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In Trust Accounts: the Good, the Bad and the Ugly

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When clients decide to invest for their children or grandchildren's futures, they are faced with a variety of investment options. One such option is an "in trust account," also known as an ITF account or an "in trust for" account. These accounts have gained popularity as an easy and inexpensive way to set up a trust for one's children or grandchildren while also enjoying tax benefits. These accounts may sound appealing, but are they worth it?

What is an in trust account?

An in trust account is an investment account or a bank account. In theory, these accounts should be set up with a contributor or settlor (typically the parent or grandparent who opens the account), a named trustee (usually the contributor or settlor) and a beneficiary who is the ultimate owner of everything invested (typically a minor child). While the account is open, the contributor makes contributions of cash or assets. The trustee makes investment decisions and can make withdrawals from the fund, while under a legal responsibility to do so prudently and in the best interests of the beneficiary. Once the beneficiary reaches the age of majority in his or her province, he or she becomes legally entitled to the same degree of control over the account as the trustee, generally with the intention that the trustee will eventually transfer all control over the account to the beneficiary entirely. The beneficiary is the sole person entitled to receive the proceeds of any withdrawal or transfer.

In British Columbia, minors do not have legal capacity to enter into contracts. An in trust account therefore allows a parent or grandparent to do those things on a minor's behalf and make investment decisions with those funds.

In trust accounts are different from formal trusts

At this point, you might be thinking: "wait a second, this sounds familiar… isn't that how a trust works?" And you'd be right. An in trust account is often referred to as an "informal" trust. The intention behind opening these accounts is to create a trust but without the formal trust documentation required to create a formal trust. That means your client gets to skip paying a lawyer's fees to set it up, and instead simply note the trust relationship they intend to establish in the investment contract through an "in trust account" designation. Sounds pretty good, doesn't it?

What these accounts are lacking however, is certainty – and that can have serious consequences.

In order to create a legal trust, there must be three identifiable certainties; there must be certainty of the intention to create a trust; certainty as to what property makes up the trust; and certainty as to who the beneficiary or beneficiaries are. A formal trust is typically evidenced by a document called a Deed of Trust or a Deed of Settlement, so there is no question as to whether or not those certainties exist.

In trust accounts are seen as 'easy' to set up because they don't require formal documentation or other supporting documents. Instead, the bank's account opening documents are relied on to create the trust. Every bank will have different documentation and every account manager will have different levels of understanding regarding the three required certainties.

Enter the risk of uncertainty inherent in opening these accounts.

These account opening forms may lack adequate documentation with respect to who the contributor is, who the trustee is and who the beneficiaries are. They are also commonly set up with one individual acting as contributor and trustee. Without formal documentation of intention – as well as definition around key issues such as how the funds should be managed, how long the trust will continue and how assets can be distributed to the beneficiary – things can get messy.

When someone opens an in trust account, in the eyes of the Canada Revenue Agency (CRA) a trust may or may not have been created – it will depend on whether those three certainties can been established. The account might be construed as having established more of an agency relationship between the contributor and the beneficiary for investment purposes. Depending on what decision the CRA makes, the account holder might want a Court to consider the issues. So much for skipping on those lawyer fees.

How are they taxed?

Speaking of the CRA, let's go over how these accounts are taxed.

Contributions made to an in trust account are not tax deductible. However, the contributor to the account can divide some of the taxable income with the beneficiary. Typically, all interest and dividend income is taxable in the hands of the contributor, and all capital gains are taxable in the hands of the beneficiary.

There are some exceptions:

First, if the contributor is also the trustee or if the account has been otherwise set up so that the assets can only be disposed of by direction of the contributor, then all of the income may be taxable in the contributors hands under section 75(2) the *Income Tax (Canada) Act*.

Second, if the funds in the in trust account are solely derived from Canada Child Tax Benefit payments – or an inheritance – all of the income is taxable in the hands of the child.

Lastly, secondary income (income earned on the income already generated by the original investment) is again taxable entirely in the hands of the child.

Once the child reaches the age of majority, all of the income is taxed in his or her hands. Note that the trustee is responsible for filing annual T3 trust returns to report income.

If upon a review, the CRA decides that the account in question is actually not a trust, it may attribute all income to the contributor from the inception of the account, including capital gains. This could result in back taxes and penalties.

Avoiding audit risk

To avoid the risk that the CRA will not interpret one of these accounts as a trust, it would be prudent to create some sort of written document that clearly sets out the intention to permanently transfer assets and funds to this account for the benefit of the named beneficiary.

It would also be prudent to keep meticulous records regarding where the funds of the account are coming from for tax purposes. Account holders should consider keeping certain funds (such as secondary income) from different sources in different accounts in order to maximize the tax benefits with absolute clarity.

How does an unexpected death factor in?

