneficiaries and taxed at their personal tax rate will generally be taxed in the trust at the top tax rate applicable in the province, excluding surtaxes.

Testamentary trust

A trust established upon the death of the settlor (quite often under the will) is known as a "testamentary" trust. Income that is not distributed to the beneficiaries to be taxed at their personal tax rate will generally be taxed in the trust at the top tax rates applicable in the province or territory.

The exception to the rule of the top tax rate for testamentary trusts are Graduated Rate Estates and Qualified Disability Trusts, with income not distributed to be generally taxed at the graduated tax rates applicable in the province or territory (refer to Graduated Rate Estates and Qualified Disability Trusts).

Graduated Rate Estate ("GRE"): A Graduated Rate Estate ("GRE") is an estate that arose on and as a consequence of death, with the conditions that such an estate (and no other estate) designates itself as a GRE for a taxation year that ends after 2015; and such a designation must occur no more than 36 months after the death. The GRE designation is not applicable to certain trusts such as spousal and insurance trusts.

Qualified Disability Trust ("QDT"): A Qualified Disability Trust ("QDT") is a trust that arose on and as a consequence of death, is a resident of Canada and a QDT for the trust year, has an 'electing beneficiary' that qualifies for a disability tax credit, with the electing beneficiary making a joint election with the trust to be a QDT. It must be noted, however, that the electing beneficiary is permitted to have only one QDT at any particular time.

The 21-year rule

In most tax jurisdictions there are rules that require periodic taxation on trust property. In Canada the rule is that every 21 years personal trusts are subject to a deemed disposition of capital property. All unrealized gains will be taxed at this point. Part of the plan for a trust needs to include tax planning, especially if the trust will hold property such as the family cottage. The settlor will have to provide a way to pay the tax bill on the increased value of the property every 21 years, or may be forced to sell some or all of the property, or make other arrangements that are not desirable to the settlor.

Dispositions from a trust

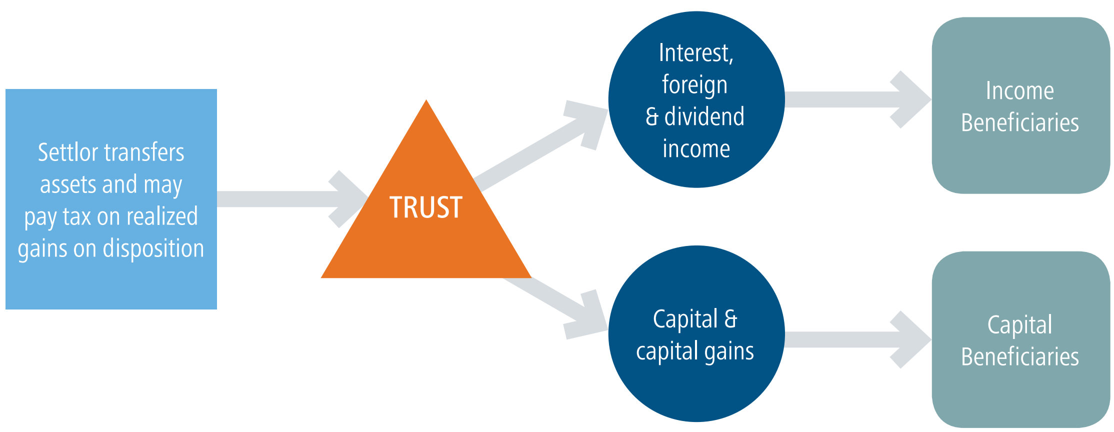
Legal ownership of capital property that is rolled out to specified Canadian resident beneficiaries can be done at the cost amount and is generally considered a tax deferred transfer. This is due to the fact that tax was originally paid on the transfer of assets into the trust and also is payable on an ongoing basis. The exceptions to this rule are qualifying spousal trusts and alter ego and joint partner trusts (tax is paid by the trust when the settlor dies and the assets transfer to capital beneficiaries). Tax is paid on the accrued gains at termination of these trusts since these types of trusts enjoyed a tax-free rollover into the trust at the time the trust was established.

Types of beneficiaries

You as the settlor can identify in the trust document who will be a specific income beneficiary, a capital beneficiary or a beneficiary entitled to both income and capital. An income beneficiary is entitled to the income of the trust in the form of interest, foreign or dividend income but no capital. A capital beneficiary is entitled to any proceeds from the sale of trust assets, dividends that are part of a corporate capital distribution or the proceeds of a share redemption, as well as to any of the original trust assets.

