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.***

TRUSTS FOR MANY PURPOSES

So often financial and tax advisors talk about the magnificence of trusts in personal finical planning. But when push comes to shove, trusts are not always used because individuals complain about complexity, uncertainty and are generally uneasy about this mythical creature of the law. However, depending on an individual's need, there are at least six types of trusts that are tried and true and that have seen no particular challenge by Canadian taxing authorities. While other trusts could be included in this ***TAX ALERT,*** discussion will revolve around the following trusts:

- Insurance trusts
- Immigration trusts
- Henson trusts
- Capital gains exemption trusts
- Asset protection trusts
- Alberta trusts

The six trusts mentioned above vary in use from tax savings to creditor proofing, planning for the disabled and estate planning. While some may suggest that trusts are primarily for the rich and high net worth person, that is really no longer the case. It is not unusual for a person of modest income to accumulate $500,000 to a million in his lifetime and so this level is not considered necessarily to be high net worth anymore. But it is substantial and individuals can better protect and effectively distribute wealth through the trusts. This ***TAX ALERT*** will not be an extensive review of the trusts but only a look at the potential uses for each one of them.

Insurance Trusts

A life insurance trust is funded by the proceeds of insurance and can be set up either during one's lifetime or on death. Primarily, however, these trusts are created by an individual's will.

Ordinarily, a standard life insurance policy names one or more beneficiaries to receive insurance proceeds with little or no conditions. By using a trust to receive the proceeds, bequests can be tailored much more effectively to reduce taxes on the future income and capital appreciation generated inside the trust.

The insurance proceeds held within the trust arising on death are subject to the graduated tax rates as a separate tax payer (reducing income taxes) and can be distributed to trust beneficiaries over time in some predetermined manner as dictated by the trust. For example, there may be beneficiaries of the trust with special needs and the trust terms and conditions will utilize its funds for that person without government clawbacks or other reductions. Trusts are allowed to distribute funds to minors which is not possible directly through an insurance policy.

There are many other possible uses for an insurance trust which can be incorporated into a will. Where there are multiple beneficiaries, separate insurance trusts could be established for each beneficiary – each having different terms and conditions. Because the insurance proceeds pass directly to the trust, they are not subject to probate and the beneficiaries receive creditor protection because the trustees own the assets and not the beneficiaries.

Immigration Trusts

In the last few years Canada Revenue Agency (CRA) has completely overhauled the offshore trust provisions to prevent taxpayers from avoiding Canadian income taxes. However, in doing this, and rightly so, tax rules still allow people moving to Canada to shield income from investments for a period of five year. In that five-year period individuals with significant assets can completely eliminate the income from the Canadian tax net. For example, an individual with a million dollars of investments earning 8% interest could save about $40,000 in tax a year or $200,000 over the five-year period. That is no small potatoes.

Such trusts should be established in foreign jurisdictions with foreign investments. To be effective, the trust must be in jurisdictions that do not levy income tax which for example could include Jersey, Guernsey, or Isle of Mann. Should the immigrant wish to maintain the trust after the five-year period, this could be done but the income from the trust would be taxable to the beneficiary. Nevertheless, an element of creditor proofing would be an obvious continuing benefit of the trust. Such trusts have little benefit to Americans moving to Canada for short stays since they are taxed on the basis of citizenship and would have to pay US income taxes on the trust income.

Henson Trusts

Individuals with children with disabilities know about the Henson Trust – named after an individual in Guelph Ontario who had a clause in his will creating a trust for his disabled daughter. Because Audrey Henson was a beneficiary of this discretionary trust but had no absolute right to income or capital of the trust, she was not prevented from receiving disability support from the province of Ontario. The beneficiary of disability support payments may receive $4,000 a year in gifts without affecting benefits but we understand there is no limit on how much the trust may pay on behalf of the person receiving the benefit. The wording of the trust document is critical to prevent the provincial government from attacking it.

There is no reason why such trusts should not be set up in a will before a child is eligible for disability support payments since such a trust may undoubtedly be needed should the disabled child receive substantial amounts of capital. Without such a trust in place in the event of a premature death all advantages would be lost. Families without significant assets may also choose to fund a Henson Trust through life insurance which has been reviewed to under the heading *Insurance Trusts* above.

Capital Gains Exemption Trust

Individuals owning shares of a company carrying on an active business in Canada receive a $500,000 capital gains exemption on any gains related to those shares. It is important to note that the $500,000 capital gains exemption is allowed to everyone owning shares of the corporation. There is no limit of $500,000 per corporation. An effective way to multiply the capital gains exemption is to have the common shares of the corporation owned by a trust. The trust could have several family members as beneficiaries and if the shares of the trust were sold or deemed to have been sold on death, capital gains on those shares could be flowed through to each of the beneficiaries according to the terms of the trust. Each of the beneficiaries could claim up to $500,000 of the gain on the shares as non-taxable using the capital gains exemption. Through the terms of the trust the individual establishing the trust could effectively control distributions. A taxpayer with say a corporation worth 2 million dollars and four children using capital gains exemption trust could eliminate income tax entirely that otherwise would be in the neighbourhood of $450,000. That's worth spending a few bucks on.

Asset Protection Trust

Anyone who is in good financial shape and has no existing or pending claims by creditors could use an asset protection trust to assure future creditor protection for family assets. An individual who may have investments with the potential of significant future growth could transfer these assets to a trust for the benefit of children, a spouse or even other family members. The terms of the trust could be as detailed as one could imagine with respect to the distribution on income and capital to beneficiaries at the discretion of the trustees. If the trust, for example, were the holder of a family corporation, the corporation could pay substantial dividends to the trust which in turn could be loaned back to the corporation on a fully secured basis. Both the shares owned by the trust and the assets of the corporation to the extent secured would be protected from outside creditors.

Sometimes people think that when things are going well that creditor protection is not needed but it often seems in a moment's notice individuals with an outstanding record of success can be looking at substantial law suits, a turn of bad luck or an unhappy divorce that could strip them of everything. So putting an asset protection trust in place when everything is going well is not such a bad idea.

Alberta Trust

Higher tax rates in Ontario and lower tax rates in other provinces - primarily Alberta – are attracting interest to reduce income taxes. The tax rate of a trust is determined by the tax rate of the province in which the trust is resident. So if you establish a trust resident say in Alberta, the income of the trust will be subject to Alberta tax rates not Ontario rates. The tax rate of the trust established during one's lifetime is at the maximum rate but if you are already in this tax bracket, shifting income from Ontario to Alberta would still result in tax savings. Professionals in Alberta are available to administer such trusts. There is about a 7% tax savings on interest and dividends in the top bracket and a savings of 3% on capital gains. Obviously such trusts are only worthwhile for the very wealthy.

Summing Up

These six specific purpose trusts are well accepted in Canada and have not been seriously threatened by taxing authorities. Perfect documentation is mandatory. Canada Revenue Agency could change its mind at any time but that is not likely to happen. The use of trusts in wills and estate planning is well accepted and has been less attacked by taxing authorities than other areas of tax planning. There are also valid tax policy reasons for allowing the use of trusts.

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