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Inter vivos trust

Family trusts

Testamentary trusts

Alter ego and
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Disability trusts

Spousal trusts

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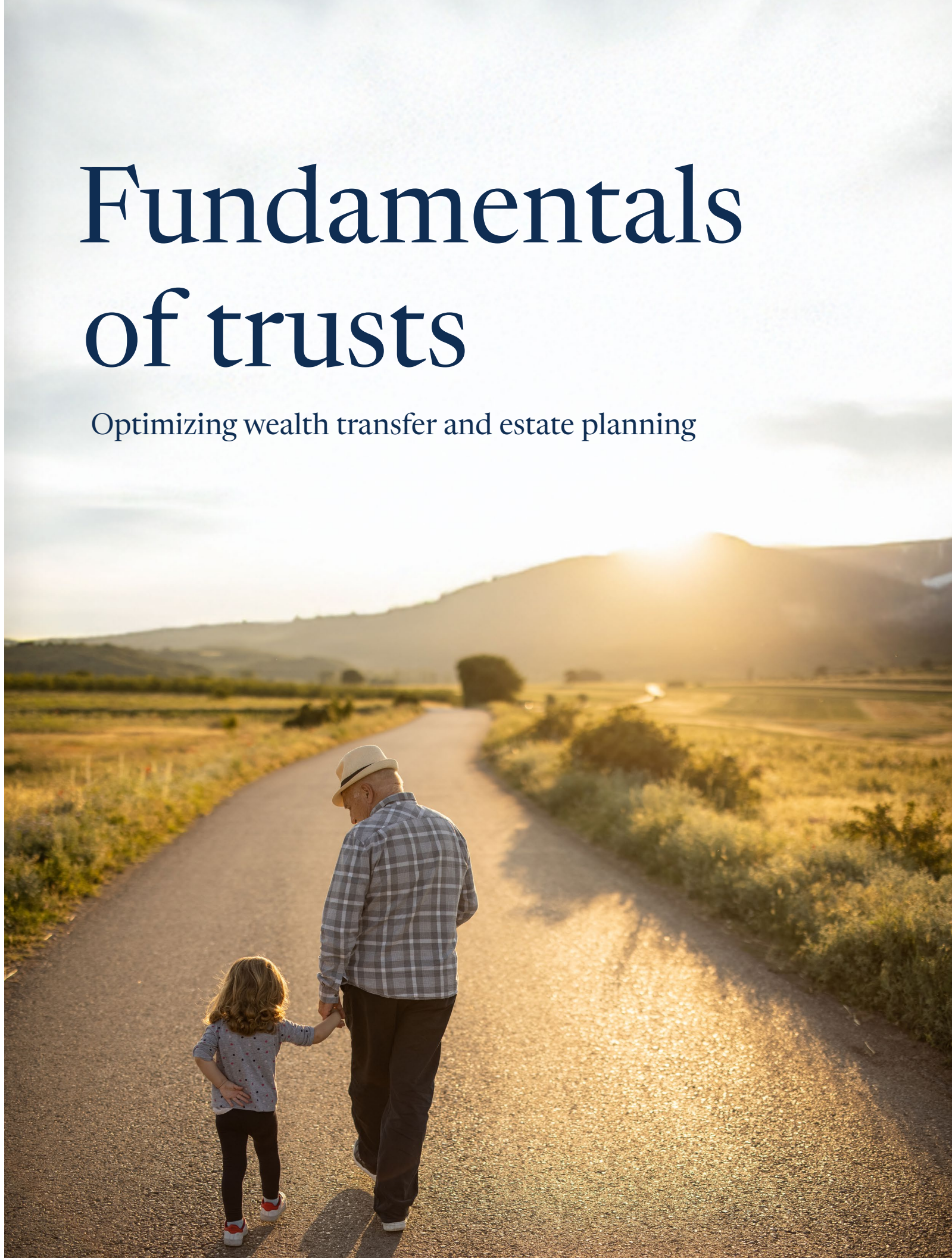


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Fundamentals of trusts

Optimizing wealth transfer and estate planning



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This guide provides an in-depth overview of trusts as a versatile tool for tax-efficient wealth transfer and estate planning. It covers various trust structures, detailing their advantages, tax implications and strategic applications.

The guide also explores key considerations such as trustee obligations, beneficiary classification and tax reporting requirements, to assist in optimizing clients' tax and estate plans.