Beneficiary taxation:

- Any income or gain must be included on personal tax return (unless spouse or minor child – under attribution rules)
- Receives capital distributions after-tax



Planning examples using trusts

In addition to the foregoing example of a testamentary trust for minors, there are many ways a trust can be used. The following concepts illustrate some of the most common.

Trust for individuals with disabilities

Testamentary or inter vivos trusts can be used to provide lifetime income to beneficiaries with disabilities.

If a family member with special needs is receiving disability support benefits, and is left an inheritance or receives a significant settlement amount, those funds are considered an asset and may disqualify that individual from provincial benefits.

A solution to this may be a fully discretionary trust. In Ontario, as well as BC, SK, MB, NB, and PEI, this type of trust is known as a "Henson Trust", which came into existence in 1989, when the case after which it is named was upheld by the Ontario Court of Appeal. The settlor directs that assets be placed in the care and control of a trustee for the benefit of a beneficiary on the basis that the trust is a properly prepared absolute discretionary trust. Money from the trust can be used to pay expenses on behalf of the beneficiary such as trips, clothes, homecare attendants and the like. Government support can be maximized in this case even if the trust may contain capital held on a disabled beneficiary's behalf that would make him or her ineligible for government support were it owned by them on an outright basis.

These trusts are subject to the availability of the preferred beneficiary election. This election is only available when the beneficiary of a trust is suffering from a mental or physical infirmity as defined under the relevant provisionof the Income Tax Act. Where a person qualifies as a preferred beneficiary, the trustee and beneficiary can jointly elect to tax income in the hands of the beneficiary even though these amounts are retained in the trust. Although the beneficiary may not physically receive the income, this strategy allows the income to be taxed at the graduated rates of the beneficiary rather than at top rates in an inter vivos trust. Because the income is only taxed in the hands of the beneficiary and not received, this strategy should not interfere with social assistance entitlement. Furthermore, the income, having been taxed in the trust, is not subject to tax when it is actually distributed to beneficiaries.

The laws for these types of trusts are not uniform across Canada. It is critical therefore that a legal professional well versed in this area be consulted to ensure this strategy is applicable, and that the trust document is worded correctly.

Inter vivos trust in an estate freeze

Family trusts can be an effective way for business owners to pass control of their companies to their children. In an estate freeze, the settlor can realize the growth in value of the business shares at a particular time and any future increase in value can be passed to the next generation.

Spousal trust

A spousal trust may be set up during one's lifetime or under the will to accomplish more than one planning objective:

- asset protection for a spouse who may not be capable of managing his or her finances
- asset protection for the next generation in case the surviving spouse remarries. The assets in the trust would not form part of the surviving spouse's estate to be distributed according to his or her will, but must be distributed to the children under the terms of the trust.

A spousal trust may be created to provide only income to the spouse and reserve capital for the next generation, or may allow full use of the income and capital. For a trust to be treated as a qualifying spousal trust, the trust deed terms must be established in an individual's will.

Sam and Carol are married and together hold all of the common shares of ABC Inc., currently worth $3.5 million. With an adjusted cost base of $0, if both Sam and Carol are able to take advantage of the $824,176 (2016) capital gains exemption on their shares, there will still be at least a $1.85 million capital gain on the second to die. This gain will create a taxable capital gain of $925,000. At a 50% federal-provincial marginal tax rate, the total taxes payable will be roughly $462,000. Their business is thriving and assuming that the value of the shares continues to grow, the tax liability at death could be significantly higher. They are considering succession planning and hope that at least one of their three children, Steve, 19, Martine, 16 or Todd, 14, will become involved in the business.

Setting up a family trust will be an integral part of Sam and Carol's strategy, as they want all of their children and future grandchildren to benefit from the growth of the business. At this time, however, they do not know which of their children will become active in the business and therefore they do not want any of them to own shares outright. Under the family trust the income beneficiaries of the trust are Sam and Carol, their three children and any future grandchildren. Capital beneficiaries are Steve, Martine and Todd. Sam, Carol and Carol's brother will act as trustees and must act on majority decision.

Sam and Carol will continue to manage the company by exchanging their common shares for preferred shares. The family trust holds all of the common shares of ABC Inc. ABC Inc. will pay dividends to the family trust and these dividends may be allocated between Sam, Carol and their three children. In the case of Sam and Carol and Steve, the attribution rules do not apply. Martine and Todd, the minor beneficiaries will be taxed at top marginal tax rates on any dividend income passed through the trust to them until they reach age 18. Sam and Carol can control the flow of dividends to themselves and their children through dividend sprinkling – declaring a dividend on the preferred shares, common shares, or both.

