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PLANNING MATTERS

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Trusts in Estate Planning

Trusts are regularly discussed in the course of estate planning and personal wealth planning and can be valuable elements of such plans. To the uninitiated, however, trusts can seem inaccessible and confusing. The purposes of this article is to demystify the trust and some of its uses in estate planning.

A trust is a method of holding assets, not a legal entity in and of itself. A trust is created where an owner of assets (the settlor) transfers those assets to another person as trustee or declares himself or herself to be the trustee of those assets. Once the assets have been transferred to the trustee or declared to be held in trust they are held on the terms specified by the settlor for the people (the beneficiaries) or purposes the settlor directs. The assets transferred become the trust fund. The result of this transaction is that the trustee becomes the owner of the property, but owes duties to the beneficiaries to follow the terms of the trust set by the settlor at the time the trust was created The trustee must also act in the best interests of the beneficiaries and not in conflict with those interests except as permitted by the trust terms and must account to the beneficiaries for what is done with the trust assets.

Trusts are used as a personal planning tools for a number of purposes, including:

1. Generating income tax benefits;
2. Managing assets for a settlor or for a beneficiary who is not able to manage the assets themselves;
3. Protecting beneficiaries other than the settlor from creditors and matrimonial claims;
4. Making gifts on condition;
5. Giving multiple people the benefit of an asset (such as a family cottage).

A trust can be created either during lifetime (an inter vivos trust) or on death (a testamentary trust). Trusts created either before death or after all function similarly. The primary differences between inter vivos and testamentary trusts are in their income tax consequences both at the time they are created and throughout their existence. In both cases the trust is treated as a separate taxpayer. With respect to trusts created during a settlor's lifetime, the creation of these trusts often triggers income tax when the assets are transferred to them and have accrued capital gains. There are some exceptions to this where the trust created is by a settlor over 65 years of age and meets certain requirements as to its terms (these unique trusts are called alter ego or joint partner trusts). Once assets are in an inter vivos trust, any income that is earned on those assets is taxed in the trust's hands at the highest, flat, marginal rate unless it is flowed out to the beneficiaries to be taxed in their hands. By contrast, testamentary trusts are created on the death of a person, typically under a will or life insurance policy. Such trusts have tax consequences associated with the death of the person, but no other immediate tax consequence. Unlike inter vivos trusts, any income that is earned in the testamentary trust is taxed at the graduated marginal rates that would otherwise apply to individuals. This makes them useful income splitting vehicles between the beneficiary and the trust itself. Testamentary trusts can also have flexible non-calendar year ends and other benefits.

A common form of inter vivos trust that is used in personal wealth planning and estate planning is a family trust. This is a generic term that is used to describe trusts created by a person for the benefit of himself or herself and often his or her spouse or children. They have no required form, although often they are discretionary trusts that allow for the trustee to sprinkle income among a group of persons and to choose

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whether or not to distribute the capital and if so on what terms. The benefits most often arising from family trusts are the ability to split income among family members, probate avoidance on the death of the settlor and asset management for a group of family members (such as the management of a family vacation home). There are, however, a number consequences to be considered when creating family trusts, including:

1. Potential income tax consequences on the transfer of assets into the trust where the disposition of the asset triggers tax;
2. Attribution of income earned in the trust back to the settlor where beneficiaries are related in certain ways to the settlor;
3. The 21 year rule, which deems the trust to have disposed of all of its assets for income tax purposes every 21 years after its creation, which could result in the triggering of tax prior to the death of the original settlor;
4. Settlor's loss of absolute control of the asset and the granting of rights to information to beneficiaries.

One scenario where family trusts are often utilized is in the context of an estate freeze. Because a person is deemed to have disposed of all of his or her assets on death, any accrued capital gains are triggered on such assets and are taxed as if the assets had been sold at the date of death. An estate freeze is a series of transactions designed to cap the value of a capital asset in the hands of the original owner at the date of the freeze and to transfer any growth in the value of that asset to another person or persons or to a trust. The effect of such a freeze is that on the death of the original owner only the value of any taxable gain at the time of the freeze is taxable in his or her estate. Typically a freeze is done where it is anticipated that there will be further growth in an asset, the current owner does not require that growth for their own personal benefit and the asset is to be passed to the next generation who will likely hold it, and not sell it, after the death of the current owner. In the context of estate freezes, family trusts are often used to receive the growth interest in the asset and then a group of family members share in the benefit of that growth, including potentially the settlor, through the trust. Typically freezes utilize private company shares to separate current value (as represented by preferred shares) and growth (represented by common shares).

It is possible to achieve some of the same benefits of an estate freeze, namely the capping of the capital gain that is payable in the estate of the original owner, through the use of a trust alone. This would be done where the initial assets held are not corporate assets or cannot be transferred easily to a corporation. An example of such an asset may be a vacation home. Before implementing such a plan, however, the capital gain tax on any accrued gains in the asset must be considered. If there is a gain on the asset to be transferred and it cannot be sheltered with losses or an exemption such as the principal residence exemption, the capital gain tax is payable immediately on transfer to the trust, not on the death of the original owner. Accordingly, using a trust to achieve a freeze of the tax in the hands of the current owner works best where there is no current gain, but a later gain is expected or if any gain would not otherwise be taxable on a sale.

Trusts can be a flexible and useful tool in estate planning that can be used for such simple purposes as delaying the distribution of a gift to a grandchild until he or she reaches a certain specified age, or such complex purposes as a complex discretionary trust in the context of an estate freeze. As there are many pitfalls with respect to the drafting of trusts and the tax consequences associated with them, always consult your professional advisors as to what kind of trusts might be right for you and the risks and rewards such trusts bring.

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