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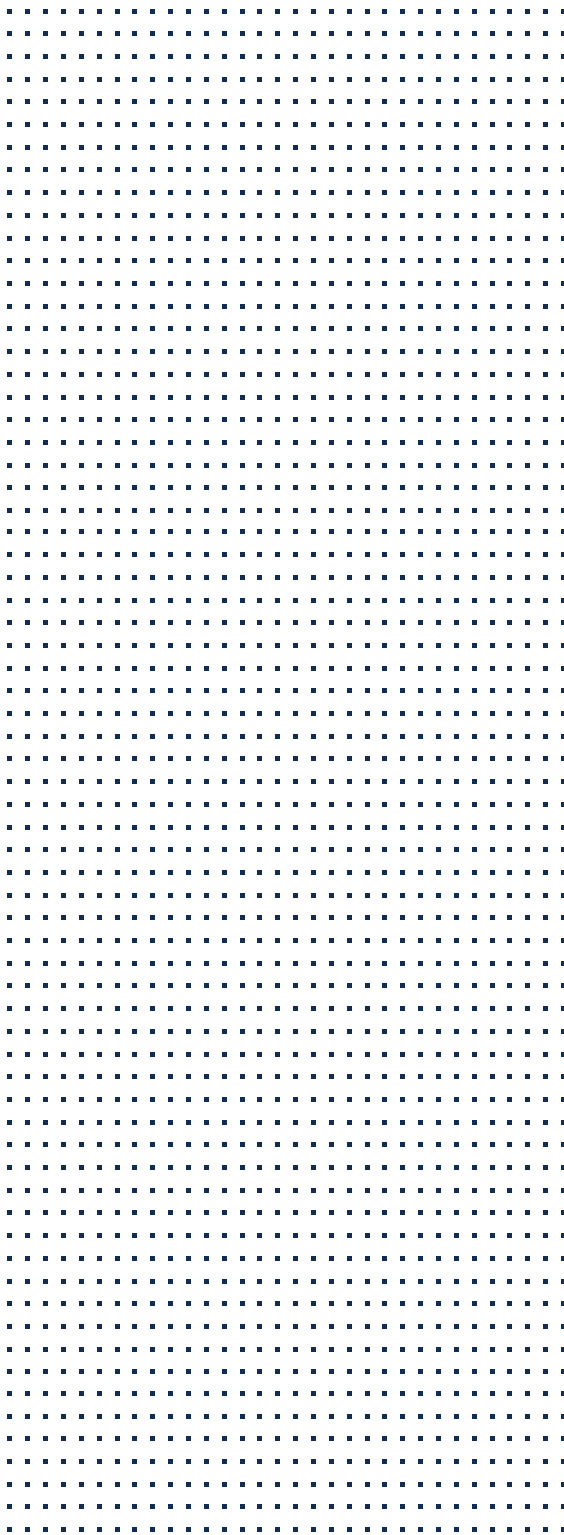
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An introduction to trusts

A trust is a legal relationship in which a trustee holds property on behalf of others, known as beneficiaries. Establishing a trust involves transferring legal ownership of assets from the original owner to the trustee. The terms governing the trust are set out in a formal legal document, typically referred to as a trust deed.

The three certainties of a trust

For a trust to be legally valid and enforceable, it must satisfy the three certainties established in common law. These principles are essential to ensure that the trust operates according to the settlor's intent and can be upheld by a court.

The three certainties are:

1. Certainty of intention

There must be a clear and unequivocal intention by the settlor to create a trust. This does not require specific legal language (for example, the word "trust" is not mandatory), but the overall language and conduct must indicate that the settlor intended to impose enforceable obligations on the trustee, not merely moral or informal duties.

2. Certainty of subject matter

The assets forming the trust property must be clearly defined or at least identifiable. Uncertainty as to what property is held in trust can render the trust void. This also extends to the shares of beneficiaries, if applicable.

3. Certainty of objects

The beneficiaries (or "objects") of the trust must be sufficiently clear. In the case of fixed trusts, this means that each beneficiary must be identifiable. For discretionary trusts, the class of beneficiaries must be defined clearly enough for the trustee to determine who may benefit.

Establishing a trust

When establishing a trust, the settlor determines how it will be structured and operated. This includes selecting the trustee(s), defining the scope of the trustee's powers and specifying the duration of the trust. A legal professional typically assists in drafting the trust document to ensure clarity and compliance with all relevant and applicable laws. The terms that establish the trust may be outlined in a last will and testament or set out in a standalone trust declaration or trust deed.

Terms and definitions

Beneficiaries: *Individuals or entities that are designated to benefit from a trust. These are the person or group for whom the trust is established and will be entitled to receive income and/or capital as per the terms of the trust deed.*

Settlor: *An individual or entity that establishes the trust and provides the assets or property to be placed in the trust. The settlor creates the terms that govern the trust.*

Trustee: *Person(s) or organization appointed to hold, manage and administer the assets held in trust based on the terms of the trust laid out in the trust deed.*

Trust deed: *A legal document that sets out the terms and conditions of a trust. It explains how the trust is to be managed and administered, specifies which assets are included, and outlines the rules for distributing income or capital to the beneficiaries.*

Trust property: *Assets and property that have been placed in the trust for the benefit of the trust's beneficiaries.*



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Choosing the right trustee

The selection of a trustee should be approached with great care, as the effectiveness of the trust arrangement depends largely on the trustee's competence and their ability to establish and maintain a constructive relationship with the beneficiaries. In fulfilling their duties, trustees will often require support from investment advisors for asset management as well as legal and accounting professionals, to ensure compliance and proper administration.

Trustee obligations

A trustee is legally obligated to administer the trust and make decisions in the best interests of the beneficiaries. Each Canadian province and territory has its own rules governing trust administration, which outline the statutory powers and responsibilities of trustees. While the trust document may expand or, in some cases, restrict the trustee's authority, several core fiduciary duties generally apply regardless of jurisdiction.

Core fiduciary duties

1. Even-hand rule

Trustees must treat all beneficiaries — or groups of beneficiaries — fairly and impartially, without favouring one over another. This is fundamental to maintaining trust integrity.

2. Good faith and loyalty

Trustees are required to manage the trust assets in the best interests of the beneficiaries, even if they would not make the same decisions with their own personal assets. This duty underscores the trustee's obligation to act solely for the benefit of the beneficiaries.

3. Duty not to delegate

Trustees must personally carry out their responsibilities and cannot delegate decision-making authority to others unless expressly permitted by the trust document.

However, delegation of specialized functions, such as investment management, to qualified professionals is common and generally accepted — particularly when the trustee lacks the expertise to manage such tasks prudently. In such cases, the trustee remains responsible for the oversight of the delegated functions.

Trustee investment responsibilities and the prudent investor standard

One of the trustee's most critical responsibilities is the investment of trust property in a manner that aligns with the trust's stated objectives and the best interests of its beneficiaries. The trustee must consider the distinct needs of different classes of beneficiaries, which may include:

- **Income beneficiaries**, who are entitled to the interest and dividend income generated by the trust assets;
- **Capital beneficiaries**, who are entitled to the capital or capital gains realized upon disposition of those assets; and
- **Discretionary or full-benefit beneficiaries**, who may be entitled to a combination of both income and capital.