Since in trust accounts are informal and lack legal documentation, when one of the three individuals dies, control over the funds may disappear.

If the contributor dies before the beneficiary reaches the age of majority then, going forward, all future income earned from the funds in the account will be taxed in the child's hands.

If the trustee dies before the beneficiary reaches the age of majority, then the trustee's Will should be consulted to determine if an alternate trustee is named. If not, the trustee's authority over the account will remain with the trustee's estate until the beneficiary reaches the age of majority (at which time the beneficiary is granted authority over the account). Of course, the contributor may not have chosen the executor of the trustee's estate. When that person gains control over the account, a risk emerges that there may be differing views between the executor and the original contributor as to how to manage the funds.

If the beneficiary dies before reaching the age of majority, the funds will fall into the child's estate. In British Columbia, a minor child cannot legally execute a Will. The account will therefore be distributed according to the law of intestacy, which in British Columbia means the funds will go to the child's parents first, in equal shares. If the contributor opened the account for a minor who is not his or her child, the contributor will lose total control over where the funds go if the child passes away.

What are some other pitfalls?

Besides the risk that an in trust account won't be recognized as a trust for tax purposes, the following are some other pitfalls associated with opening these kinds of accounts:

1. There are no guidelines with respect to how these accounts should be managed. This places a heavy burden on the trustee to ensure they are managing the account prudently. If the beneficiary feels the funds are not being managed properly, the trustee faces the risk of the beneficiary bringing legal action against them.
2. If the in trust account is construed as a legal and valid trust, any contribution is an irrevocable gift. Once the contributor transfer funds or an asset to the beneficiary, the beneficiary becomes the owner of that asset and the contributor can no longer take it back for personal use, for the use of another child, or to contribute to a Registered Education Savings Plan (RESP).
3. If the contributor chooses to close the account despite the fact that it is an irrevocable gift, there may be serious consequences, including back taxes and penalties as mentioned. In addition, the beneficiary may take the contributor to Court and make a claim for the amount of funds invested and earned since the inception of the account plus interest (*Koons v Quibell*, [1998] 164 Sask. R. 149 (SKQB)).
4. The contributor will lose control over the funds once the minor beneficiary reaches the age of majority, at which time the beneficiary should receive full access to and control over the funds. Contrast that with a formal trust, which may have longer age restrictions as to when the beneficiary may be granted that access and control.

What are the benefits of opening an ITF?

So why, you ask, would anyone open an in trust account given the risks and pitfalls discussed? Here are some benefits of opening an in trust account to consider:

1. There is no restriction on how much you may contribute to one of these accounts. Contrast this with an RESP, which has a lifetime maximum contribution limit of $50,000.
2. The funds can be used for anything that would benefit the child or grandchild. This would be a great benefit if the beneficiary does not end up pursuing formal education once he or she reached the age of majority. Others

may view this as a pitfall because the contributor has no control over what the beneficiary spends the funds on.

3. Along the same lines, the funds will be easy for the beneficiary to access when he or she reaches the age of majority. Again, this could be a benefit or a pitfall depending on how much control the contributor wants to assert over the beneficiary's access and spending. Keep in mind, the beneficiary is entitled to take legal action if the trustee declines to give him or her access at the age of majority.
4. If the funds are derived solely from the Canada Child Tax Benefit payments or from an inheritance, all of the income is taxed in the hands of the child.
5. These accounts might be appropriate for smaller amounts of money that the contributor is comfortable with the minor receiving at the age of majority.

What are some alternatives?

Before opening an in trust account for a client, consider discussing these alternatives:

1. Open an RESP for the child or grandchild. This will give the contributor (known as a 'subscriber' in the context of an RESP account) increased control over spending of the funds once the minor reaches the age of majority, and the subscriber will receive the added benefits of the Canadian Educations Savings Grant.

Tip: set up your RESP with joint subscribers to reduce administrative burdens that may arise upon the death of one subscriber. A grandparent should open an RESP as a joint subscriber with one of the child's parents.

2. Help to pay for your children and grandchildren's expenses while you are still alive. This could consist of helping out with payments for ballet or soccer lessons, or even something as large and meaningful as helping with the purchase of their first home.
3. Set up a formal trust that benefits the children or grandchildren and lend money into the trust at a prescribed rate of interest. This arrangement allows for income splitting without the risks associated with an informal trust while creating greater certainty.
4. Take out a life insurance policy that benefits the children or grandchildren, with the proceeds to go into a formal life insurance trust or designate a trustee in the insurance forms. Note that designating a trustee on a simple form may result in similar issues associated with in trust accounts, such as the beneficiary gaining full access and control to the funds at the age of majority, as well as a lack of control over the funds.
5. Contribute to your children or grandchildren's Tax Free Savings accounts once they reach the age of majority.

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