IN-TRUST ACCOUNTS: THE BASICS

CI GLOBAL ASSET MANAGEMENT

An in-trust for account (ITF) is a convenient and popular tool for parents, grandparents and other adults to set aside funds for minor children. It allows the account holder to make investment decisions on behalf of minor beneficiaries and potentially split income for tax purposes. An ITF can protect assets for a child and also help in inheritance arrangements because minors cannot directly accept a gift under a Will. Which tax slips[1] are issued and who reports the income for tax purposes depends on the legal relationship underlying the account and whether the attribution rules of the Income Tax Act (ITA) will apply[2].

WHAT IS A TRUST?

A trust is a relationship between a settlor[3], a trustee and a beneficiary that separates legal ownership and beneficial ownership of trust property. A settlor transfers property to the trust and appoints a trustee as the legal owner of the property for the benefit of the trust's beneficiaries. At common-law, three certainties must be present for a trust relationship to exist:

1. Certainty of intention to establish the trust
2. Certainty of beneficiaries (object)
3. Certainty of trust property (subject)

While written documentation of a trust relationship is not required for a valid trust to exist, it is advisable to have evidence of these three certainties and terms of the relationship. The intention to establish a trust can be particularly difficult to prove without a formal trust deed.

FORMAL TRUST VS. ITF ACCOUNT

A formal trust created during the life of the settlor through a written and properly executed trust deed that spells out terms and conditions is the best evidence of the three certainties. In the case of a testamentary trust created under the terms of a Will, the governing document is the Will. Any related bank or investment accounts opened should operate subject to the terms of the trust deed or Will. An informal trust, including an ITF account that is considered a trust, generally is evidenced only by the opening of an investment or bank account. ITF accounts are often set up by a contributor who also acts as the sole trustee – a situation which can trigger attribution under subsection 75(2) of the ITA because the contributor can continue to control trust property in his or her capacity as sole trustee.

A trustee makes investment and other trust decisions under legal obligation to act prudently and in the best interest of the trust's beneficiaries. A formal trust can be set up as a discretionary trust, spelling out any discretionary powers of the trustee as well as any conditions, including age, at which a beneficiary may access and control the income and capital of the trust. With an informal trust, once the trust beneficiary reaches the age of majority in their province, they are legally entitled to the assets of the trust.

ITF accounts typically lack documentation regarding:

- The identity of the contributor, trustee and beneficiaries
- Certainty of intentions
- How funds should be managed
- The duration of the trust
- The circumstances under which beneficiaries can access trust income or capital

Where a trust relationship is intended, documenting the contributor's intention to irrevocably transfer property for the benefit of the beneficiary and maintaining records regarding the source of funds can help clarify the status of the arrangement, particularly where questioned by the Canada Revenue Agency (CRA).

[1]A T3 slip, Statement of Trust Income Allocations and Designations, identifies beneficiaries and reports income and capital gains that the trust designates to them. A T5 slip, Return of Investment Income, is issued in respect of investment income and capital gains earned in a client named, nominee or agency account. | [2]For purposes of this article, all parties are assumed to be residents of Canada in provinces other than Quebec. | [3]In the case of an ITF or direct gift, the settlor may be referred to as a contributor or transferor, respectively. For purposes of this article, the terms settlor, contributor and transferor may be used interchangeably.

IS AN ITF ACCOUNT A TRUST OR A DIRECT GIFT?

The answer depends on the facts of each case. If the CRA determines any of the three certainties are not present, contributions to an ITF may be considered an immediate gift to the beneficiary. As a result, the account is subject to an agency relationship between the contributor and the beneficiary as opposed to a trust relationship. Where an ITF account is set up to hold an inheritance or insurance settlement for a child, the account holder may also be acting as an agent or guardian for the property of the minor. The CRA will consider intention at the time a property is transferred to the ITF and how the account is dealt with in determining whether a trust relationship exists and who is liable for taxes payable on any income or gains earned from the account.

TAX IMPACT UPON PROPERTY TRANSFER

Non-spouse transfers of beneficial ownership (whether by direct gift or indirectly through a trust) are normally taxable dispositions in the hands of the transferor for the year of transfer. Funding such transfers with cash or unappreciated assets will alleviate exposure to tax on capital gains for the transferor. Where the transferor is acting as an agent for the beneficiary of the ITF account or the guardian of property for the beneficiary, for example, the money belongs to the beneficiary and was not sourced from the transferor, there is no disposition for tax purposes.

HOW ARE ITFS TAXED?

