EXPERT SERIES

IG PRIVATE WEALTH MANAGEMENT

Family Investment Trusts

A family investment trust might be right for you if you have cash and investments that are not needed to fund your own lifestyle needs, plus a desire to either establish an investment fund for the next generation or provide funding for schooling or other extra expenses for a child or grandchild.

A family investment trust can enhance the accumulation of capital for children or grandchildren in a tax efficient manner and reduce the after-tax cost of paying for their non-essential expenses.

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In this article, we'll discuss:

1. The two types of investment trusts
2. Funding considerations and strategies
3. Two common examples of how to fund a trust

The two types of investment trusts

A SEPARATE TRUST FOR EACH CHILD/GRANDCHILD – COMMONLY REFERRED TO AS AN AGE 40 TRUST

Age 40 Trusts can facilitate the tax efficient accumulation of investments for future use by a child or grandchild. When a beneficiary is under the age of 21, this type of trust benefits from a special provision within the Income Tax Act which deems the beneficiary to have received the trust's annual income and realized capital gains without an actual payment being made from the trust. Up until the beneficiary attains age 21, the trustees typically have the discretion to pay or not to pay income and realized gains to the beneficiary.

Regardless of whether income and realized gains are paid out from the trust, the amounts can be reported on the beneficiary's tax return. A beneficiary with no other sources of income could be allocated over $26,000 in capital gains or over $60,000 in eligible dividends before incurring any Federal tax liability (whether there is a provincial tax liability depends on the beneficiary's province of residency).

To be legally effective, all trusts are established with at least a small gift of property from a person, referred to as the "settlor".

Upon turning age 21, this deemed receipt of income and realized gains stops, and the terms of the trust usually require that annual income and realized gains must be paid to the beneficiary. The trustees generally have the discretion to at any time distribute some or all of the trust's capital to the beneficiary.

To qualify as an Age 40 trust, the beneficiary must receive any remaining assets in the trust prior to age 40. The trust can be funded with either a gift or a loan from a parent or grandparent. There are advantages to using a loan which are discussed on the following page.

A DISCRETIONARY FAMILY TRUST WITH MULTIPLE BENEFICIARIES

This is often the preferred way to go if the intention is to use income and capital gains to fund expenses for multiple children or grandchildren. The trustees have complete discretion over the distribution and allocation of income and trust capital. However, annual income and realized capital gains will be taxed in the trust at top tax rates unless made payable to one or more of the beneficiaries. This is typically accomplished by using the income and gains to pay for things such as private school, post-secondary education and extra-curricular activities. To the extent income and capital gains generated in the trust are used to pay for services or things that assist the beneficiaries, the income can be taxed in their hands and not taxed in the trust (at the top marginal tax rate).

Funding considerations and strategies

INITIAL GIFT

To be legally effective, all trusts are established with at least a small gift of property from a person, referred to as the "settlor". However, there are revisionary trust tax rules that can require a settlor to report future income and capital gains generated from the gifted property if the settlor can control or veto future decisions over the distribution of trust property. As a result, the gift needed to initially form the trust is typically property that does not produce income, such as a gold coin or a twenty dollar bill (which should be kept with the trust agreement and not spent or invested), and the settlor is often a friend or relative who has no further involvement with the trust after making the gift.

The terms of the loan do have tax implications. If the loan to the trust is interest free, or the rate of interest is below the rate prescribed by the CRA, all investment income, but not capital gains, must be reported by the lender.

MAIN FUNDING WITH A LOAN

Providing the main funding to the trust by way of a loan from the parents or grandparents has two advantages:

1. The parents/grandparents advancing the loan can be the only trustees with no adverse tax consequences*, and
2. The parents/grandparents can demand repayment of the loan at any time.

PRESCRIBED RATE LOAN

The terms of the loan do have tax implications. If the loan to the trust is interest free, or the rate of interest is below the rate prescribed by the CRA, all investment income, but not capital gains, must be reported by the lender (typically the parent or grandparent of the beneficiary(s)). However, if the trust is obligated to pay to the lender the CRA prescribed rate of interest in effect at the time the loan is advanced, and the interest is always paid by January 30th of the following year, all income and capital gains allocated to the beneficiary(s) can be reported in their hands. The interest payments on the loan would also be tax deductible to the trust. The prescribed rate of interest is historically low, and loans made at the prescribed rate of interest are generally the preferred method of funding such trusts.

