In Trusts We Trust: Tax and Estate Planning Using Inter Vivos Trusts

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Estate planning is the process of making arrangements for the management and transfer of your estate. While people often think of transferring property upon death, you may also wish to consider transferring property during your lifetime. A properly set up trust can be a useful tool in this process. Transferring assets into a trust can offer a number of benefits over direct gifts including:

- Control over the timing and amount of distributions to beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves.
- Flexibility in structuring payments to beneficiaries to allow for changes in the amount and timing of distributions, or perhaps even for changes in the choice of beneficiaries, based on future circumstances.
- Lower tax bills for the family, which may be achieved through income splitting or charitable gift planning.
- Depending on your province, reduced probate fees, since assets placed into some types of trusts are often removed from an estate.
- Maintaining privacy for your estate since, unlike a will, a trust agreement is not subject to a public probate process.

Characteristics of a Trust

Common trust characteristics include:

- Inter vivos / Testamentary: A trust created during the settlor's lifetime is known as an "inter vivos" trust. If a trust is created as a consequence of the settlor's death, for example under the will or a beneficiary designation of the settlor, it is called a "testamentary trust".
- Discretionary / Non-discretionary: In a "discretionary" trust, the trustee is given discretion to make certain decisions, usually regarding the amount and timing of distributions and sometimes, which beneficiary. In a non-discretionary trust, the distribution scheme is spelled out in the trust document and the trustee has no discretion regarding distributions.

Family trust: When the beneficiaries of a trust are all family members, the trust is sometimes referred to as a "family trust". Not all trusts that are used in estate planning are family trusts. For example, a trust may be for philanthropic goals and have a charitable organization as the beneficiary.

Creating a Trust

To create a trust, a settlor transfers assets to a trustee who manages the assets on behalf of the "beneficiary". An example would be asking your daughter to manage $10,000 on behalf of your 12-year old grandson. To do this you could create a trust of which you are the settlor, your daughter is the trustee, and your grandson is the beneficiary. The $10,000 would be the initial capital of the trust and would form the trust property.

As settlor, after you transferred the $10,000 into the trust, you would no longer own the funds legally or beneficially. This means that you would not be able to carry out any transactions related to the trust property or receive any of it back. As trustee, your daughter would have legal title to the trust property and would be able to carry out transactions (such as opening bank accounts and investing the funds); however, she would be responsible for managing the trust property according to the terms and conditions of the trust for the benefit of your grandson. Your grandson as beneficiary would have a beneficial interest in the trust.[1]

Taxation of Trusts

Generally, a trust is considered to be a separate individual for tax purposes, meaning that any income earned on trust assets is taxed as if the income were earned by a person who is separate from the settlor, trustee, or beneficiaries. If income is paid (or payable) to a beneficiary in the year it is earned, it can be deducted from the income of the trust and then becomes taxable to the beneficiary. To prevent indefinite postponement of tax on capital gains accrued on property in a trust, a disposition of trust assets is deemed to occur every 21 years (referred to as the "21 year rule"), which results in taxes on the accrued capital gain.[2] The tax can be delayed by transferring trust assets to the beneficiaries. This transfer is deemed to be made at the trust's cost base of the property. The beneficiary then would be responsible for the gain on the property from the time the trust acquired it until the beneficiary actually disposed of the property. This is often referred to as "rolling" the property out of the trust to the beneficiaries at the tax cost.

Historically, until 2016, one significant difference between an inter vivos trust and a testamentary trust was the tax rates applied to trust income. For an inter vivos trust, all income was taxed at the top personal marginal tax rate while for a testamentary trust, graduated personal marginal tax rates applied, resulting in potentially much lower taxes on income retained in the trust.

New legislation effective from 2016 applies the top personal marginal tax rate to a testamentary trust created by will as well as to an estate after 36 months. Consequently, the benefits of graduated rate taxation would generally be limited to the first three years of an estate and would not be available to testamentary trusts created by a will. Given this limitation, you may want to speak with your tax and legal advisors on the costs and benefits, tax and otherwise, of transferring your assets to beneficiaries through your estate or through testamentary trusts or direct beneficiary designations on registered plans and insurance policies.