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To fulfill this duty, the trustee must develop and implement an investment strategy that balances risk, return, liquidity and the time horizon, while ensuring the overall integrity and sustainability of the trust.

In most Canadian provinces and territories, trustees are guided by statutory provisions commonly referred to as the “prudent investor” rules. These rules represent an evolution from the older “legal list” approach and require trustees to invest trust assets with the care, skill, diligence and judgment that a prudent person would exercise in managing the property of others.

Key considerations under this standard typically include:

- Diversification of investments.
- Suitability of asset classes to the trust’s objectives.
- Maintenance of an appropriate balance between risk and return.
- Ongoing monitoring and review of investment performance.

While trustees may engage professional investment advisors to assist with portfolio management, the ultimate responsibility for oversight and decision-making remains with the trustee. Accordingly, trustees must exercise informed judgment and retain sufficient documentation to demonstrate compliance with the prudent investor standard.

Legal counsel should be consulted to interpret the applicable trust legislation and fiduciary duties in the relevant jurisdiction, as the specifics of the prudent investor rule may vary by province.

Establishing trustee compensation

Clearly addressing trustee compensation within the trust deed is a best practice that promotes transparency, sets clear expectations and helps prevent potential disputes. Ambiguity regarding compensation can result in disagreements among beneficiaries and trustees, which may ultimately require costly and time-consuming court intervention.

Structuring compensation

The settlor has significant flexibility in defining the compensation structure, which may include:

- Hourly rates for time-based services.
- Percentage-based fees linked to the value of trust assets.
- Fixed fees for ongoing administration or specific services.

If the intention is that no compensation will be paid, this must be explicitly stated in the trust instrument. Otherwise, trustees may still be entitled to reasonable compensation, either as agreed upon by the beneficiaries or determined by a court.

In most common law provinces, where the trust deed is silent on compensation, applicable statutes require that any remuneration be “fair and reasonable.” Courts typically consider several factors in determining appropriate compensation, including:

- The size and complexity of the trust.
- The degree of responsibility and risk assumed by the trustee.
- The time and expertise devoted to trust administration.
- The results achieved in managing the trust.

While adult beneficiaries may reach a consensus on the trustee’s compensation, unresolved matters must be brought before the court during the passing of accounts for approval.

Compensation paid to a trustee is treated as taxable income. Attempts to mischaracterize such payments as gifts or reimbursements may be scrutinized by the Canada Revenue Agency (CRA) and could result in tax penalties or reassessment. To ensure regulatory compliance and avoid unintended tax consequences, the nature and amount of trustee compensation should be documented clearly and transparently.



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Classification of beneficiaries: income, capital or both

The settlor may specify in the trust deed the classification of each beneficiary — whether they are entitled to receive income, capital or both. This designation plays a critical role in determining how trust assets and returns are allocated and distributed over time.

Income beneficiaries

An income beneficiary is entitled to receive the earnings generated by the trust assets, such as:

- Interest income.
- Dividend income (excluding capital distributions).
- Foreign income.

However, income beneficiaries do not have any claim to the underlying capital of the trust or to gains realized from the sale of trust property.

Capital beneficiaries

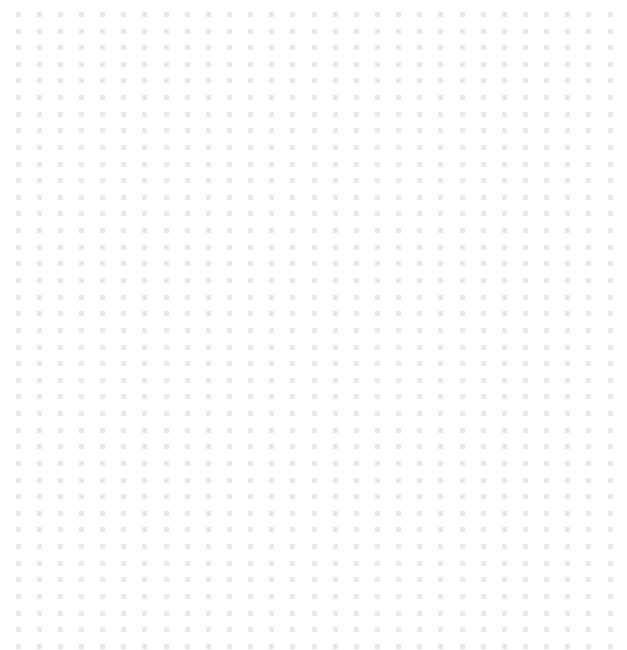
A capital beneficiary is entitled to receive distributions from the capital of the trust, which may include:

- Proceeds from the sale of trust assets.
- Dividends that form part of a corporate capital distribution.
- Proceeds of a share redemption.
- Access to any of the original capital assets settled into the trust.

Capital beneficiaries do not have rights to ongoing income distributions unless they are also named as income beneficiaries.

Mixed entitlement

The trust deed may also designate beneficiaries who are entitled to both income and capital, either concurrently or at different stages of the trust's life cycle (for example, income during the term of the trust and capital upon termination). Clearly delineating these roles helps ensure that distribution decisions align with the settlor's intentions and supports efficient trust administration.





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As a general rule under Canadian tax law, capital property transferred to a trust is deemed to be disposed of at its fair market value (FMV) at the time of transfer. As such, the settlor is responsible for realizing any accrued capital gains on the property, which are subject to taxation in the year of the transfer. In the case of a testamentary trust, this deemed disposition occurs upon death, and the resulting tax liability is borne by the deceased's estate.

The trust, in turn, acquires the assets at a cost base equal to their FMV, which serves as the trust's adjusted cost base for future tax calculations, including capital gains or losses upon subsequent disposition.