NEED FOR LOAN REPAYMENTS

If no interest is charged under the loan agreement, to ensure the loan agreement remains an enforceable contract and to provide evidence that it is a bona fide loan agreement, it is recommended that the trust make some repayment of principal every year.

TAX ON SPLIT INCOME (TOSI)

No matter the funding method, as long as the trust invests in publicly traded shares, mutual funds or interest producing investments, income reportable by a beneficiary should not be subject to the Tax on Split Income. The Tax on Split Income (TOSI) results in tax at top personal rates when dividends and other distributions from a private corporation are received by a person under the age of 18, either directly or through a trust.

* Note that it is possible to appoint additional trustees and the trust agreement should identify contingent trustees or a process for appointing contingent trustees who can step in when the original trustees are no longer able or willing to manage the trust.

Two common examples of how to use a trust

FUNDING A DISCRETIONARY FAMILY TRUST WITH A PRESCRIBED RATE LOAN.

Ken and Jill have grandchildren ranging in age from toddlers to young adults. They are prepared to lend $1,000,000 to an investment trust for the benefit of all their grandchildren. We will assume the prescribed rate of interest at the time of the loan is 1% and that in the first year the investment portfolio generates investment income of $30,000, realized capital gains of $7,500 and some additional capital appreciation.

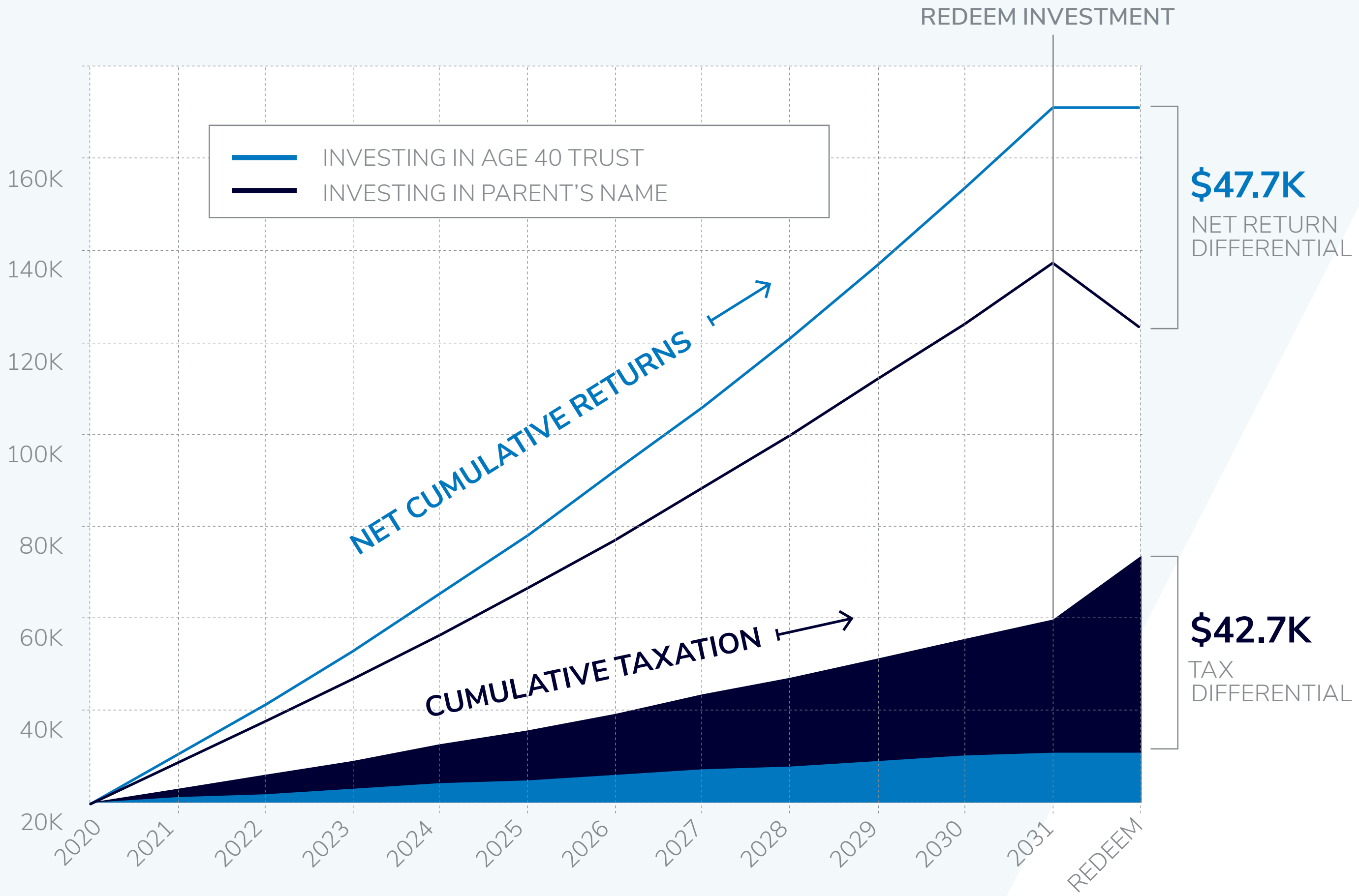
As long as the trust pays $10,000 of interest to the grandparents by January 30th of the following year, no income will attribute to the grandparents and the trust can deduct the interest expense. Furthermore, all income and capital gains paid to a beneficiary, or used to assist a beneficiary, can be reported as income by the beneficiary, not the trust. As noted earlier, such trusts are often used to help fund private school, extra circular activities and post secondary education of beneficiaries in a tax efficient manner. Through the payment of expenses, beneficiaries with no other income could each be allocated over $26,000 in capital gains or over $60,000 in eligible dividends before incurring any Federal tax liability (whether there is a provincial tax liability depends on the beneficiary's province of residency).