At the time of the change, the government did recognize, however, that the graduated rate tax system for testamentary trusts was an important planning tool for beneficiaries with a disability. As a result, the changes will not apply to certain testamentary trusts and estates whose beneficiaries are individuals who are eligible for the disability tax credit. Graduated rates will continue to be available indefinitely for these trusts and estates.

The Biggest Estate Planning Mistake of All: Waiting

The single largest mistake in estate planning is failing to implement plans early enough. One CIBC poll revealed that only 55% of respondents had created a will. It was even rarer to find Canadians who had included trusts in their estate plans, and those who did often assumed that because of the lower tax rates that

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[1] A Quebec trust is different than a common law trust. As trustee, your daughter would not own the legal title of the trust property. She will be charged with the full administration of the trust property. She would be able to carry on transactions (such as opening bank accounts and investing the funds). She will be responsible for managing the trust property according to the terms and conditions of the trust deed and the Quebec Civil Code (QCC) for the benefit of your grandson.

[2] Certain trusts are excepted from this rule.

applied previously on testamentary trust income, it would be most beneficial to transfer assets into trust upon death. It doesn't always make sense to wait until the end to transfer all of your assets, and it can be a big mistake to overlook the benefits that inter vivos trusts can offer when assets are transferred during lifetime.

Common Uses for Inter Vivos Trusts

Here are some common situations when you might consider using an inter vivos trust to transfer assets during your lifetime.

Income Splitting

If you are in a high tax bracket and want to benefit family members, you could place or loan funds into an inter vivos family trust for your children (or grandchildren) who are in lower tax brackets. If structured properly and the funds are invested in publicly traded securities, income that is paid to the children, or payable on their behalf for expenses such as private education, summer camps, etc., can be taxed in the children's hands at their lower tax rates. This can mean significant annual family tax savings every year for each trust beneficiary. However, attribution rules can result in trust income being taxed in your own hands, so a tax advisor should be consulted.

If you wait until you pass away to implement trusts, you may have missed many years of potential tax savings from income-splitting during your lifetime.

Estate Freeze for Owners of a Corporation

If you own a corporation and wish to pass future corporate income and growth to your family members, you could implement an "estate freeze" as part of your business succession planning. In the typical estate freeze transaction, the existing value of your shares of the corporation is locked into (or "frozen" in) new preference shares that are issued to you and you can then draw upon this frozen value in the future by redeeming these preferred shares. Future growth of the corporation accrues to new common shares issued by the corporation. In many estate freezes, a family trust is used to hold these new common shares for the benefit of family members, such as children or grandchildren, who can then obtain future income and growth from the corporation. Substantial changes to the taxation of private corporations took effect in 2018 and may impact the tax rate on dividends paid on shares received by family members, including through a family trust, as a result of an estate freeze. For further information, please see our report, The Updated CCPC Tax Proposals.[3]

An estate freeze can help to multiply the $866,912 lifetime capital gains exemption (2019 amount) for qualified small business corporation shares. In 2019, it may be possible to reduce tax on capital gains that arise on a disposition of shares of the corporation by over $225,000 (depending on the province) for each trust beneficiary who can claim the exemption. An estate freeze can also help to reduce the ultimate value of your estate, minimizing your taxes upon death.

Although a trust is not always essential to obtain the benefits of an estate freeze, in some circumstances a trust can add flexibility and control that cannot be achieved otherwise. Because of this flexibility, it may even be advantageous to include a trust in the ownership structure from the inception of the corporation, rather than at a later time during an estate freeze. Owners of professional corporations should consult with their professional associations about available options, such as including trusts in their estate plans.

Alter Ego and Joint Partner Trusts

Depending on your province, alter ego and joint partner trusts are used primarily for probate planning. Once you transfer assets into one of these trusts, they no longer form part of your estate that is subject to probate. This can save probate taxes of over 1.6% of your estate value. Also, unlike your will which is a public

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[3] The report titled "The New CCPC Tax Rules" is available online in the "Business owners" section at https://www.cibc.com/en/personal-banking/advice-centre/tax-savings-tips.html.

document that may be subject to a time-consuming public probate process, trusts can provide a quick and private transfer of assets to your heirs and may be less likely to be challenged in court.

You can transfer assets to an alter ego trust if you are at least 65 years of age. You must be entitled to receive all of the trust income each year and no one else can use any of the trust capital during your lifetime. Upon your death, there will be a deemed disposition of the trust assets, giving rise to tax on any assets with accrued capital gains. You can specify the beneficiaries who will receive any remaining trust capital upon your death.

