

## CHAPTER 17

### TRUSTS

#### Review Questions

1. What is a trust, and how does it differ from a partnership and corporation?
2. Briefly explain the basic unique features of a trust?
3. What are the definitions of a testamentary trust and an inter vivos trust?
4. What are the differences between a personal trust and a commercial trust?
5. Explain when a trust is liable for tax in Canada.
6. What are the unique features for determining the taxable income of a trust?
7. "A trust is considered to be an individual for tax purposes, and therefore its taxation year is the calendar year." Is this statement true? Explain.
8. Compare the methods for calculating tax payable for testamentary trusts and inter vivos trusts.
9. A trust can deduct from taxable income amounts allocated to a beneficiary. Identify the unique features of this process and how the allocation may differ from allocation made by a partnership.
10. "Capital assets held by a trust are only subject to tax on a disposition that results from a sale or when they are distributed to beneficiaries." Is this statement correct? Explain.
11. How does a spousal testamentary trust differ from a non-spousal testamentary trust?
12. What is an income trust? Briefly explain why they are used.

## Solutions to Review Questions

R17-1. A trust is an arrangement whereby a person (the *settlor*) places property under the management of a *trustee* for the benefit of one or more persons (*beneficiaries*).

Unlike a corporation, a trust does not have the status of a legal person. The format of a trust is closer to that of a partnership in that its existence is created by the writing of a trust document or deed spelling out the obligations of the trust.

Unlike a partnership, a trust is a separate taxable entity.

R17-2. Unique features of a trust:

- Income earned by a trust can be taxed in the trust or all or some of the income can be allocated to beneficiaries and taxed as part of their income [ITA 104(13)].
- The trust claims a deduction in computing net income for income allocated to beneficiaries [ITA 104(6)]. Thus, trust income is only taxed once.
- Income taxed in the trust forms part of the trust's capital and is not subject to further tax when it is eventually distributed to the beneficiaries [ITA 108(1)].

R17-3. An *inter vivos* trust is created during the settlor's lifetime whereas a *testamentary* trust is created on the settlor's death [ITA 108(1)].

R17-4. *Personal* trusts include both *inter vivos* and *testamentary* trusts whose beneficiaries did not purchase their trust interests. *Commercial trusts* generally refer to trusts whose beneficiaries purchase their trust interests or units.

R17-5. A trust is taxable in Canada if it is resident in Canada at any time during the year. The residency of a trust is determined by the resident status of the trustees who manage and control the trust property.

R17-6. Unique features for determining taxable income of a trust include the following:

- Income allocated to beneficiaries is deductible in determining the net income of the trust [ITA 104(6), (24)]. Income not allocated to beneficiaries is taxable to the trust, but thereafter can be distributed to the beneficiaries tax free.
- A trust can designate for tax purposes an amount that is actually payable to a beneficiary, not to have been payable. The designated amount is taxed in the trust [ITA 104(13.1),(13.2)]. The designation is permitted only where the taxable income of the trust is nil and remains so after the designation. Therefore, unless the trust has losses available from other years, the designation will not be permitted.
- In some circumstances, a trust can allocate income for tax purposes even though it is not payable to the beneficiary. This may occur when trusts are created for children under age 18 and income is accumulated on their behalf until they are 21 years of age or older. [ITA 104(18)].

R17-7. It is true that a trust is considered to be an individual and as such its taxation year is automatically the calendar year, December 31 [ITA 104(2), 249(1)]. The exception is graduated rate estates. Where an estate has made a designation in its tax return for its first

taxation year, that estate will qualify as a graduated rate estate for 36 months. A graduated rate estate may choose any taxation year end that ends within twelve months of the trust's inception [ITA 104(23)].

- R17-8. To calculate tax, trusts must use the highest federal personal tax rate (33%) and the applicable province's highest tax rate for all of its income [ITA 122(1)]. There are two exceptions: (1) the graduated tax rates applicable for individuals apply for graduated rate estates for the first 36 months after the individual's death, and (2) the graduated tax rates applicable for individuals apply for qualified disability trusts (testamentary trusts for the benefit of disabled individuals who are eligible for the federal Disability Tax Credit).

Trusts cannot deduct personal tax credits.

- R17-9. The trust can allocate income to beneficiaries thereby reducing the trust's income [ITA 104(6)]. In making the allocation, the trust designates the type of income being allocated. The income designated by the trust can be net taxable capital gains (net of current year capital losses, and net capital losses deducted) [ITA 104(21),(21.3)], taxable Canadian dividends – (Eligible) or (Non-eligible) [ITA 104(19)], tax-free capital dividends [ITA 104(20)], foreign income and related foreign tax paid [ITA 104(22)], and other income. All other income allocated from the trust does not retain its character and is taxed in the beneficiary's tax return as income from property [ITA 108(5)]. The beneficiary may claim the related dividend tax credit, foreign tax credit, and capital gains deduction if the taxable capital gain allocated qualifies [ITA 104(21.2)].

