Uses of Trusts in Estate Planning

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When results count.

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What is Estate Planning?

- Planning directed at:
  - Accumulating wealth
  - Transferring wealth to succeeding generations
  - Protecting wealth from unnecessary income and probate taxes and from creditors and others challenging the estate plan

What is a Trust?

- A legal relationship whereby one person (the settlor) transfers property to another person (the trustee) to hold for the benefit of others (the beneficiaries)
- The settlor, trustee and beneficiary can all be the same person, but usually two or more persons fill those roles
- A formal trust agreement or trust deed is typically required
- Testamentary trusts are established in a will

What is a Trust ? (Cont'd)

- Not a separate legal person
- Deemed a person for income tax purposes
- Trustee is a fiduciary and must always act impartially and in the best interests of the beneficiaries
- Trusts can be revocable or irrevocable, fixed interest or discretionary

What is a Trust? (Cont'd)

- Personal family trusts are often discretionary – the trustee decides who among the beneficiaries receives income and/or capital, how much each person receives and when
- Investments by the trustees can be limited or expanded in the trust agreement or left to the "prudent investor" standard in the Trustee Act
- Trusts are private (unlike a probated will) and so preserve confidentiality

What is a Trust? (Cont'd)

- Trust assets are generally free from claims by creditors, including those challenging an estate plan, possibly protecting the assets from nursing home costs and other claims
- A very flexible tool for estate planning
- The main drawback is the settlor's loss of control over the assets transferred to the trust

Taxation of Trusts

- Detailed and specific rules in the Income Tax Act
- Exceptions to almost every rule
- The settlor generally pays tax on accrued capital gains on assets settled to the trust – a disposition for tax purposes
- Income retained in a trust is taxed at the top marginal rate for individuals

Taxation of Trusts (Cont'd)

- Income paid or payable to beneficiaries is taxed in the hands of those beneficiaries
- The trust receives a deduction for all amounts paid or made payable to the beneficiaries
- If the trust is revocable, or if the settlor retains significant control over the trust assets, all income (including capital gains) is taxed in the hands of the settlor

Taxation of Trusts (Cont'd)

- If the trust is irrevocable and the beneficiaries are under 18 years of age, income (interest and dividends) is taxed in the hands of the settlor, but capital gains can be taxed in the hands of the minor beneficiaries
- Detailed rules apply to the "attribution" of income to the settlor, spouses and minors

Taxation of Trusts (Cont'd)

- All property held by a trust is deemed to be disposed of every 21 years after the year the trust was created and any resulting capital gain (or loss) calculated and taxed

Inter Vivos Trusts

- Any trust created by a settlor during her lifetime
- Property transferred to the trust will trigger a capital gain
- Trust is taxed as described earlier
- May permit the transfer of assets on death without having those assets pass through probate under the will

Inter Vivos Trusts (Cont'd)

- Negative tax implications often make it an unattractive alternative
- Could be useful for non-income producing assets such as a cottage property that has not appreciated much since acquisition
- Preserves continuity of ownership
- Need to address ongoing maintenance, repairs and other expenses of ownership (i.e. property tax)

Family Trusts

- Not a defined term
- Generally refers to an inter vivos trust which has beneficiaries who are members of the same family
- Each beneficiary can be either an income beneficiary a capital beneficiary or both
- Often used in estate freezes when operating or holding corporations are involved

Family Trusts (Cont'd)

- Trust purchases shares at fair market value so there is no negative tax implication to using the trust at that time
- Ensures flexibility by allowing for dividends to be taxed in the hands of income beneficiaries and for the distribution of shares on a tax-deferred basis to capital beneficiaries

Family Trusts (Cont'd)

- Trustees maintain control of the shares
- Terms of the trust usually provide wide discretion to the trustees to allocate income and capital among the family members

Alter Ego and Joint Partner Trusts

- A specific exception in the Income Tax Act makes these types of inter vivos trusts much more attractive
- Only applies to individuals over 65 years of age
- Alter ego trust – for the sole benefit of settlor during her lifetime
- Joint partner trust – for the joint benefit of settlor and her spouse or common-law partner for their joint lifetimes

Alter Ego and Joint Partner Trusts

- Transfer of assets by settlor occurs on a "rollover" or tax neutral basis
- The 21 year deemed disposition rule does not apply until after the settlor's death
- Beneficiaries after death of settlor and settlor's spouse can be settlor's family or other beneficiaries
- A tax-effective way to avoid probate

Alter Ego and Joint Partner Trusts

- Assets pass under the trust, not the will
- Can be considered a “will substitute”
- Protects against incapacity
- Substitute trustees maintain continuity of administration of trust assets if settlor becomes incompetent

Alter Ego and Joint Partner Trusts

- If trust is irrevocable with no power to encroach on capital during settlor's lifetime, will protect the capital (but not income) from creditors
- Main drawback is inability to transfer assets to a testamentary trust
- Usually need at least $200,000 in assets to justify the expense to set-up and maintain the trust