The net effect of the transaction is that, on their death, the capital gain for Sam and Carol will be capped or "frozen" at $1,851,648 representing the fixed value of their preferred shares. As the corporation continues to increase in value, this increase will attach to the common shares. This effectively passes additional future capital gains to the next generation. At any point the trustees can decide to collapse the trust and distribute the shares to the children involved in the business. At that time the trustees can decide to realize the gain and transfer the shares at fair market value, or distribute the shares to the beneficiaries at the cost base.

Alter ego or joint partner trust

An alter ego trust (one settlor) or joint partner trust (settlor and spouse) is an inter vivos trust set up after 1999 by individuals who are at least 65 years old. The settlor is entitled to receive all of the income of the trust during the settlor's and/or the spouse's lifetime, and no one else can directly receive any income or capital during that time. This type of trust is revocable, meaning that the trustee can withdraw assets and give them back to the settlor if desired, and because of this, no capital gains tax is triggered when growth assets are transferred to, or from, the trust. An added benefit is that the trust document can designate beneficiaries to receive assets from the trust after the settlor (or the settlor and spouse in a joint partner trust) passes away.

Howard Stone is a 73 year-old widower. He has decided that the time has come to review his estate plan because he knows that although his four adult children care about him, they do not get along well with each other. One son is bipolar, and from time to time is unpredictable in how he spends money. Another child, his daughter, is not happily married and is often asking Howard for financial support. Howard has investments carrying approximately $450,000 in capital gains, a $250,000 RRIF, the principal residence he has lived in for the past 35 years, and a cottage property valued at approximately $400,000. Howard lives on the income from his investments and his RRIF payments. He wants to continue to live in his home, and use his cottage periodically throughout the year.

Howard is planning to marry Rita, 70, although his family is not supportive. In reviewing his situation, Howard realized that should anything happen to him, his family might contest any assets he leaves to Rita under his will. He spoke with his advisor about his concerns, and it was suggested that an alter ego trust could be an option because Howard is older than the required minimum age of 65. Howard can move his investments, principal residence and cottage into the trust and name himself as trustee alone or with someone else. Howard would also name an alternate trustee to handle the trust in case Howard becomes incapable of doing so. Because the trust would be a revocable trust, Howard will not have to pay capital gains tax when moving his investments or real estate into the trust, and will continue to receive the income as he does now. He can set the trust up to benefit himself alone, or wait until he and Rita are married and include her as joint partner, protecting the assets for her during her lifetime. Howard can also put provisions in the trust as to how the trustee is to distribute the assets to the children after the death of him and Rita. The assets in the trust would not need to be distributed under Howard's will. Howard could name a successor annuitant or a beneficiary on his RRIF, which would not be included in the trust because the RRIF would have to be deregistered to do so, and this would incur taxes.

Howard is seriously thinking about this course of action to ensure that he, and Rita, are in control even in the case of death or disability. The cost of setting up the trust and transferring title of the two properties seems less important than ensuring continuity and security for his future and that of his new wife. The fact that he can set up the trust without the rest of his family knowing and delay taxation until the death of himself or Rita are two other aspects his advisor brought to his attention.

Insurance trust

An insurance trust is one funded wholly with the proceeds of a life insurance policy and established not within a person's estate but outside it as a separate trust.

In an insurance trust, a beneficiary designation is put in place that designates and pays the proceeds of the life insurance policy to the individual who is going to receive those proceeds as trustee. The proceeds are paid to that individual by name, as a flesh and blood person. This type of trust is typically established by terms included in the last will and testament of the settlor, however the terms of the insurance trust can be set out in a separate trust declaration, in which case there is no need to reference the insurance trust in the person's will. Insurance trusts are not intended to form part of the settlor's estate but are intended to stand separately and apart from the estate. Insurance trusts therefore provide unique opportunities for estate planning with a view to avoiding probate, creditor proofing and confidentiality. While all of this can be done through a simple beneficiary designation, there are other advantages to having the money flow into a trust such as protecting a spendthrift heir, or simply holding the money until a beneficiary attains a responsible age.

The Income Tax Act does not specifically deal with insurance trusts as a separate type, but they have been the subject matter of repeated commentary by the Canada Revenue Agency (CRA). The CRA is of the view that a trust funded from the proceeds of a life insurance policy available on the death of an individual will be a testamentary trust. The CRA also notes that a trust does not exist until property has been transferred to the trust and legal ownership of the property rests with the trustees. Also, no capital may be settled in the trust prior to the death of the settlor.

