

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

Jamie Golombek

Managing Director, Tax & Estate Planning, CIBC Wealth Advisory Services

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.
- **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 will receive distributions. 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 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 both the capital and income of the trust.

## 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. 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.

For an inter vivos trust, all income is taxed at the top personal marginal tax rate (up to about 55% in 2015, depending on the province).

For a testamentary trust, graduated personal marginal tax rates apply prior to 2016, resulting in lower tax rates on approximately the first \$138,000 of trust income in 2015.

After 2015, graduated rate taxation will generally be limited to the first 36 months of an estate after the date of death, and to testamentary trusts with at least one beneficiary who is eligible for the federal disability tax credit (commonly known as Qualified Disability Trusts). Additional information is available in the CIBC report titled [Planning from the Grave - Testamentary Trusts](#).<sup>1</sup>

## THE BIGGEST ESTATE PLANNING MISTAKE OF ALL: WAITING

The single largest mistake in estate planning is failing to implement plans early enough. A CIBC poll conducted in July 2015 revealed that only 44% of respondents who planned to leave an inheritance had a written will. It is even rarer to find Canadians who have included trusts in their estate plans, and those who do often assume that it would be most beneficial to transfer assets into trust only upon death, once they will no longer be around to control the assets. 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 should 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 assets into an inter vivos family trust for your children (or grandchildren) who are in lower tax brackets. 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 annual family tax savings up to approximately \$20,000 (depending on the province) 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.

In addition to the income-splitting benefits described earlier, an estate freeze can also help to multiply lifetime capital gains exemption for qualified small business corporation shares, which is \$813,600 in 2015.<sup>2</sup> It may be possible to reduce

tax on capital gains that arise on a disposition of shares of the corporation by about \$160,000 to \$220,000 (depending on the province) in 2015 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, a trust can add flexibility and control that cannot be achieved otherwise. With a trust, decisions regarding the amount and timing of distributions to beneficiaries can be made at a future date, eliminating the need to decide on the exact structure immediately. 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**

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 (depending on the province). Also, unlike your will which is a public document that is subject to a time-consuming public probate process, trusts can provide a quick and private transfer of assets to your heirs that 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 remainder 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 spouse's age at the time that you make the transfer does not matter. You or your spouse 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 remainder beneficiaries, who will receive any remaining trust capital.

Alter ego and joint partner trusts are sometimes called "life interest trusts" since you and your spouse or common-law partner (the "life interest beneficiaries") have full interest in the income and capital of the trust during your lifetime(s).

It was noted above that tax on capital gains arises from a deemed disposition of trust assets upon the death of the last surviving life interest beneficiary. There will be a change related to this capital gains tax for deaths occurring after 2015.

Prior to 2016, the capital gains are taxed in the life interest trust. After 2015, however, the capital gains will instead be taxed in the hands of the last surviving life interest beneficiary. This can be problematic when there are different beneficiaries for the life interest trust and the estate of the life interest beneficiary. It is possible that the full value of trust assets would pass to the trust beneficiaries yet the tax related to the trust assets may be paid by the estate beneficiaries, who have no access to the trust assets.<sup>3</sup>

For example, suppose Ben establishes a Joint Partner Trust for himself and his wife, Sue. Under

the terms of the trust, after Ben and Sue die, remaining trust assets will pass to Ben's son from his previous marriage. Sue's will leaves her estate to her daughter from her own previous marriage. If Sue dies after Ben in 2016, the trust assets will pass to Ben's son; however, the capital gains on the trust assets will be taxed in Sue's hands. Since Sue's estate is diminished by the capital gains taxes, the inheritance of Sue's daughter will be reduced by the tax on assets received by Ben's son.

For any Alter Ego Trust or Joint Partner Trust that will be in effect after 2015, you should consult with legal and tax advisors to determine the impact of this change in taxation for deemed dispositions of trust assets upon death.

### **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, assets 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 will not be taxable in Canada.

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 nearly 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.<sup>4</sup> Your CIBC financial advisor can provide more information about having CIBC Trust act as a trustee or about Agent for Trustee services.

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Wealth Advisory Services in Toronto.

- <sup>1</sup> Planning from the Grave is available online at [www.cibc.com/ca/pdf/advice-centre/planning-from-the-grave-en.pdf](http://www.cibc.com/ca/pdf/advice-centre/planning-from-the-grave-en.pdf).
- <sup>2</sup> The Lifetime Capital Gains Exemption (LCGE) is \$1 million for dispositions of qualified farm or fishing property after of April 20, 2015. Qualified farm or fishing property includes shares of a Canadian-controlled private corporation if more than 50% of the fair market value of the property owned by the corporation was attributable to property used principally in a farming or fishing business carried on in in Canada.
- <sup>3</sup> Although the life interest trust will be jointly liable with the Estate for payment of the tax from the deemed disposition on death, the Canada Revenue Agency has not indicated whether it would actually try to collect from the life interest trust.
- <sup>4</sup> 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.

Banking  
that fits  
your life.



**Disclaimer:**

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

This report is published by CIBC with information that is believed to be accurate at the time of publishing. CIBC and its subsidiaries and affiliates are not liable for any errors or omissions. This report is intended to provide general information and should not be construed as specific legal, lending, or tax advice. Individual circumstances and current events are critical to sound planning; anyone wishing to act on the information in this report should consult with his or her financial advisor and tax specialist.

CIBC Cube Design & "Banking that fits your life." are trademarks of CIBC.