Where there is neither a trust nor a gift, there is no transfer of property and all income and capital gains will remain taxable to the original owner.

Where the account holder is acting as an agent or guardian of property for the beneficiary, then subject to the attribution rules of the ITA (discussed below), all income and gains are taxed in the beneficiary's hands. Note that in most circumstances account holders, including parents, require a court order to be appointed as a guardian over a child's property.

Where the three certainties are present, an ITF account is a trust. Trusts are taxed as separate individuals under the ITA. The CRA makes no distinction between formal trusts and informal trusts for tax purposes, including the requirement by the trustee to file a T3 Trust and Information Tax Return on an annual basis[4]. Trust income, including taxable capital gains, that is not paid or payable to a beneficiary or attributed back to the transferor is taxed in the trust at top marginal rates.) Income and capital gains paid or payable to a beneficiary may be taxed in their hands at their own graduated tax rates. Losses cannot be allocated to a beneficiary unless attribution applies.

If, upon review of the facts, the CRA determines the ITF is not a trust, all income and capital gains since inception may attribute back to the contributor resulting in arrears taxes and penalties in their hands. Note that attribution does not apply to inheritances or to most arm's length transfers.

In the case of Blum vs. the Queen[5], a grandfather successfully appealed a CRA reassessment where the CRA attributed capital gains to him that were previously taxed in the hands of his grandchildren. Even though there was no formal trust agreement, he won his appeal as it was determined all three certainties were present. The trust property (shares of his own companies) was identified and clearly delivered to his name as trustee for the benefit his grandchildren as clearly named beneficiaries.

WHEN IS TRUST INCOME CONSIDERED PAID OR PAYABLE TO A BENEFICIARY?

Amounts considered paid or payable to a beneficiary for a year are deductible by the trust and included in the beneficiary's income for tax purposes. For these purposes, income includes taxable capital gains. Subsection 104(24) says for an amount to be considered payable to a beneficiary, it must be paid to the beneficiary or the beneficiary must be entitled to enforce payment. Subsection 104(18) provides that where a right to the income of a trust has vested in a minor, but is not payable in the year, and the only reason is the income is not payable is because the beneficiary was a minor, then the income is deemed payable to the beneficiary in the year. Subsection 104(18) is not likely to apply to discretionary trusts, but it can apply to an ITF that is a valid trust.

[4]Currently, a T3 is required only if a trust has tax payable or allocates income or capital to beneficiaries at any time during the year. For tax years ending on or after December 31, 2021, new trust tax reporting rules will require most trusts to file a T3 return every year, with penalties for non-compliance. Where the fair market value of the trust's assets is under $50,000 throughout the year and the trust's assets consist of cash, certain debt obligations, or publicly traded securities including mutual funds and segregated funds, the trust will be exempt from the new rules. Trusts that are subject to the new reporting requirements will be required to report the name, address, date of birth, residence and tax identification number for each person who is a trustee, beneficiary, settlor, or protector on a separate schedule within the T3 return. | [5] Joseph Blum v. the Queen, Tax Court of Canada, 1998

RESIDENTS OF QUEBEC

The Quebec Civil Code stipulates that a valid trust in Quebec must have the following four elements: (1) an act whereby a person, the settlor, transfers property from his or her patrimony; (2) to another patrimony constituted by he or she; (3) which is appropriated to a particular purpose; (4) and which a trustee undertakes, by acceptance, to hold and administer.

As a result, unless there is formal trust documentation highlighting the four elements., for Quebec tax purposes, all income or losses and capital gains or losses of an ITF are reported by the account holder. If the assets of the ITF were transferred by someone other than the account holder then the attribution rules should be considered.

RELATED MINORS[6] AND ATTRIBUTION OF INCOME AND LOSSES

The attribution rules in subsections 74.1(2) and 74.3(1) apply to direct gifts to related minors and transfers or loans to trusts for related minors. Subsection 74.1(2)[7] applies to direct transfers to a minor, including situations where a related adult is acting as agent or guardian of a child's property or is a joint account holder. Subsection 74.3(1) applies to trust income payable to a minor under subsection 104(24) or deemed to be payable to a minor under subsection 104(18).

First generation income, for example, interest and dividend income, is covered by these rules, which attribute income and losses back to the contributor for tax purposes. These rules do not apply to second generation income, capital gains and losses, or income derived from child tax benefits[8]. Attribution under section 74.1 ceases when the beneficiary reaches age 18 or the contributor dies or becomes a non-resident of Canada.

