O'SULLIVAN
ESTATE LAWYERS

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Advisory

Using a Trust in Your Estate Plan

This Advisory provides an overview of the legal concept of a trust, including its role in family wealth preservation and management. It also describes interesting tax-effective strategies for using a trust, which you may find relevant to your own situation.

GENERAL TRUST PRINCIPLES

What is a Trust?

A trust is a type of relationship. The key element of a trust is that title to property is transferred to a person (the "trustee") who has a legal obligation to hold the property for the benefit of others (the "beneficiaries").

Creation of a Trust

To establish a valid trust, the person who transfers the property must intend it be held for the benefit of other persons. The trust comes into existence when the property is transferred to the trustee. The three "certainties" or requirements in order to establish a trust are (i) the intention to create a trust (ii) property held on trust, and (iii) identifiable beneficiaries.

Dual Ownership Under a Trust

The trust is viewed as one of the great achievements of English common law because of its concept of "dual" ownership of property—the trustee has "legal" ownership, while the beneficiaries have "beneficial" ownership. Once a trust is created, the person who has contributed the property loses his or her ownership. Ownership is then held between the trustee and the beneficiaries. The trustee, who holds legal title in his or her name to the trust property, is responsible for its management, but is not entitled to benefit from it in his or her capacity as trustee. Only the beneficiaries are entitled to benefit from the trust property.

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The Trust Agreement

A trust agreement provides how the trust property is to be held, to whom, and when it is to be distributed, in what amounts, and upon which terms and conditions. The trust agreement also defines the obligations of the trustee.

The trust agreement can be tailored to meet various objectives. It can be broad in the discretion it provides the trustee in distributing and managing the trust property, or it can be restrictive and provide little or no discretion, but instead require the trustee to distribute the trust property according to specific instructions.

Inter Vivos and Testamentary Trusts

A trust may be established during a settlor's lifetime (an "*inter vivos*" trust), or it may be established under a will and as a result only take effect on death in accordance with the terms provided under the will (a "testamentary" trust).

GENERAL USES OF TRUSTS

A trust is one of the most powerful tools available to assist in wealth preservation and management. By use of a trust, it is possible to provide for family members now, and protect their financial interests in future, while maintaining control over the management and distribution of the trust property. A trust can be used to achieve one or more of the following estate planning objectives.

Wealth Protection and Management

By use of a trust, third-party professional management of financial assets can be obtained while ensuring succession of property to future generations of family members. A trust can also be used to protect assets from possible future unknown claims, including matrimonial and creditor claims.

Protecting Beneficiaries with Disabilities

A trust can also be used to hold and manage property for persons who by virtue of aging, disease, infirmity, or physical or mental disability require special assistance to manage their property. A trust can be structured to allow the trustee to control the level of payments for the benefit of a disabled individual, while providing flexibility as needs change over time.

Using a Trust as a Will Substitute

One of the areas in which use of a trust is becoming increasingly popular is as a "will substitute." The trust is used as an alternative to a will, or in combination with a will and other vehicles to distribute property on death.

Most provincial and territorial jurisdictions charge probate fees (in Ontario, Estate Administration Tax) to obtain a Court grant confirming the validity of a will and the authority of the executors ("probate") or for the appointment of an estate trustee or administrator of an estate where there is no will.

In Ontario, Estate Administration Tax, at a rate of approximately 1.5% of the value of the estate over $50,000, may be viewed as a form of "wealth tax" payable on death. To circumvent the need to probate a will, and to minimize exposure to this wealth tax, increasing attention has been focused on transferring property on death by other means, including by use of a trust. Income tax legislation provides for two types of trusts, the "alter ego" trust and the "joint partner" trust, to which property may be transferred on a tax-deferred basis by persons aged 65 or older. This legislation facilitates the use of these types of trusts as effective will substitutes and important estate planning vehicles.

Estate Freeze

Another common use of a trust is in conjunction with an "estate freeze." In an estate freeze, in order to minimize capital gains liability on death, the value of assets is frozen for tax purposes at their current level, and future growth is passed on to others. Use of a trust to hold the growth property, such as common shares of a private company, can ensure continued control and management of the growth property in the hands of trustees, and is generally more protective and tax-efficient than an outright gift of growth property to children and others.

Providing for Education and Other Expenses of Children and Grandchildren

One of the popular uses of a trust is to fund children's and grandchildren's education and other expenses in a tax-efficient way. By use of a trust, trustees can control the investment and management of the trust property and its distribution. If the trust is discretionary, the trustees can be provided with the flexibility to determine who will receive the income and capital of the property, in what amounts, and at what ages. This idea is further explored below.

Tax Minimization

Trusts, whether *inter vivos* or testamentary, discretionary or restrictive in their terms, may be used to minimize tax by a variety of means. The two strategies outlined below are two attractive examples.

Income-Splitting

a. Using an *Inter Vivos* Family Trust

Under Canadian tax legislation, income of an *inter vivos* trust is taxed at the highest marginal rate of tax. However, if an income-producing asset is held by an *inter vivos* trust, and provided the trust is properly structured from a tax perspective, the trust's income and capital gains subject to certain rules (such as the attribution rules or the Tax on Split Income (TOSI) rules) may be flowed-through to the beneficiaries of the trust, and taxed in their hands at their own marginal rates. If the beneficiaries have lower tax rates, tax savings will result.

Two common uses of an *inter vivos* trust for these purposes are: (i) to hold capital-growth investments for the benefit of children and grandchildren, including those under eighteen years of age and (ii) to hold investments which earn interest, dividends, and capital gains for the benefit of children and grandchildren who are 18 years of age or older.

