



Introduction to Trusts

Trusts date back many hundreds of years and were primarily used for legal purposes. Today, however, trusts have evolved into an important tool from both a tax and estate planning perspective. The appropriate implementation of a trust allows for the effective flow-through of income and capital to a beneficiary to achieve substantial tax savings, while for legal purposes, a trust can provide a mechanism to control and preserve precious assets.

Structure of a Trust

In its simplest form, a trust provides a method for an individual (the settlor) to transfer legal title of property to another person (the trustee) who in turn has a fiduciary responsibility for administering the property on

behalf of the beneficiary. The beneficiary does not have legal title to the property, but may enjoy benefits from it. Since trusts can be quite complex, this article will concentrate on the basics of personal trusts.

Parties to a Trust

There are three parties to a trust: the settlor, trustee and beneficiary.

Settlor

The settlor is the individual who contributes money or property to establish the trust. Legal title is transferred to the trustee for the benefit of the beneficiaries. If a trust is *revocable*, the settlor continues to enjoy control over the property and can revoke the trust as specified in the trust document. The settlor, in this instance, may also be a beneficiary. If a trust is *irrevocable*, the settlor gives up their right to use the property and will generally not be a beneficiary. A testamentary trust exists when the settlor's death causes the trust to come into existence and is usually part of a will, while an inter vivos trust is created during the settlor's lifetime. The fair market value of the property transferred to the trust by the settlor cannot be exceeded by the fair market value of other property subsequently transferred to the trust by other parties. If this occurs, there may be a question as to who is the actual settlor of the trust.

Trustee(s)

A trustee is appointed by the settlor and is charged with fiduciary responsibility in administering property within the terms of the trust agreement. Where the agreement is silent on powers and obligations or in the instance where no trust agreement exists, provincial trustee legislation is applied. The current legislation is much less restrictive than it was in the past as the provinces (other than Quebec) have now adopted a prudent investor approach that allows the trustee to use most types of investments.

The selection of a trustee requires utmost care and some preliminary considerations should be undertaken before making the appointment. For example, the settlor of the trust should not be a trustee due to the negative impact of the attribution rules. Basically, these rules redirect income back to the settlor even though income is paid to a beneficiary. However, a beneficiary of the trust may be a trustee. If a beneficiary is to become a trustee, there should be a separation between legal ownership and beneficial ownership. As well, there should be consideration given to the potential for a conflict of interest when the beneficiary is also a trustee. Actions taken by the trustee, who is a beneficiary, may be viewed as self-serving and not in the best interests of all of the beneficiaries. For instance, someone who will become the capital beneficiary under a trust on the death of the income beneficiary may have conflict of interest. The income beneficiary may not be fairly treated in order to preserve the maximum amount of capital for distribution to the capital beneficiary. As a result, it may be preferable to name other parties as trustees.

Trusts can provide the following benefits

- Create substantial tax savings
- Provide continuing control over assets and beneficiaries
- Protect assets from potential creditors
- Maintain privacy
- By-pass probate

It is extremely important to assess the person who will take on the role of trustee. In many instances, the settlor may seek an individual who knows them well and understands the way in which they would like the property distributed. The complexity of the trust should be considered when selecting a trustee. Consider these factors, amongst others, before appointing a trustee: Do they possess skills to manage and control the assets? Do they have necessary investment and banking knowledge? Do they have the ability to work with professional advisors?

Where there is no suitable trustee, a corporate trustee may be considered. However, the fees associated with this service should be considered in light of the size of the trust and its complexity.

Beneficiary(ies)

The beneficiary will be entitled to the use of the property of the trust. Beneficiaries can receive either income, capital or both from the trust depending upon the terms of the trust regarding distribution. The trustee has a fiduciary duty to take an "even hand" approach to the trust unless the trust document dictates otherwise. This means that the interests of all beneficiaries must be taken into account.

In the case of a minor beneficiary (under the age of majority which varies from province to province), payment cannot be made directly to the minor beneficiary. Payment must be made to someone on their behalf, as the minor cannot provide a valid release for the payments. The trust agreement may specify the amounts and circumstances of payments made for the benefit of a minor. If a trust is silent, an application may be made to the court to provide for the payment of income towards the beneficiary's maintenance, education or benefit. Most provincial trustee legislation will permit the court to approve payment for food, shelter, clothing, special care and education. A court may also allow for capital payments for the benefit of a minor to be made where warranted.