Exceptions to the deemed disposition rule

Certain types of trusts are specifically excluded from the deemed disposition rules at the time of transfer. These exceptions include:

- Qualifying spousal or common-law partner trusts.
- Alter ego trusts – available to individuals who are 65 years of age or older.
- Joint partner trusts – the settlor must be at least 65 years old. The spouse or common-law partner can be a beneficiary regardless of age but cannot contribute assets to the trust until they turn 65.

In these cases, the transfer of capital property may occur on a tax-deferred, rollover basis, meaning that no immediate tax is payable by the settlor at the time of transfer. Instead, the tax liability is deferred until a later triggering event, such as the death of the beneficiary.



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Trusts in estate planning: strategic applications

Trusts are versatile instruments that can support a wide range of tax-efficient and non-tax estate planning objectives. When properly structured, they offer individuals and families enhanced control, protection and flexibility in the management and distribution of assets across generations.

Key applications include:

- **Safeguarding assets for vulnerable beneficiaries**
Trusts can provide structured oversight and long-term support for minor children, individuals with special needs, or beneficiaries who may lack financial maturity or capacity.
- **Financial stewardship and asset protection**
A trust enables the settlor to appoint a competent trustee to manage assets on behalf of beneficiaries, offering protection for family members who may be inexperienced or vulnerable to undue influence.
- **Income splitting and tax efficiency**
Trust structures can facilitate income splitting among family members in lower tax brackets, thereby reducing the overall family tax burden, subject to applicable attribution rules and tax legislation.
- **Protection against family law and creditor claims**
Trusts may offer a degree of insulation from claims arising from marital breakdowns, family law regimes or third-party creditors, depending on the jurisdiction and structure of the trust.
- **Privacy and confidentiality**
Unlike wills, which become public upon probate, trusts generally remain private, allowing for confidential management and distribution of assets.
- **Minimization of probate fees**
Assets held within an inter vivos trust do not pass through probate, which can result in savings on probate fees and administrative delays upon death.
- **Customized retirement and estate planning**
Trusts can be designed to support specific retirement objectives, such as supplementing retirement income or to ensure orderly intergenerational wealth transfer in accordance with the settlor's intentions.
- **Structured charitable giving**
Trusts can facilitate planned philanthropic initiatives, including ongoing charitable distributions or the establishment of charitable remainder trusts and foundations.



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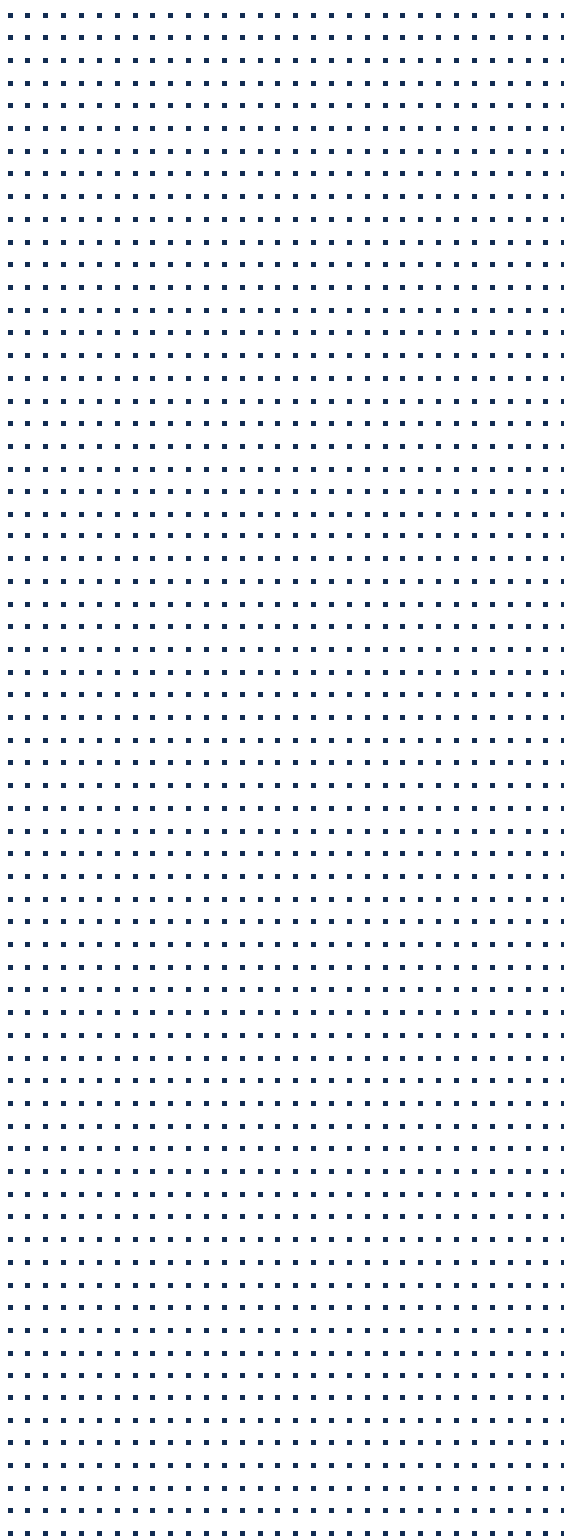
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Discretionary trust

A discretionary trust gives the trustee full authority to decide how and when to distribute income or capital among beneficiaries.

Unlike fixed trusts, where entitlements are clearly defined, discretionary trusts provide flexibility to respond to beneficiaries' individual needs and circumstances.

This structure is especially useful for minor children, young adults, beneficiaries with disabilities or those lacking financial responsibility. Because beneficiaries do not have a fixed entitlement, discretionary trusts potentially offer asset protection, helping shield trust assets from creditors, legal claims and family law disputes.