The trustee can allocate income types to beneficiaries in different proportions. For example, if attribution is a concern, the trustee may allocate more capital gains to a beneficiary who is under age 18 (since capital gains earned by minors are not subject to attribution). Other beneficiaries may then receive a greater proportion of other types of income.

- R17-10. The statement is not correct. Inter vivos and testamentary trusts are deemed to have disposed of certain properties at fair market value on its 21<sup>st</sup> anniversary date and every 21 years thereafter [ITA 104(4),(5)]. The properties include:

- capital property [ITA 104(4)]
- depreciable property [ITA 104(5)]
- land that is inventory [ITA 104(4)]
- resource property [ITA 104(5.2)]

The trust is deemed to reacquire the properties at that market value, which becomes the new cost for tax purposes of the property for the trust. Property owned by a spousal trust is excluded from this 21-year deemed disposition rule.

A trust can often successfully avoid the deemed disposition rule by transferring the particular properties to the beneficiary prior to the 21-year anniversary date. Such transfers are normally deemed to be a disposition at the property's cost amount [ITA 107(2)]. The beneficiary simply takes over the tax position of the property received from the trust. Once the property is in the hands of the beneficiary, the gain will be taxed when the property is sold by the beneficiary or upon his/her death.

- R17-11. A trust is a spousal trust if the spouse of the settlor is entitled to receive all of the income of the trust and no person other than that spouse can use or receive the capital of the trust before the death of the spouse [ITA 70(6)&104(4)].

When the trust is a spousal trust, the following unique rules apply:

- When property is transferred to the trust, the settlor is deemed to have sold the property at its tax value [ITA 70(6)]. Therefore, the tax value of the property prior to its transfer is assumed by the trust.
- The 21-year deemed disposition requirement is waived for the first 21-year anniversary [ITA 104(4)]. Therefore, in most situations, the property remains without tax until the death of the beneficiary spouse.
- Upon the death of the spouse who is the beneficiary, the spousal trust property is deemed to be sold at market value [ITA 104(4)].

R17-12. An income trust is used as a structure to operate a business. The primary incentives for using income trusts (prior to October 31, 2006) as an alternative to the corporate structure were:

- The trust income was not taxable because its income could be allocated to the unit holders (beneficiaries) and taxed as part of their income; and
- The allocation to unit holders retained its source and characteristic for tax preferred income like capital gains and dividends.

A corporation pays tax on its earnings and distributes after-tax income. An income trust that is an investment trust (used to operate an active business) created after October 31, 2006 pays a distributions tax on the amount of distributions to investors [ITA 122(1)(b), 122(1.01)]. The rate of tax is a combination of a federal rate plus an additional rate in lieu of provincial tax. The combined rate of tax is 25% (15% federal + 10% addition). This rate is similar to the combined federal and provincial general tax rate for corporations. The distribution does not retain the characteristics of its source in the trust. Instead, the trust distribution is deemed to be an eligible dividend. Investment trusts are referred to as “specified investment flow-throughs (SIFTs)”.

These rules apply to income trusts (excluding REITs) in existence before October 31, 2006.

## Key Concept Questions

### QUESTION ONE

In each of the following cases, an individual has established a trust.

- 1) Anita Arroyo establishes a family trust to hold investments in shares of public corporations for the benefit of her children.
- 2) Bob Oneal establishes a trust for the benefit of his spouse. His spouse is entitled to receive all of the income from the trust and no one, other than his spouse, can have the use or enjoyment of the assets held by the trust until after the spouse's death.
- 3) Safia Lang's trust directs that on her death, a trust be established to hold assets for her children until the youngest reaches age 25.
- 4) Krishan Pemberton died in the current year, leaving substantial assets under the control of the executor of his estate.

Determine the type of trust that has been established in each case.

*CPA Competency 6.1.1 General concepts and principles of taxation – legal forms and structures. Income Tax Act reference: ITA 108(1).*

### QUESTION TWO

During the current year, an inter vivos trust receives the following income:

Interest	\$30,000
Eligible dividends	20,000
Capital gains	12,000

One half of the income is paid to a beneficiary of the trust, Gail Booker, a 22-year-old student, with no other source of income. The remainder of the income is retained by the trust. The trust designates the source of the income paid to the beneficiary as follows: interest \$15,000, eligible dividends \$10,000 and capital gains \$6,000.