Residency of the Trust

A trust is generally resident where a majority of its controlling trustees reside. If the trustees emigrate to a new jurisdiction outside of Canada, the trust will become a non-resident of Canada. Tax consequences associated with the emigration of the trust will apply, resulting in a deemed year-end immediately before the date the trust became non-resident as well as a deemed disposition and reacquisition of each property of the trust at fair market value. It is therefore important that the settlor of a trust be fully aware of any potential residency issues of the trustees. The use of non-resident and off shore trusts in planning is beyond the scope of this article and we recommend that you consult your independent legal and tax advisors before implementing these types of strategies.

Distributions from a Trust

There are two types of beneficiaries under a trust: "income beneficiaries," where they are entitled to only the income of the trust or "capital beneficiaries" (also referred to as "residuary beneficiaries") where they are eligible to receive the capital from the trust. A beneficiary may be entitled to receive both income and capital from a trust. Income can be taxed within the trust or allocated to a beneficiary. Payments can be in the form of cash, a transfer of assets, which is referred to as "in specie", or by way of a promise to pay in the form of a Promissory Note.

Discretionary Versus Non-Discretionary Trusts

A trust can be discretionary or non-discretionary in nature. When a trust is discretionary, the trustee exercises discretionary powers as to when, if at all, payment will occur. This may be advantageous in a number of situations including the following:

- **Beneficiary is facing creditors** - payment can be deferred or paid to a third party at the discretion of the trustee. This avoids the payment being exposed to the creditors of the beneficiary.

Requirements to Create a Trust

In order to meet the legal requirements of a trust, three certainties must exist.

- **Certainty of intention** – a clear intention to create a trust by the settlor;
- **Certainty of property** – the property must be clearly ascertainable; and
- **Certainty of beneficiary** – the beneficiary must be clearly identifiable either by name or by class.

If these three elements do not exist, the trust will fail. Trusts can be either informal (without documentation) or formal (with written documentation). A formal written trust is preferred because it can confirm the intention of the settlor and the existence of the three certainties.

Saunders v Vautier – Take Care When Using Trusts

Where a trust exists, a beneficiary may enforce payment regardless of the provisions or conditions found in the trust document. In this instance, what is referred to as the rule in **Saunders v. Vautier** should be considered. This case stands for the premise that if there are no subsequent beneficial interests to consider or all beneficiaries agree (assuming no minor beneficiaries); application may be made to the court to have the assets of the trust paid to the beneficiary.

To demonstrate this, assume there is a trust set up and a beneficiary is not entitled to distributions until age 35. If there are no contingent beneficiaries (a beneficiary who would receive the property or remainder of the property if the original beneficiary was deceased), the beneficiary could apply to have the amounts paid out once they reached the age of majority.

- **Beneficiary is disabled and receiving government assistance payments** - a discretionary trust may be used to avoid jeopardizing these payments (often referred to as a discretionary "Henson Trust").
- **Marital breakdown** - entitlement to payments under a discretionary trust may not form part of the division or equalization calculation. Unfortunately, the law in this area is not entirely clear as cases have been awarded both ways, depending upon the jurisdiction.

Changing the Terms of a Trust

Generally, a court will be reluctant to vary the terms of a trust. Only where it can be demonstrated that the variation will benefit the beneficiaries, will a court provide approval. Unless the trust agreement allows for a variation, provincial trustee legislation - in most instances - will require that a trustee seek approval from the court. Where the beneficiaries agree on a variation, but a minor child is also a beneficiary, a court application must be sought to ensure that the minor child's interests are also considered. A variation of a trust may also effectively terminate the original trust and create a new one. If a new trust is created, potential tax issues may arise causing a deemed disposition of all the trust property, which could result in a realization of taxable capital gains. It should be noted that a variation of a trust might also cause the attribution rules to apply. Caution in that regard should be taken when seeking a variation of trust terms.

Winding up a Trust

Generally a trust agreement will address wind up provisions within 21 years from the date of establishment in order to avoid the deemed disposition rules. Where the trust document does not address this issue, provincial trustee legislation requires the trustee to seek court approval for a winding up of the trust. Where the beneficiaries and guardians of minor beneficiaries approve the wind up, the court must be satisfied that it will be in the best interests of all of the beneficiaries.

A Spousal, Alter Ego and Joint Partner Trusts receive special treatment and are not subject to the 21-year rule.

Property of a trust can be distributed to any Canadian resident beneficiary, at its cost, pursuant to the Income Tax Act deferring any capital gain until death of the beneficiary. However if the beneficiary disposed of the property prior to their death, the capital gain would be payable.

Summary

Trusts can provide a vehicle that allows for effective tax planning and control of assets and should be considered part of an overall estate plan. Before making a decision to implement a trust, careful consideration and investigation of all options and issues is necessary to provide the appropriate solution for your unique situation.

This article is one in an extensive series of educational reports that discuss relevant and timely wealth management topics. If you would like to learn more about a particular subject, your Investment Advisor would be pleased to assist.

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