From a tax perspective, discretionary trusts must file T3 tax returns annually. Income retained in the trust is generally taxed at the highest marginal rate, unless distributed to beneficiaries within the same year. Careful drafting and active trustee oversight are essential to ensure compliance and proper administration.

This structure enables the trustee to provide support for essential needs — such as housing, education or healthcare — while preventing access to a lump sum that could be mismanaged. It also offers protection from creditors and legal claims, shielding the assets from potential financial risks associated with the beneficiary.

CASE EXAMPLE

Using a discretionary trust to protect a beneficiary

A parent, concerned about leaving a substantial inheritance to an adult child with a history of financial instability and impulsive spending, establishes a discretionary trust through their will. While the child is named as a beneficiary, the trust grants the trustee full discretion over when and how income or capital is distributed.

By retaining control over distributions, the parent ensures the inheritance is managed responsibly and in the child's best interest, with the flexibility to respond to changing circumstances over time.



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Inter vivos trust

An inter vivos trust, also referred to as a living trust, is a trust established by a settlor during their lifetime. Commonly used as a tax and estate planning instrument, it is particularly effective for individuals in higher tax brackets seeking to benefit family members while retaining control over asset distribution.

One of the primary advantages of an inter vivos trust is the potential for income splitting. When properly structured, income generated within the trust may be allocated to children or other beneficiaries and taxed in their hands, often at lower marginal rates. However, Canada's tax attribution rules must be carefully navigated to avoid unintended tax consequences.

From a tax standpoint, inter vivos trusts are generally taxed at the highest marginal tax rate applicable to individuals within the relevant province. Income that is retained in the trust is subject to this top rate, making it less efficient unless distributed to beneficiaries in the same taxation year. The trust must also file an annual T3 tax return, typically requiring professional accounting support, which adds to administrative costs.

Despite these tax considerations, inter vivos trusts offer meaningful benefits, including:

- Reduction of overall family tax burden.
- Structured charitable giving.
- Control over the timing and terms of distributions.
- Probate avoidance, resulting in cost savings, reduced delays and enhanced privacy, as trust assets do not form part of the public estate.

These features make inter vivos trusts a versatile and powerful tool in the context of comprehensive estate and tax planning, especially when long-term control, privacy and intergenerational wealth transfer are key objectives.

CASE EXAMPLE

Inter vivos trust for income splitting and family tax planning

A high-income professional seeks to reduce their personal tax burden while supporting two adult children in lower tax brackets. To achieve this, they establish an inter vivos trust and transfer a portfolio of dividend-generating investments into it.

The trust earns investment income annually, which is then distributed to the children to help fund their post-secondary education and living expenses. Since the income is paid out and taxed in the children's hands, it is subject to lower marginal tax rates, resulting in a reduction of the overall family tax liability.

This strategy allows the settlor to split income effectively, maintain control over distributions and ensure the funds are used for specific purposes. In addition, the assets held in the trust bypass probate and remain private, preserving confidentiality around the family's financial affairs.



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Use of inter vivos trusts in estate freezes

An inter vivos trust, particularly a discretionary family trust, is commonly used in conjunction with an estate freeze to facilitate the tax-efficient transfer of future business growth to the next generation. In a typical freeze, a business owner exchanges their common shares of a private corporation for fixed-value preferred shares, thereby crystallizing the current value of their interest. New common shares, which capture all future appreciation, are then issued to a family trust.

This structure allows the settlor to retain control of the corporation while allocating future growth to beneficiaries, such as children or grandchildren. The discretionary nature of the trust provides flexibility in determining the timing and manner of income or capital distributions.

When structured appropriately, this approach may also enable multiple family members to access the Lifetime Capital Gains Exemption (LCGE) on qualifying shares, further enhancing tax efficiency. However, careful attention must be paid to the Tax on Split Income (TOSI) rules, which may limit tax benefits for beneficiaries who are not actively involved in the business.

Given the complexity of these arrangements, specialized legal and tax advice is essential to ensure compliance and to optimize the benefits of the freeze strategy.



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A family trust is a legal structure designed to manage and distribute assets among family members, either during the settlor's lifetime (*inter vivos*) or upon death (*testamentary*).

Family trusts are widely used for tax planning, asset protection and succession planning, offering flexibility, control and privacy in the transfer of wealth across generations.

For a deeper analysis — including case studies on using family trusts for private corporation shares and income splitting strategies — please refer to Mackenzie's whitepaper [How a trust can safeguard your family's wealth](#).

Revocable vs. irrevocable trusts: key distinctions and tax implications

Trusts are broadly classified as either revocable or irrevocable, depending on the level of control retained by the settlor.

Revocable trusts

A revocable trust allows the settlor to amend, revoke or reclaim trust assets at any time. While this flexibility may be appealing, it limits tax planning benefits. Under Canadian tax rules, if the settlor retains control or the power to influence distributions, income and capital gains may be attributed back to the settlor, potentially leading to unfavourable tax consequences. Additionally, distributions to beneficiaries during the settlor's lifetime may be constrained.

Irrevocable trusts

An irrevocable trust, once established, cannot generally be altered, and the settlor relinquishes control over the assets. This structure is more advantageous for tax and estate planning, as income is typically taxed in the hands of the trust or its beneficiaries, depending on distributions. However, if the settlor or their spouse serve as the sole trustee or retain overriding powers, the trust may still be considered revocable for tax purposes.

To avoid attribution, it is advisable to:

- Appoint independent trustees.
- Ensure the settlor cannot override trustee decisions.

Tax considerations

Irrevocable trusts are taxed at the highest marginal rate on retained income. However, with proper planning, income splitting through distributions to beneficiaries in lower tax brackets can reduce the overall tax burden. Due to the complexity of attribution rules, structuring either type of trust should be carried out with professional legal and tax advice.