Insurance trusts must be worded very carefully and the insurance designation itself has to be properly drafted. Advisors who are involved should be careful to make sure that the settlor owns the policy and that it is the settlor's life that is insured. Also care must be taken to ensure that the insurance proceeds themselves are not required for some other purpose such as to defray income tax liabilities anticipated within the client's estate on their death or to fund a buy-sell agreement. Specialized estate lawyers should be consulted with respect to establishing a testamentary insurance trust. Insurance trusts may also be used as a QDT which enables such a trust to access the graduated tax rate.

Insurance trust for minors

The Insurance Act in each province or territory generally provides that insurance proceeds cannot be paid to a beneficiary who is a minor. Instead, they must be paid into court to the credit of the minor or to a person who has been appointed by a court to oversee the child's property. Both of these options have drawbacks, not the least of which is that, upon reaching age 18, the beneficiary will be entitled to receive the entire sum of the insurance proceeds. This may not suit the wishes of many testators, in which case they should establish a separate testamentary insurance trust. The terms of the trust can allow the settlor to control the timing of the receipt of the funds, even beyond the year in which the child reaches the age of majority.

Qualifying spousal insurance trust

For an insurance trust to be created as a qualifying spousal trust it must be established in the last will and testament of the deceased. This does not mean that the insurance proceeds have to flow through the estate but simply that the terms that establish the insurance trust have to be set out in the same document as the person's will. If the terms of the trust are set out in a freestanding document then CRA has indicated that the trust will not be treated as a spousal trust for tax purposes.

RRSP trust

In a release from CRA the issue was raised as to whether a trust established under terms provided by the deceased individual during his lifetime and separate from his will, and funded from the proceeds of a registered retirement income fund (RRIF) or a registered retirement savings plan (RRSP) available on the death of an individual qualified as a "testamentary trust" under the Income Tax Act.

The CRA is of the view that proceeds from a RRIF or RRSP may be paid directly to trustees on the death of the annuitant via a direct beneficiary designation and in doing so create a testamentary trust with the proceeds staying out of the annuitant's estate. This would work in the same manner as an insurance testamentary trust. The advantage is to avoid probate or maintain confidentiality.

For an RRSP or RRIF to be tax-deferred on an individual's death, the RRSP or RRIF can be transferred to a spouse, common-law partner, dependent minor child or grandchild or mentally or physically infirm child. In cases where these rollover opportunities do not exist, the taxes on the RRSP or RRIF will have to be paid by the deceased on their final tax return. An RRSP trust is not designed to take advantage of tax deferral. It assumes that the registered investments are being brought into income and are not being transferred on a tax-deferred basis to a qualifying beneficiary.

David and Donna Jones live on Vancouver Island and have a joint and last to die insurance policy of $1,000,000. When they took out this policy years ago they had large estate liabilities anticipated on the death of the second of them. This was due to the large capital gains in the offing with respect to their private company shares, their cottage, and their registered investments. Since that policy was put in place, they have sold their business and therefore are now in a position where they do not need to be concerned about the ability of their estate to pay a tax liability at death. Therefore, the $1,000,000 insurance policy is no longer dedicated to any particular purpose.

David and Donna's advisor, Ellyn, suggests that the Jones' consider setting up an insurance testamentary trust in their wills. Rather than have the $1,000,000 insurance proceeds payable through their estate on the second of them to die, they change the wording of their wills to specify that the proceeds of their life insurance policy shall be paid equally to their 2 children, Mark and Amanda, to be received by them as trustees of an insurance trust. All the terms of the insurance trust are written out in a portion of each of the new wills of David and Donna. The insurance money, after the second of them dies, is to be held under the terms of two separate trusts, one for each of their two children. Both Mark and Amanda are going to be co-trustees as well as both capital and income beneficiaries. There will be complete discretion in connection with each of the two trusts to use income or capital as may suit the best interest of the child, or any spouse they may have, or any children they may have. Since the trust is set up outside the estate, no probate fees will be payable. If the insurance money had been left payable to the estate, the probate fees in the province of British Columbia would have amounted to about $14,000.

These insurance testamentary trusts will provide a powerful tool for income splitting in each of Mark's and Amanda's households.

Expert help is required

As you can see, the range of benefits of using a trust is very compelling. Once a trust is set up, it can be very difficult and expensive to make changes so you want to obtain expert advice on legal and tax issues. There is a cost for annual management, administration and tax reporting that must be considered and measured against the overall benefits anticipated. Lastly, one of the most important issues is the amount of income tax payable if assets are transferred from the settlor to the trust. This issue can be a deciding factor in choosing a testamentary trust instead of an inter vivos trust.

GENERAL INQUIRIES

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