

TAX ALERT



TAX ALERT is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new CRA administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information.

GIVING YOUR KIDS SOMETHING NOW

Jane is in her late seventies. She is in good health and starting to think about how she can begin moving assets to the next generation so she can see some of the benefits while still alive. She is well off and can easily do this without financial worry. Jane is working with her advisor on a number of fronts in this area and setting up of trusts for her grandchildren is one of them. Here's her advisor's note to Jane's children.

Your mother Jane has recently set up two family trusts for her grandchildren – primarily for their education, health and general well being. Each of you as parents of these children will become the trustee of separate trusts. The children range in ages from 4 to 16. While there may be some immediate requirement for funds, given their ages there will not be any significant need for 5 to 10 years. Hence, investments of the two trusts can be done on a long-term basis. Separate trusts were set up for each family so each of you can control the funds for your own children.

The use of these family trusts helps you and Jane in several ways.

- ◆ It reduces her future tax liabilities
- ◆ It helps her with estate planning
- ◆ It lets her see the benefits of her generosity while she is still alive
- ◆ It gives you the opportunity to provide additional financial assistance to your children in ways you wish
- ◆ It lowers income taxes and may in fact eliminate most of it if trust income can be offset for example against children's tuition costs

Taxation of the Trusts

Since these trusts will have been set up during Jane's lifetime, trust income is taxed at the maximum tax rate but Jane would have been taxed at top rates as well so there is no real difference. On the other hand, if income of the trust is allocated to beneficiaries (children), the income will be taxed to the beneficiary (and not the trust) at much lower rates subject to comments below. The trust need not distribute cash and can instead make distributions of trust income or capital in the form of a note payable by the trust. Since children typically have little or no income, it is beneficial from a tax point of view to allocate income to them annually. Here's a comparison of tax rates.

	Trust Income	Children's Income
Interest	46%	22%
Dividends	21%	4%
Capital Gains	23%	11%

One of the useful things about trusts like this one is that you can distribute appreciated assets to beneficiaries as capital distributions without any tax on unrealized gains. This is usually not the case.

Taxation of Allocated Income

Since all of the children are under the age of eighteen, there are rules in the Income Tax Act to tax most types of allocated income not to the children but to the person who contributed the funds in the first place, Jane. The exception to this income attribution rule is capital gains that are not attributed to Jane and will be taxed in the hands of the children. Again, the children would not necessarily receive funds but a note payable could be set up by the trust for income allocated to them each year. The trust defines income to include capital gains which is ordinarily not the case in a legal sense.

These special tax rules exist to prevent transferring income earning assets to others in order to gain the advantage of their lower tax rates. But since the trusts will be taxed at the highest tax rates anyway, the rule effectively has no teeth. In fact, it allows Jane to transfer even more property to her grandchildren since she may be paying the tax on some of the income herself.

Choice of Trust Investments

Since capital gains are the most beneficial source of income for tax purposes (particularly in this situation), the investment policy of the trust should favour investment in publicly traded shares over bonds. If stocks are held in a trust, the trustees should be prudent in their choice of investments and only the highest quality stocks should be in the portfolio. While it is sometimes suggested that stocks are risky, it is more appropriate to say the stocks are volatile and while values go up and down, if the underlying choice of stocks is done properly, there should not be any significant risk over bonds – in the medium to long term.

Fees and Returns

The portfolio should be conservative and therefore will have an expected rate of return lower than a more aggressive portfolio. An annual return of 8% (dividends and capital gains) on stocks and 4% on bonds would be realistic.

Fees to earn this income might be as follows:

Equity mutual funds	3%
International mutual funds	4%
Bond mutual funds	2%
Investment counsel fees	1.25%

The fees on mutual funds are not tax deductible and will reduce gross returns by between 40% and 50% using the above numbers. On the other hand, investment counsel fees (which are tax deductible) reduce returns by only about 10% on stocks and less than 20% on bonds. We strongly advise you to review the fee levels and tax deductibility of fees when selecting an investment advisor.

The Recent Market Turn Down

As you may know, the stock market has declined about 10% recently which is a normal correction at the end of a long period of gains. This does not mean that the stock market is inherently risky but that from time to time it does undergo a correction. The recent downturn in fact represents an opportunity for the trust to make investments in shares of public corporations at good prices. It also helps reduce Jane's taxes if she needs to sell appreciated stocks to make the contribution to the trusts.

Accounting

You are a trustee of a trust for your children but in fact your children own the trust assets and so you must be careful to account for everything properly. Each trust will need to prepare an annual tax return and financial statements. The trusts will need to keep track of all amounts allocated to any beneficiaries. You are entitled to a fee for this work if you wish but it is fully taxable to you.

Trust Fund Disbursements

The two family trusts are very flexible in how they are permitted to disburse funds. Trust assets can be used in the following ways.

- ◆ Retained by the trust
- ◆ Paid to children
- ◆ Transferred to another trust (say for children with special needs)
- ◆ Transferred to a corporation

The flexibility of these trusts should not be overlooked in future tax and estate planning for your children. The allocation of income or capital of the trust is completely discretionary at your call which means you can favour one child over another for reasons you believe are proper – without fear that there are some adverse repercussions of making such a decision. Assets of the trust and distributions from the trust do not have to be part of net family property under family law in Ontario.

Summary

This memo is a summary of the tax and other implications of family trusts and your responsibility as trustees. Hopefully it will be a mini guidebook for each of you as trustees. You must of course understand all terms of the trust as well and should read it thoroughly.

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