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Testamentary trusts

A testamentary trust is a legal arrangement that takes effect upon the death of the settlor, typically established through provisions in the last will and testament or via a beneficiary designation.

Unlike inter vivos trusts, which are created during the settlor's lifetime, a testamentary trust arises only as a consequence of death. This type of trust is often used to manage and distribute assets over time, rather than through an outright transfer. It is especially beneficial when:

- Beneficiaries are minors or vulnerable individuals.
- The settlor wishes to control the timing and conditions of distributions.
- Ongoing financial oversight or protection is required.

Tax treatment and special designations

Testamentary trusts are required to file annual T3 tax returns, often necessitating professional accounting services and incurring administrative costs. In general, income retained within the trust is taxed at the highest marginal rate applicable in the relevant province or territory.

However, two key exceptions provide access to graduated tax rates:

- **Graduated Rate Estate (GRE):**
A testamentary trust may qualify as a GRE for up to 36 months following the settlor's death, provided it meets specific designation criteria under the Income Tax Act. GREs are taxed at graduated tax rates similar to individual marginal rates, offering a temporary window of tax efficiency.
- **Qualified Disability Trust (QDT):**
If the trust is resident in Canada and has an electing beneficiary eligible for the Disability Tax Credit, it may qualify as a QDT. This status allows continued access to graduated tax rates beyond the GRE period. Notably, a beneficiary may only be associated with one QDT at any given time.

In all other cases, to avoid top-rate taxation, income should be distributed to beneficiaries in the same taxation year it is earned, where it may be taxed at individual marginal rates. Testamentary trusts remain a valuable tool in post-mortem estate planning, offering control, protection and tax planning benefits. However, the rules surrounding their taxation are nuanced, and eligibility for GRE or QDT status must be carefully assessed. Proper legal structuring and ongoing professional advice are essential to ensure compliance and optimized tax outcomes.

CASE EXAMPLE

Testamentary trust for minor children

A widowed parent with two young children wishes to ensure their long-term financial security in the event of death. Through their will, the parent establishes a testamentary trust to manage and distribute the estate on the children's behalf.

A trusted family member is appointed as trustee, responsible for overseeing the assets and making targeted distributions to support the children's education, healthcare and overall well-being. Rather than receiving a lump sum inheritance at an early age, the children benefit from structured support, with the remaining capital distributed when they reach a specified age. This arrangement provides both control and protection, helping ensure that assets are used responsibly and in the children's best interests.



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Alter ego and joint partner trusts

An alter ego trust (for a single individual) or a joint partner trust (for a settlor and their spouse or common-law partner) is a type of inter vivos trust available to individuals aged 65 or older. These trusts are designed to provide lifetime financial control and planning flexibility, while offering tax deferral and estate planning benefits.

During the lifetime of the settlor (or both partners in the case of a joint partner trust), the settlor is entitled to receive all income generated by the trust. No other person may receive income or capital from the trust during this period.

These trusts are typically revocable, meaning the trustee may return assets to the settlor if desired. Because the settlor retains beneficial entitlement and control, the transfer of assets to the trust does not trigger capital gains tax at the time of settlement. This feature makes them particularly attractive for individuals seeking to transfer growth assets into a trust without immediate tax consequences.

Additionally, the trust deed may designate successor beneficiaries, enabling the direct transfer of trust assets upon the death of the settlor (or the surviving partner in a joint partner trust) without passing through probate. This allows for privacy, avoidance of probate fees and greater certainty in estate distribution.

CASE EXAMPLE

Alter ego trust for simplified estate settlement

A 70-year-old individual transfers their investment portfolio into an alter ego trust, retaining full access to income generated by the portfolio during their lifetime. Upon death, the trust assets are distributed directly to the children, bypassing probate and reducing estate administration costs.

As the trust is revocable and the settlor maintains control, the transfer does not trigger immediate capital gains tax. This strategy is particularly effective for individuals seeking tax deferral, simplified estate settlement, and continued control and protection of assets during their lifetime.



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Disability trusts

For individuals with disabilities who receive an inheritance or settlement, direct ownership of funds can result in the loss of provincial disability benefits, which are often income- and asset-tested.

A solution in most jurisdictions is the **Henson trust**, a fully discretionary trust designed to preserve eligibility for government support. The structure was affirmed in the 1989 Ontario Court of Appeal decision *Ontario (Director of Income Maintenance, Ministry of Community & Social Services) v. Henson*. In this landmark case, the court ruled that because the beneficiary had no enforceable right to receive income or capital — distribution was entirely at the trustee's discretion — the trust assets were not considered the beneficiary's property for social assistance purposes.

Henson trusts are commonly used in both inter vivos and testamentary planning. Trustees can use the funds to enhance the beneficiary's quality of life — covering expenses such as homecare, education or personal needs — without jeopardizing essential supports.

Because eligibility rules and trust law vary by province, it's critical to obtain specialized legal advice to ensure the trust is drafted and administered in accordance with applicable legislation.

The approach in the case example provides:

- Ongoing financial protection without disqualifying him from provincial support.
- Oversight by a trusted decision-maker, tailored to his needs.
- Preservation of dignity and independence, without the burden of direct financial management.

The Henson trust ensures that the parent's legacy provides lifelong support, not unintended complications.

For more information, refer to [Disability planning in Canada: navigating the RDSP and beyond](#).

CASE EXAMPLE

Safeguarding a child's future with a Henson trust

A mother in her 60s is planning her estate. Her adult son, who has a developmental disability, receives provincial disability assistance and lives semi-independently with occasional support. Aware that a direct inheritance could disqualify him from benefits and overwhelm his ability to manage funds, she sets up a Henson trust through her will.