FUND AN AGE 40 TRUST WITH A PRESCRIBED RATE LOAN

Antonio and Maria have a 5-year-old granddaughter. They have loaned $200,000 to a trust established solely for her benefit. The trustees have the discretion to distribute income and capital to their granddaughter in any amount at any time, subject to the condition that all capital must be distributed to their granddaughter prior to her 40th birthday. Only if the granddaughter fails to survive until the final distribution can other "contingent" beneficiaries (named in the trust document) benefit from the trust. Based on an annual return assumption of 5.75%, the investment purchased with the $200,000 is expected to generate investment income, realized gains and capital appreciation of $11,500 in the first year.

Assuming a prescribed interest rate of 1%, as long as the trust pays $2,000 of interest to the grandparents within 30 days of year end, no income will attribute to the grandparents and the trust can deduct the interest expense. Furthermore, until the year in which the beneficiary turns age 21, all income and capital gains will be deemed payable to the granddaughter and will be reported by her, not the trust. Assuming the granddaughter has no other income, she would need to be allocated over $13,000 of interest income, $26,000 in capital gains or $60,000 in eligible dividends before incurring any Federal tax liability (whether there is a provincial tax liability depends on the beneficiary's province of residency).

HOUSEHOLD COMPARISON OF RETURNS AND TAXATION FOR $200,000 INVESTMENT



ASSUMPTIONS:

- $200,000 loan at 1% interest cost, with interest paid annually via redemption of investments
- 5.75% annual rate of return (comprised of distributions of 1.5% interest, 1.5% dividends, 0.75% capital gains, 2% deferred growth)
- Lender (parents) in top marginal tax rate (marginal tax rate applied of 50% interest income, 35% dividend income, 25% capital gains)
- Child in lowest marginal tax bracket, with capital gains triggered annually by the trust to limit tax liability when redeemed

Establishing and maintaining a trust does come with associated costs and complexity, so it is important to work with your IG Consultant to determine whether strategies utilizing family trusts add value in your circumstances.

ABOUT THE AUTHOR

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Jack leads the Advanced Financial Planning department at IG Wealth Management and is responsible for coordinating planning support for high net worth clients. His goal is to ensure that clients receive the highest quality tax, estate and financial planning advice tailored to their goals and circumstances. Jack has practiced law in both the private and public sectors and his experience includes five years as tax litigation counsel with the Federal Department of Justice. Over the last 22 years with IG, Jack has worked with owner-managers of private companies on issues relating to tax planning, business succession, executive compensation and trusts. He is a member of the Canadian Tax Foundation and Society of Trust and Estate Practitioners, and a Fellow of FP Canada.

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