

Understanding In-trust Accounts

The "in-trust" account is an arrangement frequently used by parents and grandparents to accumulate savings for their children or grandchildren.

The popularity of this account stems from the common perception that it is an inexpensive way to set up a trust to take advantage of capital gains splitting with the minor beneficiary. However, the true legal and tax implications of setting up an in-trust account are often not fully understood. This article examines the nature of the in-trust account, its tax implications and highlights areas of concern when setting one up.

Capital gains splitting

The Income Tax Act contains attribution rules which restrict a Canadian resident taxpayer's ability to split income by transferring assets between family members.

The rules provide that where assets are gifted to a "related minor" (which includes the taxpayer's children, grandchildren, nieces and nephews), any interest or dividend income earned on assets transferred as a gift, whether directly or indirectly through a trust, will be taxed back in the hands of the transferor. Such attribution of interest and dividend income continues until the beneficiary reaches 18 years of age. [Note: income attribution does not apply to funds originating from the Canada Child Tax Benefit or the Universal Child Care Benefit.]

Income attribution, however, does not apply to capital gains or losses. Therefore, if assets gifted to a minor beneficiary are invested with a view to capital appreciation, the eventual gains may be taxed in the hands of the beneficiary. Given that the beneficiary tends to be in a much lower tax bracket, income splitting may be achieved.

Legal nature of an in-trust account

Children under the age of majority cannot enter into binding financial contracts; however, assets gifted to them have to be held in trust for them by an adult.

This can be achieved by setting up a formal trust relationship, which typically entails the preparation of a legal document known as a deed of trust, which sets out specifics as to how the trust is to be administered and when and how the trust assets are to be distributed to the beneficiary.

As this document requires drafting by a lawyer and hence legal costs, many people opt to set up in-trust or "informal trust" accounts with a financial institution in an attempt to save on legal costs.

Few people realize however that the law does not recognize "informal trusts". At law, either there is a valid trust, or there isn't one. A valid trust is created when the required elements of a trust ("the Three Certainties") exist:

- The settlor (the person who establishes the trust and contributes the funds) has clear intention to create the trust;
- The trust property is sufficiently identified; and
- The beneficiary or beneficiaries is/are sufficiently identified.

Written trust documentation is not a strict legal requirement for the creation of a valid trust, but the problem with informal arrangements such as in-trust accounts is that it is difficult to prove the settlor's intention when there is no proper written documentation in place. As a result, the Canada Revenue Agency (CRA) may determine that there is no trust, in which case the settlor will remain liable for all taxes on income and capital gains from the account.



Tax implications of setting up an in-trust account

If there is no valid trust

As mentioned earlier, where it cannot be proven that the requisite formalities for the creation of a valid trust have been observed, the assets in an in-trust account still belong to the settlor; and CRA will likely tax the settlor on all income as well as capital gains from the trust funds.

If there is a valid trust but the settlor retains control over the trust assets

Even if a valid trust has been created, the settlor may still be liable for all income as well as capital gains earned inside the account. This is because the Income Tax Act contains a provision that, where the terms of the trust are such that the trust property may only be distributed with the consent of, or in accordance with, the directions of the settlor, all income as well as capital gains earned inside a trust be attributed back to the settlor.

The CRA has generally interpreted this to be the case in situations where the settlor is also the trustee. This presents a particular problem to the in-trust account, which is habitually created by the settlor simply by opening an account with a financial institution "in trust for" a named beneficiary.

This undesirable tax consequence can potentially be avoided by having the settlor's spouse act as trustee instead. Whether this strategy is practicable may depend on the settlor's view as to the stability of their family situation.

Inter vivos trust are taxed at the highest marginal tax rate

Unlike testamentary trusts which are subject to the same graduated tax rates of a natural person, any income earned inside an inter vivos trust (i.e. trusts established during the settlor's lifetime) are taxed at the highest marginal rate. To avoid this result, income generated within an in-trust account can be distributed to the beneficiary and taxed in their hands.

Filing of tax returns

As indicated earlier, there is no distinction between formal and informal trusts in the eyes of the CRA. An in-trust account that is a validly created trust will be subject to the same tax filing requirements as a trust created by a legal document. T3 trust returns are required to be filed annually to report income earned in the trust.

Tax implications upon transfer of assets to the trust

Instead of depositing cash into an in-trust account, a settlor may choose to transfer an investment asset held in their own name into an in-trust account. It should be borne in mind that this transfer constitutes a "deemed disposition" of the asset (i.e. the asset is treated as being sold) and may result in the realization of accrued capital gains.

Factors to consider before establishing an in-trust account

Who owns the trust assets now?

Once a settlor deposits an asset into an in-trust account with clear intention of making a gift to the beneficiary, they have divested themselves of the asset forever, and the beneficial ownership of the asset belongs to the beneficiary.

What this means is that the transferor can no longer take the money back for their personal use, for the use of another child, or even for contribution to an RESP for the beneficiary of the in-trust account.

When the beneficiary comes of age

At law, if there are no limits on when the beneficiary will be entitled to the trust funds (as is the case with an informal, unwritten arrangement), the beneficiary will be legally entitled, upon reaching age of majority, to demand that the trust be wound up and the trust funds paid to them.

Few parents are willing to turn over control of the funds to an 18-year-old, so this is something that needs to be carefully considered prior to establishing an in-trust account. If maintaining control is a priority, a formal trust may be preferable, notwithstanding the initial set-up and ongoing administration expenses involved.

Summary

This article highlighted some of the tax and legal implications of setting up an in-trust account that you may not be aware of. If you are considering the use of an in-trust account to implement income splitting with your child or grandchild, it is strongly recommended that you discuss the proposed strategy with your professional legal and/or tax advisor prior to implementation.

Last revised: July 29, 2010

The information contained herein has been provided by TD Waterhouse Canada Inc. and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading or tax strategies should be evaluated relative to each individual's objectives and risk tolerance.

TD Waterhouse Canada Inc., The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Waterhouse represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Waterhouse Private Banking (offered by The Toronto-Dominion Bank) and TD Waterhouse Private Trust (offered by The Canada Trust Company).

®/ The TD logo and other trade-marks are the property of The Toronto-Dominion Bank or a wholly-owned subsidiary, in Canada and/or in other countries.