On her passing, the trust — not her son — legally receives the inheritance. A trusted family member is named as trustee, with full discretion to use the funds for the son's supplemental needs, such as homecare, transportation, therapies and quality-of-life enhancements. The son has no legal entitlement to demand funds, which ensures the trust assets are not counted as his own and his government support continues uninterrupted.



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Spousal trusts

A testamentary spousal trust is a legal arrangement established through a settlor's will, designed to provide financial security for a surviving spouse while preserving capital for future beneficiaries, often the settlor's children.

To qualify as a spousal trust under the Income Tax Act:

- The spouse must be entitled to all trust income during their lifetime; and
- No one else may access the capital while the spouse is alive.

This structure is particularly valuable in second marriages or blended families, where the settlor wishes to support a spouse while ultimately ensuring the remaining assets pass to biological children. It is also appropriate when the spouse may lack financial experience, face health or addiction challenges, or where asset protection is a concern (for example, remarriage or creditor exposure).

Benefits and tax considerations

Spousal trusts provide:

- Tax deferral: assets can be transferred to the trust on a tax-deferred rollover upon the settlor's death.
- Control: the settlor can dictate the terms of income and capital access.
- Protection: assets may be shielded from certain legal claims or mismanagement.
- Estate planning flexibility: ensures alignment of current support and future legacy goals.

The trust becomes a separate taxpayer and must file annual T3 returns. On the death of the surviving spouse, a deemed disposition of trust assets occurs, potentially triggering capital gains tax.

Proper legal structuring is essential to ensure compliance with legislative requirements and alignment with the settlor's intent.

CASE EXAMPLE

Spousal trust in a blended family estate plan

An individual in a second marriage, with children from a previous relationship, wishes to ensure their spouse is financially supported after death while preserving the estate for their children. To achieve this, they establish a testamentary spousal trust through their will.

Upon the individual's death, all estate assets are transferred into the trust. The surviving spouse is entitled to receive all income generated by the trust for life and may access capital if permitted by the trust terms.

When the surviving spouse passes away, the remaining capital is distributed to the children, as specified in the trust.

This structure ensures the spouse is cared for during their lifetime, while safeguarding the inheritance for the next generation — particularly valuable in situations involving blended families, concerns about remarriage or the need for asset protection and financial oversight.



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Insurance trusts

An insurance trust is a specialized estate planning structure funded entirely by the proceeds of a life insurance policy. Unlike traditional testamentary arrangements, it is designed to operate outside the settlor's estate, offering benefits such as probate avoidance, confidentiality and protection from creditors.

In this structure, a beneficiary designation directs the insurance proceeds to a named individual, not in their personal capacity, but as trustee of the insurance trust. This can be established through the settlor's will, or preferably, through a standalone trust declaration, in which case it need not be referenced in the will at all.

The trust only comes into existence at death, when the insurance proceeds are paid and legal ownership transfers to the trustee.

Planning advantages

While life insurance proceeds can be paid directly to named beneficiaries, routing them through a trust allows for:

- Control over timing and use of funds (for example, holding money until a beneficiary reaches a responsible age).
- Protection for vulnerable or spendthrift heirs.
- Shielding assets from family law claims or outside creditors.
- Preserving confidentiality by keeping the arrangement outside probate.

Tax and legal considerations

Precise legal drafting is essential. The settlor must own the policy, and it must be on the settlor's life. Care must also be taken to ensure the insurance proceeds are not otherwise earmarked, for example, to pay estate tax liabilities or fund a buy-sell agreement.

Due to the complexity of beneficiary designations and trust language, specialized legal advice is strongly recommended when establishing an insurance trust.

Qualifying spousal insurance trust

To be recognized as a qualifying spousal trust for tax purposes, an insurance trust must be established through the deceased's last will and testament. Importantly, this requirement does not mean that the life insurance proceeds must flow through the estate. Instead, it refers to the location of the trust's governing terms.

According to the Canada Revenue Agency (CRA), for an insurance trust to receive spousal trust treatment under the Income Tax Act, the terms that create and define the trust must be included in the will itself. If the trust terms are set out in a separate, freestanding document, the trust will not qualify as a spousal trust for tax purposes.

This distinction is critical for individuals seeking to take advantage of the tax-deferred rollover provisions available to qualifying spousal trusts. As such, careful legal drafting is essential to ensure compliance with CRA requirements and to preserve the intended tax treatment.



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Bare trusts

A bare trust is a straightforward trust arrangement in which the trustee holds legal title to an asset but exercises no independent authority or discretion. The beneficiary retains full beneficial ownership and directs all actions related to the trust property. The trustee's role is purely administrative — holding or transferring property strictly in accordance with the beneficiary's instructions.

Bare trusts are commonly used in everyday scenarios, such as:

- An elderly parent adding an adult child to a bank account for convenience.
- A parent co-signing a mortgage and being listed on title, while the child is the true owner.
- Holding property for minor children until they reach the age of majority.

Because there is no change in beneficial ownership, the setup in the case example provided does not trigger a taxable disposition under the Income Tax Act. However, under recent CRA rules, this bare trust arrangement may now require disclosure, even if no income is generated.

Effective for tax years ending after December 30, 2023, a T3 trust return and schedule 15 may be required to report beneficial ownership information — even in cases where no trust income exists.

Please note that as announced on October 29, 2024, bare trusts are not required to file a T3 return and schedule 15 for the 2023 and 2024 tax years, unless the Canada Revenue Agency (CRA) makes a direct request for these filings.

CASE EXAMPLE

Bare trust

An elderly parent adds their adult child to the title of their home for estate planning and administrative convenience — for example, to simplify future transfer of ownership or assist with financial matters. In this arrangement, the child holds legal title as a bare trustee, while the parent retains full beneficial ownership of the property.

