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Planning Matters

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Estate Planning – Use of Trusts

The recent tragic events in Australia and Japan have caused many to think about planning for the unexpected, and look at their affairs to ensure they are in order. One way to achieve effective estate planning is the use of trusts. This planning can be quite simple or very complex depending on your circumstances and there are several different approaches that may be appropriate.

A trust is merely an arrangement whereby one or more persons (the trustees) hold legal title to property (the trust property) for the benefit of other persons (the beneficiaries). The settlor is the person who creates the trust and transfers property to the trust. Trusts are used in commercial, financing and investing activities (such as mutual funds) but could also be an integral part of an estate plan. Two types of trusts are used in estate planning – inter vivos trusts and testamentary trusts.

Inter vivos trust

An inter vivos trust (some call it a living trust), such as a family trust and an alter ego/joint partner trust, is created by a settlor during their lifetime. Family trusts are used in planning for private corporations as part of a "freeze" transaction where the estate value is fixed at a specific point in time and the future growth accrues to the beneficiaries of the trust. Alter-ego trusts are created by a settlor that is 65 or older where they may be the only beneficiary during their lifetime (joint partner trusts include spouses).

Advantages of inter vivos trusts include:

- **Stewardship** – The trustee controls and manages assets on behalf of the beneficiaries. This is valuable when dealing with funds held for minors or disabled or incapable beneficiaries.
- **Flexibility** – Assets held in a discretionary trust are not considered to be owned by the beneficiary, unless the trustee has paid income or capital to them. This provides flexibility in making future distributions, such as the shares of a family business.
- **Protection** – There may be a potential layer of legal protection, since the assets are not owned by the beneficiaries. In B.C., assets distributed under a will may be challenged under the Wills Variation Act, whereas assets held in a trust may be protected from possible challenges under this legislation. Legal advice should be obtained on this matter.
- **Ease of administration** – Assets held in a trust pass outside the estate. This reduces probate fees (in B.C., 1.4% of fair value) and delays in the distribution of assets caused by the probate court process. Under the probate process all of the details of your estate will be part of the public record that anyone can access.
- **Income splitting** – Family trusts that own shares of a private company may be allowed to split income by paying dividends to beneficiaries over 18 years old with no or low income. Also, a $750,000 capital gains exemption may be available for each beneficiary of the trust on a future sale of shares of a qualifying small business corporation to a third party. Currently, the exemption is worth up to $164,000 of tax savings in B.C per individual. However, there are several attribution rules that must be addressed to obtain these benefits.

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Testamentary trust

A testamentary trust is created as a result of the death of a settlor through their will. Testamentary trusts provide the stewardship and flexibility benefits noted above, but the assets will be subject to probate and potential Wills Variation Act claims since the trust is created through a will.

A testamentary trust created solely for the benefit of a spouse during their lifetime allows for a deferral of capital gains tax on assets having accrued gains that are transferred to the trust. Any capital gains tax would be payable at the time of the second spouse's passing.

Unlike an inter vivos trust, a testamentary trust is treated as a separate taxpayer and is entitled to its marginal tax rates. This may provide annual income tax savings of up to $16,000 per trust. The ongoing income tax benefits generally offset any probate fees payable. Note that you cannot simply multiply this benefit by setting up a number of trusts for the same person – they will be treated as one by the Canada Revenue Agency (CRA).

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Administering a trust

To create a trust, it is critical that proper legal documentation be in place. The CRA recently successfully challenged an offshore trust on the basis that it was not property established and, therefore, did not exist.

A trust is a separate taxpayer and must file an annual tax return to report its income within 90 days after its year-end. Inter vivos trusts must have a December 31st year end, whereas testamentary trusts may select any year-end within the first year after death. The trust will pay tax where the management and control of the trust assets takes place – this is generally the place where the trustee resides. Separate books and records should be maintained for the trust and documentation is recommended to support trustee decisions (similar to directors' resolutions).

Trusts do not have an indefinite shelf life for income tax purposes. With the exception of alter ego/joint partner and spousal trusts, the trust is deemed to have disposed of all its assets at fair market value in the year of its 21st anniversary, thereby triggering any unrealized gains. However, assets can be distributed to Canadian resident beneficiaries at the trust's tax cost without immediate tax implications.

Summary

Whether you have your own company or own an investment portfolio, proper planning is important. As with all plans, you must identify your objectives, review the alternatives and determine the best course of action. Working with your professional advisors can help you determine if a trust can help meet your estate planning objectives.