Determine the net income, taxable income and federal tax payable for both Gail and the trust.

*Income Tax Act reference: ITA 104(2), (6), (19), (21); 122(1), (1.1).*

### QUESTION THREE

During the current year, a testamentary trust earns interest income of \$45,000, all of which is paid to Bill Bautista, the sole beneficiary of the trust. Bill has other sources of income that total \$300,000. The trust has no other source of income and has \$50,000 of losses carried forward from past years.

What can be done to reduce the overall tax liability?

*CPA Competency 6.3.2 Income taxes payable for an individual. Income Tax Act reference: ITA 104(13.1).*

## QUESTION FOUR

During the current year, a trust has the following income (losses):

Capital gains	\$ 20,000
Capital losses	(50,000)
Business loss	<u>(40,000)</u>
	<u><u>\$(70,000)</u></u>

Beverley Ramirez, the sole beneficiary of the trust, has income from other sources that puts her in the top tax bracket. Determine the appropriate allocation of income from the trust.

*CPA Competency 6.3.2 Income taxes payable for an individual. Income Tax Act reference: ITA 104(21).*

## QUESTION FIVE

A trust has the following results for the current year:

Capital gains	\$100,000
Capital losses	20,000

The trust has available net capital losses of \$35,000 incurred in the previous year. Determine the maximum amount that can be allocated to a beneficiary.

*CPA Competency 6.3.2 Income taxes payable for an individual. Income Tax Act reference: ITA 104(21), (21.3).*

## QUESTION SIX

Felicia Corrigan, age 14, is the sole beneficiary of a trust. The trust document indicates that the income earned by the trust is to be retained by the trust until Felicia turns 18.

Does this mean that the income must be subject to tax in the trust until Felicia turns 18?

*CPA Competency 6.3.1 General tax issues for an individual. Income Tax Act reference: ITA 104(18).*

## QUESTION SEVEN

Kiranjit Sharma died on June 30, 2022, leaving two adult children as beneficiaries. Both children earn annual income of approximately \$65,000. Due to the complexity of Kiranjit's investments, the estate executor anticipates it will take four years to dispose of all properties and wind-up the estate. During this period, the estate will earn various types of investment income and capital gains.

What tax issues must the executor be aware of regarding the management and windup of the estate?

*CPA Competency 6.4 Tax administration. Income Tax Act reference: ITA 104(6), 104(18), 249(1), 249(5), 258(1), 122(1), 122(2), 122(3).*

## Solutions to Key Concept Questions

### KC 17-1

[ITA: 108(1) – Types of Trusts]

- 1) The family trust established by Anita is an inter vivos trust. It was established by Anita during her lifetime.
- 2) The trust established by Bob is an inter vivos trust. The trust appears to be a qualifying spousal trust and as such Bob can transfer assets to the trust on a tax-deferred basis [ITA 73(1)].
- 3) The trust established on Safia’s death is a testamentary trust and can be designated as a graduated rate estate. Only one estate may be designated as a graduated rate estate.
- 4) The trust established on Krishan Pemberton’s death is a testamentary trust and can be designated as a graduated rate estate.

### KC 17-2

[ITA: 104(2), (6), (19), (21); 122(1), (1.1) – Trusts – Liability for tax & Income Determination]

For tax purposes the trust is considered to be an individual [ITA 104(2)]. Therefore, the eligible dividends are subject to the 38% gross-up and the dividend tax credit.

Unlike an individual, a trust is permitted to deduct, in computing net income, any income paid or payable to beneficiaries [ITA 104(6)].

	Amount Received	Allocated to Gail 50%	Retained by Trust 50%
Interest	\$30,000	\$15,000	\$15,000
Eligible dividends	20,000	10,000	10,000
Capital gains	12,000	6,000	6,000
	<u>\$62,000</u>	<u>\$31,000</u>	<u>\$31,000</u>

Net income and taxable income for the trust and for Gail is the same.

	Gail	Trust
Interest	\$15,000	\$15,000
Eligible dividends (\$10,000 x 138%)	13,800	13,800
Taxable capital gain (\$6,000 x ½)	3,000	3,000
Net Income	<u>\$31,800</u>	<u>\$31,800</u>
Taxable Income	<u>\$31,800</u>	<u>\$31,800</u>

The highest federal personal tax rate (33%) must be applied to the trust’s income. Deductions for personal tax credits are not permitted to a trust [ITA 122(1.1)].