The child has no independent authority to use, manage or benefit from the property. All actions must be taken solely under the direction of the parent, and the property continues to be treated as belonging to the parent for tax and estate purposes.



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Vacation property trusts

A vacation property trust is a specialized estate planning tool designed to manage and preserve family cottages or vacation homes over the long term.

These properties often hold deep sentimental value and many families wish to keep them within the family for future generations. However, they can also present complex challenges, including:

- Disagreements over usage and access.
- Unequal contributions to maintenance or repairs.
- Unclear or conflicting expectations about succession and ownership.

By transferring the property into a trust, the settlor can establish a governance framework that outlines how the property is to be used and maintained.

Key features and benefits

A well-structured vacation property trust can:

- Define who may use the property, when and how often.
- Establish a usage schedule to promote fairness among beneficiaries.
- Create a reserve fund to cover maintenance, taxes and capital improvements.
- Include dispute resolution mechanisms to address non-compliance or disagreements.
- Ensure continuity of ownership and oversight, avoiding forced sales or fragmentation of title.

This structure helps reduce the risk of family disputes, protects the property from inconsistent upkeep and provides a long-term strategy for multi-generational enjoyment.

CASE EXAMPLE

Preserving a family cottage through a vacation property trust

A couple owns a cherished lakeside cottage that has been in the family for generations and is now shared by their three adult children and several grandchildren. To ensure the property remains a source of joy rather than conflict, they establish a vacation property trust through provisions in their wills. Two of the children, who live nearby, are appointed as co-trustees, responsible for managing the property.

The trust in the example includes:

- A reserve fund to cover major repairs and capital improvements.
- A system for sharing ongoing maintenance costs based on individual usage.
- A rotating usage schedule for summer and holiday periods, formalized annually by the trustees.
- A dispute resolution clause to address disagreements among beneficiaries.
- A first right of refusal if the property is ever sold, with provisions to ensure fair distribution of sale proceeds.

This trust structure provides a clear governance framework, maintains equity among family members and ensures the cottage remains in the family, well-maintained and free from ownership disputes across generations.



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Tax reporting: trustee obligations and beneficiary implications

The trustee is legally responsible for ensuring accurate and timely tax reporting on behalf of the trust. Each year, a T3 trust income tax and information return must be filed to report income earned by the trust, and to calculate tax payable on any income not allocated to beneficiaries.

Key tax reporting requirements

- **Trust income:** income earned by the trust is calculated annually. Any portion that is paid or payable to beneficiaries during the year is deducted from the trust's taxable income and instead taxed in the hands of the beneficiaries.
- **Unallocated income:** income retained in the trust is taxed at the highest marginal rate, unless the trust qualifies for an exception (for example, it is a Graduated Rate Estate or a Qualified Disability Trust).
- **Losses:** capital and non-capital losses realized by the trust cannot be allocated to beneficiaries. These losses may only be used to offset the trust's own future income or gains, subject to applicable carryforward rules.
- **Tax elections:** trustees may elect, in certain circumstances, to have income or capital gains that are distributed to beneficiaries taxed as if they were retained in the trust. This provides planning flexibility for managing tax outcomes year to year.

Beneficiary reporting

Beneficiaries who receive taxable income from a trust will receive a T3 statement of trust income allocations and designations, issued by the trustee. This statement must be provided no later than 90 days after the end of the trust's taxation year and must be attached to the beneficiary's personal tax return.

Computation of income: taxation of trusts and beneficiaries

The Income Tax Act treats a trust as a separate taxpayer, distinct from its trustees and beneficiaries. Although legal title to the trust assets is held by the trustee, income earned within the trust may be taxed either within the trust itself or in the hands of the beneficiaries, depending on how the income is allocated.

Income character and allocation

A key feature of trust taxation is that income retains its character as it flows through to the beneficiaries. This means that:

- Interest, dividends, foreign income and net capital gains maintain their original tax character when allocated.
- Income can be either:
 - Taxed in the trust and distributed after-tax; or
 - Paid or made payable to beneficiaries and taxed in their hands.

Income allocation decisions must be made annually and reflected in the T3 return, with corresponding T3 slips issued to beneficiaries.

Tax rates and trust residency

The tax rates applicable to a trust depend on its classification and residency:

- Most trusts are taxed at the top marginal rate on income retained within the trust.
- Certain trusts, such as a Graduated Rate Estate (GRE) or a Qualified Disability Trust (QDT), may access graduated personal tax rates if they meet the legislative criteria.



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The residency of a trust — which determines its provincial and federal tax obligations — is generally based on the residency of the trustee(s). However, as established by the Supreme Court of Canada, residency may also be determined by the location where central management and control of the trust is exercised, such as where investment or distribution decisions are made.

Beneficiary taxation

In Canada, trust beneficiaries must report any income or capital gains they receive on their personal tax returns. This includes interest, dividends, rental income and realized capital gains, as reported on a T3 slip issued by the trust.

However, attribution rules apply when the beneficiary is the spouse or a minor child of the settlor. In these cases, income may be taxed in the settlor's hands rather than the beneficiary's, to prevent income splitting and tax avoidance. These rules apply primarily in situations involving inter vivos trusts (trusts created during the settlor's lifetime).

The 21-year deemed disposition rule

In Canada, most personal trusts are subject to a deemed disposition of all capital property every 21 years. This means that all unrealized capital gains are treated as if the assets were sold, and tax is payable on the accrued gains — even if no actual sale occurs.

This rule is particularly important for trusts holding appreciating assets such as real estate or family cottages. Without proper tax planning, the trust may face a significant tax liability, potentially forcing the sale of assets or other unintended consequences.

Trust planning should include a strategy for funding this tax liability, whether through insurance, liquidity planning or intergenerational transfers, to preserve the trust's long-term objectives.



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