A joint partner trust is similar to an alter ego trust but provides for both you and your spouse or common-law partner during your lifetimes. You can transfer assets to a joint partner trust if you are at least 65 years of age; your partner's age at the time that you make the transfer does not matter. You or your partner must be entitled to receive all of the trust income each year and no one else can use any of the trust capital during either of your lifetimes. Upon your death or your spouse's/common-law partner's death, whichever is later, there will be a deemed disposition of the trust assets. This will give rise to tax on any assets with accrued capital gains. You can then specify the beneficiaries who will receive any remaining trust capital.

Foreign Inheritance Trusts

Foreign trusts can provide a significant opportunity for tax savings if a foreign family member leaves you assets by way of a gift or inheritance.

To qualify for this favourable tax treatment, the assets provided by the non-resident must be held in a foreign trust, which resides in a jurisdiction other than Canada. A trust will generally be considered to be a foreign trust if it has a non-Canadian trustee who makes all management decisions in connection with trust-related activities. If the trust jurisdiction does not have income tax itself, the trust income may escape not only Canadian tax, but tax worldwide. It is interesting to note that, while the trust cannot reside in Canada, the assets held in the trust can be Canadian investments. This means that, depending on the type of assets held, income from certain Canadian assets held in a foreign trust may not be taxable in Canada, so long as non-resident withholding tax is not applied on income earned on the Canadian assets.

An "inheritance trust" is useful if a foreign family member wishes to leave a gift or inheritance to a Canadian resident. For example, suppose you live in Canada and expect to receive substantial funds from a parent who has always resided outside Canada. If your parent transfers the assets into a foreign trust, no Canadian tax will be levied on the trust assets. The transfer must be made directly from your parent to the trust; if you receive the funds first and then transfer them into an inheritance trust, the tax-free benefits will not apply.

Since trust and tax laws are very complex and can vary internationally, advice should be obtained from legal and tax professionals in all relevant jurisdictions prior to implementing any inheritance trust.

Choosing a Trustee

A trustee has many responsibilities. One of the primary duties is managing the trust property, which can include making investment decisions, purchasing and selling assets, securing and maintaining property (such as arranging for the upkeep of real estate), and paying for expenses related to the property. Additional trustee duties include making payments to beneficiaries, maintaining financial records, and filing tax returns and reporting forms. Where the trustee has discretion as to distributions, the trustee must also determine the proper amount, timing and type of distributions, considering the interests of all beneficiaries, who may have competing interests in trust income and capital.

Given the numerous responsibilities, it is crucial to choose a trustee who has the skill, time and knowledge to properly administer the trust. While a family member or friend is often named as trustee, these individuals may not be qualified to effectively handle all the requirements. It may, therefore, be beneficial to name a corporate trustee who has experience in the various aspects of managing trust property and administering trusts. A knowledgeable trustee may help to maximize wealth for the beneficiaries, for example by implementing strategies to reduce taxes and other fees. Also, by being independent of family members, a corporate trustee can make decisions objectively, which can be particularly beneficial where there is family conflict.

CIBC Trust has a wealth of experience with all types of trusts and can help you to assess whether an inter vivos trust could be a beneficial component of your estate plan. CIBC Trust and its predecessors have over 100 years of experience in acting as trustee for numerous clients and can administer the trust efficiently. It has expertise dealing with legal issues, tax filings, investment decisions and discretionary payments while balancing the needs of all beneficiaries. You can appoint CIBC Trust as the trustee of a trust, either alone or as a co-trustee along with another individual.

If you have been appointed as a trustee and find yourself in need of assistance in carrying out your duties, CIBC Trust also offers "Agent for Trustee" services. This allows you to maintain decision-making authority, but delegate the burden of handling the administrative duties to CIBC Trust.

Since trust and tax laws are very complex, advice should be obtained from legal and tax professionals prior to implementing any trusts.[4] Your CIBC financial advisor can provide more information about having CIBC Trust act as a trustee or about Agent for Trustee services.

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[4] Although a Quebec Civil Law trust accomplishes the same legal and tax benefits than a Common Law Trust, there may be significant differences in the legal rules and wording used to implement one appropriately.

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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