Under the *Income Tax Act*, if property is gifted or loaned to a trust and the trust earns capital gains, there is no attribution of the capital gains to the person who contributed the property to the trust when the gains are paid to children or grandchildren who are under 18. However, interest and dividend income earned on the transferred property would be attributed to the contributor and taxable to him or her, unless the property was loaned to the trust on a commercial-rate basis, including the prescribed rate under the *Income Tax Act*.

Example:

> *The following is an example of how a family trust may be used for capital gains splitting:*
>
> *Ken MacDonald (who it is assumed pays income taxes at the top Ontario marginal rate) wishes to invest $50,000 in growth-oriented investments such as shares of public companies, primarily for the purpose of saving for future post-secondary education expenses of his minor children, Kevin and Keira, ages three and one. If the $50,000 investment grows approximately 10% per year and no withdrawals are made, it will be worth almost $210,000 in fifteen years when Kevin will be ready for university.*

If Ken invests the funds in his own name and later uses the funds to pay for university expenses, capital gains of approximately $160,000 (i.e. market value at $210,000 less cost base of $50,000) will be taxed at a current top rate of approximately 26.7%, resulting in tax of almost $43,000. If he waits until the children start university and pays for their expenses using his after-tax employment income or interest from investments, he will be paying a rate of over 53% of his earnings to fund their expenses.

However, if instead Ken either gifts or loans the funds using a family trust, and if capital gains are triggered and paid to the children while the children are in university attendance, little or no tax may be payable.

The children would report the capital gains paid to them in their own income tax returns, but as long as the taxable capital gains (currently one-half of the capital gains) in each year do not exceed their basic personal credit and provided each has no other sources of income, no tax will be payable (subject to potential AMT). This means that based on current federal rates, approximately $28,000 of capital gains can be paid out annually to each child without payment of any tax. Funds paid out in excess of this amount for education or other purposes (financing for a home, assistance with a business, etc.) will attract lower rates based on each child's marginal rate as opposed to Ken's highest marginal rate.

As well, Ken can use this same strategy on a tax-effective basis to fund certain of Kevin and Keira's current expenses such as private school fees, music lessons, summer camp, and travel expenses, rather than using his after-tax income.

Subject to the aforementioned limitations, the family trust could also be used for income-splitting of interest and dividends (as opposed to only capital gains) when Kevin and Keira are 18 and older.

Since Ken's children are under age 18 at this time, tax rules would attribute interest and dividend income earned by the trust (but not capital gains) to Ken unless he loans the funds to the trust at the prescribed rate under the Income Tax Act. However, after a child has reached age 18, if funds are either gifted outright to the trust, or loaned to the trustees at the prescribed rate under the Income Tax Act, this tax rule no longer applies. All interest and dividend income and capital gains received by the trust can be taxed in each adult child's hands, rather than Ken's.

Ken could combine both of these two strategies by establishing a family trust while the children are under 18. He could ensure that the trust's investment strategy in

the early years is geared towards capital growth. However, the trust's investment strategy could be changed when the children are 18 and include generating interest and dividend income, taking into account prevailing market conditions.

b. Using a Testamentary Trust

Testamentary trusts with certain limited exceptions are taxed the same as *inter vivos* trusts—they are taxed at the highest marginal tax rate. It is possible to use a testamentary trust to "sprinkle" income among a group of beneficiaries as long as the trust provides the trustees with discretion to do so.

Example:

Martha's will gives a gift of $1M to her daughter, Claire, a top tax bracket taxpayer living in Ontario with a young family. If Claire invests these funds and earns 6% interest per annum, she would pay approximately $32,000 in tax on the $60,000 of interest she receives in the first year, leaving only $28,000 in her hands after-tax.

However, if Martha instead establishes a testamentary trust under her will for Claire and her children, income could be sprinkled among them as long as the trustees are given broad discretion to distribute income of the trust to Claire and her children. Each of Claire's children could have funds paid or applied to or for their benefit, such as for the payment of tuition fees, equal to their basic personal credit per annum. No tax would be paid on income up to their basic personal credit, assuming they have no other income.

If Claire has three children and the trust paid approximately $15,000 in tuition fees for each child (i.e., the approximate amount of income each child can receive (directly or indirectly) tax-free), this would leave approximately $15,000 to be taxed in the trust (or to be taxed to Claire if paid to her) resulting in tax of about $8,000. Overall, tax of approximately $8,000 would have been paid annually, as opposed to the $32,000 otherwise paid by Claire annually, for an annual tax savings of approximately $24,000.

COSTS INVOLVED IN SETTING UP AND MANAGING A TRUST

In considering the advantages of establishing a trust, the costs associated with its establishment and continued management must always be considered. These costs will vary depending upon the terms of the trust and the time period for which the trust will operate. Any trustee compensation, as well as professional fees, including preparing annual tax

returns must also be taken into consideration. Some of these fees may be tax-deductible at the level of the trust.

CONCLUSION

A number of attractive opportunities exist for using a trust in family wealth planning. The desire to accumulate, protect and manage family wealth in a tax-efficient manner is of paramount concern for many individuals. Significant tax and non-tax advantages may be obtained in many situations by incorporating effective trust planning into the estate plan.

The comments offered in this Client Advisory are meant to be general in nature, are limited to Ontario law and are not intended to provide legal advice on any individual situation. Before taking any action involving your individual situation, you should seek legal advice to ensure it is appropriate to your personal circumstances.

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