Loaning property to a trust at the prescribed rate of interest can avoid application of these rules. Also, separating funds from different sources in different accounts can simplify administration and mitigate exposure to income attribution.

ATTRIBUTION UNDER SUBSECTION 75(2)

Attribution under subsection 75(2) applies only to trusts but catches all trust income and losses including capital gains and losses, regardless of the age of the beneficiaries. Subsection 75(2) applies where a trust has reversionary provisions enabling the contributor take back trust property, control the disposition of trust property or change the beneficiaries after the trust is settled. Where subsection 75(2) applies, any income or losses and capital gains or losses earned by the trust on property transferred, attribute back to the contributor so long as he or she is alive and resident in Canada.

Trusts where the contributor is the sole trustee are particularly vulnerable to the application of subsection 75(2), including, for example, where a grandparent contributed to an ITF account for a grand-child and was the sole trustee of the account. Naming someone other than the contributor as trustee or appointing multiple trustees where the contributor does not have majority control, are ways to mitigate exposure to subsection 75(2).

Note that while trust property can be distributed to Canadian resident beneficiaries on a tax-deferred basis, where subsection 75(2) ever applied to the trust relationship, and the settlor/contributor of the assets is living at the time of the transfer, the trust's assets must be transferred at fair market value (FMV).

SUMMARY REGARDING ATTRIBUTION RULES ON GRATUITOUS TRANSFERS TO RELATED MINORS[9]

Where the ITF account is a trust and subsection 75(2) does not apply, only first generation income may attribute back to the transferor. Where the trust income is paid or payable to the child, or the conditions of subsection 104(18) are met, second generation income and taxable capital gains are taxed in the child's hands. In the absence of either of these conditions, second generation income and taxable capital gains are taxed in the trust.

Where the ITF is not a trust, first generation income may attribute back to the transferor, but second generation income and taxable capital gains would not. Income and capital gains not subject to attribution would be taxed in the child's hands.

[6]For these purposes, the definition of related minor is a child, grandchild or other lineal descendant by blood or adoption or a niece or nephew under age 18; attribution applies only to dividends, interest, rent, royalties and other income but NOT to capital gains. | [7]There is no requirement under 74.1(2) that the transferor's SIN be shown on the T5 slip.
[8]74.1(2) does not apply to Canada Child Benefit (CCB) payments or (pre-July 2016) Universal Child Care Benefits (UCCB) payments placed on account for the child. This exclusion does not extend to Quebec child tax benefits. [9] T.I. 9833995 - Filing Requirements for In-Trust Accounts June 7.1999.

IMPACT UPON DEATH OF TRANSFEROR, TRUSTEE OR BENEFICIARY

If the transferor dies, attribution ceases and all future income earned in the account is taxable in the child's hands. If the trustee passes before the beneficiary reaches the age of majority, the trustee's Will should be reviewed to determine if an alternate trustee is named. If a new trustee is not found, the estate could maintain authority over the account until the beneficiary reaches the age of majority and takes control of the account.

If the beneficiary dies before reaching the age of majority, the funds fall to the child's estate to be distributed according to the laws of intestacy in the jurisdiction the child lived, assuming the child would not have a Will. This means if someone opened an account for a minor who is not their child the contributor will lose control over the funds if that child dies.

INHERITANCES AND ITFS

Where an ITF account is set up to accommodate an inheritance received by a minor beneficiary under a Will, the terms of the Will determine the timing of distribution of the income and capital of the trust to the beneficiary This is true across Canada, except in Quebec, where legislation requires the beneficiary to take ownership of the ITF assets at age 18.

FINAL CONSIDERATIONS AND ALTERNATIVES TO THE ITF

Having no trust deed to establish guidelines regarding how to manage an ITF account exposes the trustee to the possibility of legal action on the part of a beneficiary who feels the account has not been properly managed. Contributions to an ITF are also irrevocable so cannot be redirected or returned to the contributor without serious consequences, including the risk that a beneficiary may make a claim for the capital and earnings of the account since inception[10].

Alternatives to an ITF include:

- An RESP
- Simply paying for certain expenses for the child or grandchild during your life
- Setting up a formal trust and using a prescribed rate loan strategy to avoid attribution rules while the beneficiaries are minors
- Contributing to a TFSA for a child once the child turns 18

Whether an ITF account or the above alternatives are best will depend on the resources, goals and objectives of the contributors and the needs of the beneficiaries involved.

[10](Koons v Quibell, [1998] 164 Sask. R. 149 (SKQB)).

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