Federal tax calculation:

	Gail	Trust
Federal tax @ 15% @ 33%	\$4,770	\$10,494
Basic personal tax credit (\$14,398 x 15%)	(2,160)	NA
Dividend tax credit (\$3,800 x 6/11)	(2,073)	(2,073)
Federal tax payable	<u>\$ 537</u>	<u>\$ 8,421</u>

### KC 17-3

[ITA: 104(13.1) – Trusts – Amounts deemed not paid

A trust can choose to designate an amount that is actually payable to a beneficiary, not to have been payable. The designated amount is then taxed in the trust rather than as part of the beneficiary's income. This designation is only available where the taxable income of the trust will remain nil.

Bill's \$300,000 of other income puts him in the top tax bracket. Thus, income paid to him by the trust, if included on his tax return, will be subject to tax at the top tax bracket for individuals.

The trust has losses carried forward from past years that exceed the \$45,000 of income distributed to Bill. Therefore, the trust is eligible to designate the \$45,000 of income not to have been payable since the taxable income of the trust will remain nil.

Thus, the trust should designate the \$45,000 not to have been payable to Bill. The income will be included in the trust's income for tax purposes instead of in Bill's tax return. Significant tax savings will result.

### KC 17-4

[ITA 104(21)]

Losses incurred in the trust cannot be allocated to beneficiaries. Where losses exceed income for the year, they remain with the trust and may be carried back or forward in accordance with the normal loss carry-over rules. The trust, in this case, has a net capital loss of \$15,000 ( $(\$20,000 - \$50,000) \times \frac{1}{2}$ ) that can be carried back three years and forward indefinitely to be used against taxable capital gains earned in the trust. The trust has a non-capital loss of \$40,000 that can be carried back three years and forward twenty years to be used against all sources of income earned in the trust.



**KC 17-5**

[ITA 104(21), (21.3) – Trusts – Net taxable capital gains]

A trust is permitted to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains [ITA 104(21)]. The expression “net taxable capital gains” is defined in ITA 104(21.3) as the excess of the taxable capital gains for the year over the total of:

- Allowable capital losses for the year and
- Net capital losses deducted in the year.

In this case, the trust’s net taxable capital gains balance is \$5,000 and, thus, that is the maximum amount that can be designated.

Taxable capital gains (\$100,000 x ½)		\$50,000
Allowable capital losses (\$20,000 x ½)	\$(10,000)	
Net capital losses deducted in the year	<u>(35,000)</u>	<u>(45,000)</u>
Net taxable capital gains balance		<u>\$ 5,000</u>

**KC 17-6**

[ITA: 104(18) – Trusts – Amounts Retained for Beneficiary Under Age 21]

Provided the eventual payment is not subject to any future condition, income that is retained by the trust for a beneficiary who is under age 21 at the end of the year is deducted by the trust and taxed in the hands of the beneficiary. Therefore, even though Felicia will not receive income from the trust until she turns 18, the income earned in each of those years is taxed on Felicia’s tax return and not in the trust. When these amounts are eventually distributed to Felicia, they will be received by Felicia on a tax free basis.

**KC 17-7**

[ITA 104(6), 104(18), 249(1), 249(5), 258(1), 122(1), 122(2), 122(3)]

The estate qualifies to be designated a *graduated rate estate* for a period of 36 months from June 30, 2022. Thereafter, it will be classified as simply a testamentary trust until its windup.

The estate designates itself, in its T3 return of income for its first taxation year, as the deceased individual’s graduated rate estate.

As a graduated rate estate, the executor can choose a taxation year other than a calendar year. For example, a June 30 taxation year could be chosen making the first taxation year end June 30, 2023. During the 36-month period as a graduated rate estate, the trust income is subject to the graduated personal tax rates. As both beneficiaries are in a modest tax bracket, the executor should allocate a portion of the estate’s income to them to be taxed at their graduated rates. Effectively, this creates three separate taxpayers with each having a graduated set of tax rates. With careful planning the overall tax on the estate’s income will be minimized.

On June 30, 2025 (36 months from the date of death), the estate loses the graduated rate estate classification and thereafter its taxation year must be a calendar year. If the executor had initially chosen a June 30 taxation year for the estate, it would be necessary for the estate to have a short six-month taxation year from July 1, 2025 to December 31, 2025.

In addition, after the estate loses its graduated rate estate classification, it will no longer be eligible to apply graduated tax rates on its income. Instead, all income earned will be taxed at the highest marginal tax rates for the various types of income. So, there will be no benefit to retaining taxable income in the estate; the entire taxable income should be allocated to the beneficiaries.