Spousal Trusts

- Similar to alter ego and joint partner trusts
- Settlor transfers property on a rollover basis on death or on an inter vivos basis to a trust for the sole benefit of her spouse
- Spouse must be entitled to receive all of the income while alive and not one else can receive capital from the trust while the spouse is alive

Spousal Trusts (Cont'd)

- Alternate beneficiaries (i.e. children) can be named on spouse's death
- A way to preserve assets in the event of re-marriage by a spouse (if limit access to capital)
- Subject to spousal attribution rules if trust is inter vivos

Spousal Trusts (Cont'd)

- Can elect out of the spousal rollover provisions if, for example, the property transferred would otherwise qualify for the $750,000 enhanced capital gains exemption for qualified small business corporation shares

Testamentary Trusts

- Established in the settlor's will at the time of her death
- Assets pass through the settlor's estate, but are then transferred to or held by the trustee of the testamentary trust
- Probate tax (1.479% in Nova Scotia) is payable on those assets

Testamentary Trusts (Cont'd)

- Income tax savings far outweigh the probate tax over time
- Testamentary trust can take advantage of the graduated tax rates in the *Income Tax Act*
- Different than an inter vivos trust which pays tax at the highest marginal rate

Testamentary Trusts (Cont'd)

- Depending on type of income earned in the trust and province of residence of the trust for tax purposes, tax savings can exceed $10,000 per year
- Can be combined with a spousal trust to create a testamentary spousal trust

Testamentary Trusts (Cont'd)

- Useful in many situations:
  - Spouses who have significant assets in their own name
  - Adult children who have significant assets of their own (separate trusts for each child are best)
  - To protect assets from marriage breakdown

Testamentary Trusts (Cont’d)

- To preserve continuity of ownership (i.e. cottage property, family business)
- To benefit charity after assets are no longer needed to support family

- Access to capital can be as tight or as loose as required
- As little as $100,000 placed in a testamentary trust can be tax effective if there are no trustee fees taken and the only extra cost is filing a tax return

Insurance Trusts

- A form of testamentary trust funded with the proceeds of an insurance policy payable on death of the testator
- Executor and trustee of the will is designated as beneficiary in the will “in trust”
- Terms of trust mirror the terms of testamentary trusts for spouse, children or other beneficiaries in the will

Insurance Trusts (Cont'd)

- If the trust is funded only from the proceeds of a life insurance policy, the terms of the trust have been established by an individual during his or her lifetime and the trust is separate from that individual's estate, CRA will consider that trust as a testamentary trust
- The document creating the trust must be a "testamentary instrument" under provincial law
- Placing the designation directly in the will is therefore preferable

Insurance Trusts (Cont'd)

- If the beneficiary is the executor and trustee (not "estate"), then the policy proceeds will also pass outside of probate
- Policy also retains its creditor exempt status under the Insurance Act provided the beneficiaries of the trust are the prescribed class of family members (spouse or common-law partner, child, grandchild or parent)

Insurance Trusts (Cont'd)

- Useful in many situations:
  - Spouses who would otherwise name each other as direct beneficiaries of existing policies – an insurance trust creates income splitting opportunities for the surviving spouse that would not otherwise exist
  - Testators with adult children who may also benefit from income splitting
  - Testators with minor children who need testamentary trusts for estate planning purposes more than tax purposes

RRSP Trusts

- Similar principles apply to testamentary trusts created with registered plan proceeds (RRSPs or RRIFs)
- Executor and trustee can be designated as beneficiary of the RRSP in trust on the same terms as the insurance trust noted previously
- RRSP proceeds still pass outside the estate from a probate perspective because they have a designated beneficiary

RRSP Trusts (Cont'd)

- Once paid out to the trustee, the plan proceeds will be a testamentary trust provided the same conditions as with an insurance trust noted previously are met
- **Caution** – the fair market value of the plan as of the date of death will still be taxed as income in the testator's estate on the terminal tax return, even if a spouse or common-law partner is the beneficiary of the trust – there is no rollover to a trust

RRSP Trusts (Cont'd)

- As a result, the estate will pay the tax notwithstanding that the separate trust receives the proceeds – this needs to be addressed as part of the overall estate plan
- RRSPs do retain their creditor protection while the beneficiary designation is in force
- Amendments to the ITA permitting rollover of an RRSP to a spousal trust have been proposed to preserve the non-tax benefits of using a spousal trust, particularly in a second marriage situation, without deregistering the plan and paying tax prematurely

RRSP Trusts (Cont'd)

- Until that legislative change occurs, this strategy is not very attractive as between spouses or common-law partners
- It could be useful for annuitants who have no spouse and would otherwise designate children or other beneficiaries directly and thereby miss the income-splitting benefits of a testamentary trust

Conclusion

- A properly structured trust can be an extremely flexible instrument for estate planning
- As with all estate planning, the income tax consequences of each type of trust must be fully considered
- Care must be taken to ensure the particular trust chosen fits into the overall estate plan

Questions?

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