Professional Financial Planning Course

TRUSTS

An Overview

- A trust is created when one party (the settlor) transfers assets to another party who then holds legal title to the assets (the trustee), with instructions as to how the assets are to be used for the benefit of main parties (the beneficiaries). In setting up a trust it is possible for an individual to be the settlor and the trustee but the settlor cannot be the trustee and the sole beneficiary (except for alter ego trusts).

- A trust is not a legal entity like a corporation. Procedure and administrative aspects and the responsibilities and powers of the trustee are outlined in individual provincial trustee acts.

- When assets are transferred to a trust, a disposition occurs that may trigger capital gains or losses for the settlor.

- A settlor of a testamentary trust is the person upon whose death the trust is created. A settlor must be the age of majority and not be legally restricted or mentally incompetent.
- A settlor in an inter-vivos (or living) trust is the person who created the trust by transferring property to it.

- The beneficiary is the person who has a contingent or absolute right to receive the assets held in trust.

- A trustee is a person who has control over the assets of the trust without possessing any right to obtain the assets held in the trust.

- Trustees must be mentally competent but not necessarily the age of majority.

- There are four primary duties imposed on trustees by the common law:

    - *Conflict of Interest and Duty:* trustees cannot be seen to be in conflict of interest or duty as between his or her own interest and that of the beneficiaries. In practice, a trustee cannot profit from actions, cannot acquire trust property, cannot enter into a contract with the trust, or cannot benefit from that which is made available to them as a result of being a trustee.

- *Management of Trust Funds:* the courts impose a duty of care on a trustee to prudently manage trust funds.

- *Delegation by Trustee:* generally, a trustee cannot delegate his or her duties. However, a trustee can employ an agent when necessary. The trustee will not be held responsible for the agent's errors or dishonesty, if the circumstances justify the actions of the trustee in employing the agent.

- *Maintaining an Even Hand:* trustees are required to act impartially in dealing with trust assets for the benefit of the beneficiaries.

• In a discretionary trust, the trustee may choose to confer a benefit on one beneficiary and not on another beneficiary. Assets need not be split equally.

• Upon termination of a trust, it is the trustee's responsibility to deliver the assets of the trust to those whose are entitled.

Types of Trusts

• A trust is constituted when the intention to create the trust is determined, the trust property is delivered to the trustee and the objective of the trust is clear.

• A trust is generally not created until property is actually deposited to and owned by the trust.

• The ITA treats a trust relationship as if it were a separate entity. A separate tax return must be filed annually by a trust.

• A trust can be created by a contract, a will, or a legal judgement.

• An inter-vivos or living trust is set-up during one's lifetime. It is often referred to as a family trust or personal trust.

• A testamentary trust arises at one's death and is established by a will.

- A resulting trust is created by the intention for a trust to exist. This can occur when an original trust cannot be set up or is void or when a surplus exists after a trust has been established.

- A constructive trust occurs by circumstances or because of the law and when there was not any specific and direct intention for the trust to exist (e.g. when a trustee with fiduciary responsibility gains personal advantage from a trust).

- A life insurance trust is comprised of proceeds of either one or several insurance policies.

- A charitable trust is established to benefit the community or the public.

- Living trusts can be designated as either revocable, which means it can be undone by the settlor at any time, or irrevocable which means the settlor cannot revoke the terms of the trust and has no legal right to take back any of the trust's assets.

- If it is not clearly stated in trust documents that a trust is revocable, it is irrevocable.

- Reasons to set up a living trust include:

- Concern about putting capital directly in the hands of a beneficiary because he or she would be irresponsible, unsophisticated or mentally challenged.

- To "freeze" the estate so that the value of the growth of the assets are frozen for income tax purposes so that all future capital gains will accrue to the beneficiaries.

- The drawbacks to setting up a trust include:

- The set up procedures can be tedious and expensive.

- Annual tax reporting is required.

- Legal and accounting fee.

- A trust can also be a way to donate funds to charity. The settlor receives an immediate tax credit and also receives all the income generated by the trust for his or her remaining lifetime. At death all remaining capital goes to the charity.

- A spousal trust is essentially any testamentary trust or inter-vivos trust created by a settlor for the benefit of a spouse as long as certain conditions are met.

- The spouse must receive all of the income of the trust during her lifetime; no other person may obtain or use the income or capital of the trust.

- Although a settlor may wish to create a trust that lasts forever, such trusts are generally invalid because they are contrary to the existing rules concerning perpetuities.

The common elements of trusts are:

- *Identification of the Parties to the Trust:* The initial settlor, trustee(s) and beneficiary(s) should be identified.

- *Settlement of the Trust:* The indenture should refer to the trust property given to and accepted by the trustee. If securities ettle the trust, the trust is irrevocable.

- *Determination of the Beneficiaries:* The beneficiaries must be determined with certainty. Often beneficiaries are treated as a class (e.g. "my children") instead of a specific name(s). This ensures that if a child is born or deceased, the trust documents need not be revised.

- *Purposes of the Trust:* The purpose for which a trust is established should be clearly set out. In a discretionary trust, the trust may distribute capital and income to any beneficiary. In a non-discretionary trust, the trustee has no discretion in the distribution of capital or income.

- *Indemnification of the Trustees:* Trust indentures typically have a series of provisions aimed at limiting the high standards that trustees must otherwise meet so that trustees will only be liable in the event of wilful default. Trustees are often indemnified for any actions taken by them within the scope of the duties specified in the trust indenture.

- *Trustees' Power:* The investment powers vested in a trustee are those set out in the applicable provincial statute, unless a trust indenture states otherwise. These powers are very restrictive. In Quebec, the power to invest is unlimited.

- *Time of Division:* Many "personal trusts" contain a time of division clause designed to automatically distribute all the trust property to the beneficiaries on a tax-deferred basis before the application of the 21-year deemed distribution rule.

- *Failure of the Trust:* If a trust fails because the beneficiaries die, then the trust property must be returned to the settlor. To avoid the attribution that would result, the trust should provide an alternative distribution.

- *Deeds of Appointment:* Trustees exercise the power to distribute or hold property for a particular beneficiary by executing a deed of appointment.

- *Letter of Wishes:* This is a non-binding declaration of the settlor's wishes; it can accompany discretionary trust indentures.

REASONS FOR USING TRUSTS

Asset Management

- Discretionary trusts provide flexibility for an estate freeze because benefits from the shares can be changed to suit changing circumstances of family members. When family members own shares, it is less easy to make adjustments or reallocations.

Asset Protection

- Holding assets in a discretionary trust protects the asset both from the creditors of beneficiaries and from the beneficiaries themselves.

Avoiding Deemed Disposition at Death

- Beneficial interests in trust property can pass without tax as the benefits of trust property accrue to beneficiaries of successive generations.

Secrecy

- Trusts are not subject to public disclosure and provide an element of secrecy that is not available to corporations, their shareholders or wills and heirs.