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How Can Trusts Help Me and My Family?

Trusts offer a variety of exciting estate planning opportunities. In this brochure, we explain what a trust is, some commonly-used terms, and the role of trustee. We also discuss some of the most popular kinds of trusts and how they might help you and your family.

What is a trust?

A "trust" is a relationship where one person holds assets for the benefit of someone else. There is a separation between the legal owner of the assets, the "trustee", and the person who enjoys the benefits of the assets, the "beneficiary". The person who establishes the trust is known as the "settlor". A trust can have more than one trustee and more than one beneficiary.

What is required of a trustee?

The trustee controls and makes decisions about how the trust assets are to be managed. The trustee has what is called a 'fiduciary duty' to the beneficiary and is required to act in the best interests of the beneficiary. This includes the prudent management and investment of the trust assets. Trustees should obtain professional financial management advice rather than make decisions on their own unless the trustee is a professional financial manager or the amount in the trust is relatively small. Note a trustee who is a professional financial manager should not also benefit from how the trust assets are invested such as by receiving a commission.

How do you create a trust?

A trust is usually created by a written document. It generally describes the role of the trustee and under what circumstances the beneficiary can receive assets from the trust. Depending on the terms of the trust, the trustee can have a little or a lot of discretion in making decisions about managing the trust property and distributing to the beneficiaries.

When does the trust take effect?

A trust that is set up to take effect only upon the death of the settlor is called a "testamentary" trust. This type of trust is taxed as a separate taxpayer at the same marginal tax rates as individuals.

A trust that is established or "settled" while the settlor is living is called an "inter vivos" trust. One drawback associated with this type of trust is that it is taxed at the highest income tax rate for individuals, which is approximately 45% in Ontario.

Why establish a trust?

There are many reasons to set up a trust:

- save money;
- protect wealth;
- ensure funds are available to raise young children;
- protect a beneficiary who receives disability payments;
- ensure young adult beneficiaries aren't given too much money before they are ready to handle it; and,
- protect assets from your creditors or a beneficiary's creditors.

One of the main reasons for setting up a testamentary trust is to provide for the possibility of income splitting. As described above, a testamentary trust is taxed as a separate taxpayer at the same marginal tax rates as individuals. A properly-drafted trust can offer significant tax savings as the beneficiary's personal income and the trust income can be taxed separately for the first 21 years of the trust's existence.

Tax savings through income splitting are also possible by setting up a trust for each child (rather than one trust for all of your children). In addition, naming a child's spouse and children as potential trust income beneficiaries can offer further income splitting and tax savings.

What is income?

If a trust receives interest, dividends, or other amounts, these are income to the trust. Tax rules set limits on how long income can be accumulated in a trust.

What is capital?

The assets that a trust starts with are capital. Any increase or decrease in asset value is a capital gain or capital loss. For most trusts, capital gains or losses must be reported every 21 years of the trust's existence. If income is not paid out of the trust each year and is, instead, kept inside the trust, it becomes capital. However, tax rules usually limit how long this can be done.

Testamentary trusts: Some options

Three popular kinds of testamentary trusts are spousal trusts, trusts for children (minor and adult), and discretionary trusts. These trusts are commonly set out in a person's will although they can also be set up in a separate document.

Spousal trusts

There are a number of reasons why you might consider setting up a trust for your spouse to take effect upon your death:

- Using a trust to transfer the value of your estate to a spousal trust avoids having to pay tax at your death (although it will have to be paid eventually).
- To take advantage of possible tax savings on investment income through income splitting during the lifetime of the surviving spouse. Tax savings are possible depending on various factors such as the province of residence, current tax rates, and your surviving spouse's own income.
- In a second marriage, a spousal trust allows you to provide for your spouse after your death but then give what's left to your children when your spouse dies.

For tax reasons, a spousal trust usually provides that all of the income of the trust is payable to the spouse and that any amount, or even the whole, of the capital of the trust can be used for the benefit of the spouse. The surviving spouse may be a trustee of his or her trust; however, he or she should not be the only trustee. One option is to appoint the spouse along with one or more of his or her children or a professional trustee.

Trusts for children (minor and adult)

For minor (under 18) children, setting up a trust can provide financial help to those raising your children. For older children who are not yet responsible enough to manage large sums of money, directing an inheritance into a trust ensures the assets are being managed by a trustee until the children are old enough to manage the assets themselves.

A trust for a minor child is often structured to provide for one or more distributions of capital to the child at various ages, for example, 5% of the value of the trust at age 18, 20% at age 25, and the balance at age 30. The ages and amounts of distributions can be whatever you feel is appropriate for your children. The trustee can also be given the discretion to make payments from the trust at any time to or for the child's education, maintenance, support, etc. For tax reasons, the income from the trust should be paid directly to the child from age 18 onwards or starting on the 21st anniversary of your death.

The use of trusts for adult children have other potential benefits besides preventing your children from a spending spree:

- Tax savings as a result of income splitting opportunities between the child, his or her trust, the child's spouse, and his or her children if they are included as potential beneficiaries of the trust. This can minimize the overall amount of income tax that your child's family pays.
- Trust assets are usually out of the reach of your child's creditors or your child's spouse on marriage breakdown if correctly drafted.

Your adult child may be a trustee of his or her trust but not as the only trustee. If you have more than one child and if your children get along well with each other, you may consider appointing a child's sibling as co-trustee.

Trusts for a beneficiary with a disability

You can set up a special type of trust, referred to as a discretionary trust or a Henson Trust, for a beneficiary with a disability. Please see our brochures entitled Providing for a Family Member with a Disability and Acting as a Trustee of a Henson Trust for further information.

Life insurance

For many, life insurance represents a significant asset. There is a special tool, known as an "insurance trust declaration", which can allow life insurance proceeds to flow directly into a testamentary trust without being subject to probate fees. When life insurance is payable to a beneficiary, no probate fees are payable and the proceeds are protected from the deceased's creditors. Furthermore, if the beneficiaries are the spouse, child, grandchildren, or parent of the insured person, any interest that the insured has in the policy during his or her lifetime is protected from the insured's creditors. An insurance trust also enjoys these benefits. The trust into which the insurance flows can be any of the trusts described above.

Inter vivos trusts

There may be situations where you want to establish a trust that will come into existence or be "settled" while you are still living (an "inter vivos" trust). There are a variety of situations where an inter vivos trust may be useful:

- If you are 65 or older, you may want to establish an inter vivos trust for yourself or for you and your spouse. For example, an alter ego or joint partner trust can save probate fees, offer privacy, and ensure your assets are immediately distributable upon your death. Please see our brochure entitled *Alter Ego And Joint Partner Trusts* for further information.
- For people who own a family business, it is possible to use a trust to transfer the value of the business from the parent to benefit a child or children in such a way that the future capital gain on the value of the business will not be payable on the parent's death.
- If you are a new resident in Canada, it is possible to set up a trust in another country which allows your investments to accumulate outside of Canada and not be subject to Canadian tax for a period of 60 months after you move to Canada.

Conclusion

Trusts offer a variety of benefits for you and your family. This makes them an important estate planning tool. We encourage you to seek the advice of an estate planning specialist to determine if you should be including one or more trusts in your estate plan.

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