

# In-Trust Accounts

TAX & ESTATE BULLETIN



Parents and other relatives are using in-trust accounts more and more to save money for a child, generally for his or her education. The child can save birthday and holiday gifts, as well as Child Tax Benefit cheques in this type of account. Inheritances not already governed by a formal testamentary trust created by a will can also be managed for children through in-trust accounts.

## What is an in-trust account?

An in-trust account is an “informal trust” set up with a financial institution to invest funds for a minor. The account is set up in-trust because children cannot enter into binding financial contracts. An adult is then responsible for investing funds for the child and signing the contract on the child’s behalf.

An in-trust account is an informal trust and generally will have the following components:

### A DONOR

The person(s) who is/are giving a gift or contributing an asset to someone else.

### A BENEFICIARY

The person(s) who benefit(s) from the account’s assets. The beneficiary(ies) of an in-trust account will usually be a minor child or children related to the donor. The beneficiary, not the donor or trustee, is the ultimate owner of the assets.

### AN ASSET

Money or other assets contributed by the donor. In a trust relationship, the assets must be managed by one or more persons on behalf of one or more others.

### A TRUSTEE

The individual who manages or controls the assets or investments in an account on behalf of the beneficiary. The trustee will manage the assets in the account for the benefit of the child until he or she reaches the age of majority.

## What is the difference between a formal and an informal trust?

An in-trust account, as it is set up at most financial institutions, is an informal trust because the only document that establishes the trust relationship is the investment contract containing the in-trust account designation. The relationship created by the in-trust account is not a formal relationship, and often may not be recognized in law without suitable supporting documentation. Therefore, it is important to ensure that the application establishing the in-trust account is completed properly. The trustee and beneficiary must be clearly identified to support the trust relationship and to ensure the beneficial ownership of the account remains with the beneficiary.

The donor may wish to use a written document that clearly states that he or she is irrevocably giving the stated property to the trust for the benefit of the named beneficiary to clearly indicate his or her intentions.

On the other hand, a formal trust is usually created by a legal document known as a deed of trust. The deed identifies the donor(s), trustee(s), beneficiary(ies) and assets of the trust. It specifies how the assets of the trust are to be administered, states how long the trust is to continue and indicates when and how the trust's assets are to be distributed to the beneficiary(ies). Formal trusts can be simple or complex, but all generally require drafting by a lawyer.

### **Does a beneficiary always have to be specified?**

Yes. If an account is designated as an in-trust account (i.e., there is no formal trust agreement) and there is no beneficiary named on the application form, one of the major criteria for establishing the trust relationship is missing. Without a beneficiary, there is, in fact, no trust and therefore any associated benefits would not be available.

AIM applications identify the trustee and the beneficiary. More than one trustee and more than one beneficiary may be specified on each account.

### **How is the in-trust account taxed?**

Another Tax & Estate Bulletin, *Income Splitting Opportunities and the Income Attribution Rules That May Prevent Them*, describes in detail the attribution rules that relate to funds transferred or given as a gift to a minor. For a copy of this Tax & Estate Bulletin, please contact your financial advisor.

In short, when money is put into an in-trust account for either a related minor child (which includes children, grandchildren, nieces and nephews, among others) or a minor who does not deal at arm's length with the donor, all income (interest, dividends, foreign and other income) is attributed back to the donor(s) if it is earned during a year in which the donor(s) was (were) resident in Canada. The donor(s) would then include these amounts in income and pay the related taxes.

There are some exceptions. For example, if the funds are provided solely from Child Tax Benefit payments or an inheritance, the income would be taxed in the hands of the child and not attributed back to the donor(s).

Similarly, if the money contributed to the account comes from the child, perhaps through a part-time or summer job, the income would also be taxed in the child's hands.

It is the trustee's or trustees' responsibility to document the source of the funds in an in-trust account, as well as to account for the appropriate income tax treatment.

Capital gains, whether from distributions from the fund or sale of any assets in the account, may, depending on how the in-trust account is set up, be taxed in the hands of the child. This income-splitting opportunity is discussed on p. 3 under the heading, "What are some of the tax advantages of in-trust accounts?"

### **What happens when assets other than cash are contributed to the account?**

When a donor contributes or transfers assets to an in-trust account, the donor is deemed to have disposed of these assets at fair market value on the transaction date. If the market value of the transferred asset is greater than its original cost, the donor may be subject to capital gains tax. The informal trust would then be deemed to have acquired these transferred assets at the fair market value on the transfer date.

### **Can the donor get his or her money back?**

No. One of the most important things to remember about in-trust accounts is that, although they are "informal" trusts because there is no deed of trust, they are still legal and valid trusts. Depositing funds into an in-trust account divests, deprives and dispossesses the donor of title to the deposited funds and vests the property irrevocably in the beneficiary's or beneficiaries' hands.

If assets are indeed taken out of the in-trust account, they must be used for the child's benefit because the trustee manages, but is not entitled to, the funds in the account.

## What are some of the tax advantages of in-trust accounts?

Contributions made to an in-trust account are not tax deductible. The income-splitting of capital gains referred to above, however, may create some tax-planning opportunities, specifically if saving for a minor for educational or other purposes.

If a donor contributes to an in-trust account for a minor and the account is designed to provide primarily capital gains (either through distribution or disposition of assets) the resulting taxes, if any, may be paid by the child, presuming the account is set up properly. The child would normally have a lower taxable income than the donor so their incomes have been split effectively. This could continue until the child reaches the age of majority, at which time the account's assets are turned over to the beneficiary to manage.

Investments that have capital growth as their primary investment objective are ideally suited to this income-splitting plan because they usually result only in capital gains. Capital gains may also have tax advantages over interest income.

For this type of income-splitting to work, care must be taken in setting up the in-trust account to ensure that it complies with the applicable tax rules. The provisions of the Income Tax Act state that both income as well as capital gains earned by a trust may, in some situations, be attributed back to the donor. One of these situations occurs when the terms of the trust are such that the property may only be disposed of with the consent of, or in accordance with the direction of, the donor. The Canada Customs and Revenue Agency (or CCRA) has generally interpreted this to mean that the provision will apply if the donor is also the trustee of the account. This would apply regardless of the relationship between the donor and beneficiary.

There are various other pitfalls that may prove to be a trap for the unwary; we recommend that you discuss any proposed arrangements carefully with your financial planner and tax consultant.

## What happens to income on income?

Income on income, also known as secondary income or second-generation income, is income earned on the first-generation income that is retained in the account. First-generation income has already been taxed in the hands of the donor so any income earned on these taxed earnings will become income of the child, without further attribution.

Meticulous records have to be kept to track this secondary income. The easiest way to do this is by moving first-generation income into a separate account that then earns future or secondary income that is not subject to attribution.

AIM's Customizing Service enables unitholders to transfer distributions from one fund or account to another. If an existing account derives income solely from the old Family Allowance Benefit or the new Child Tax Benefit programs, these "taxed" distributions could be transferred to this existing account, which is not subject to the attribution rules.

## What happens when the child reaches the age of majority?

When the child reaches the age of majority, 18 or 19 depending on the province, he or she takes control of the funds. Beneficial ownership of the account has always resided with the child, and although the trustee has managed the money, the informal trust dissolves when the beneficiary reaches the age of majority. AIM, however, will not give the child access to the funds automatically – we will await instructions from the trustee(s).

Assuming the account has been set up properly, there should be no capital gains implications to changing the registration from an in-trust account to the beneficiary's name because there has not been a disposition of any assets in the account. All future income and capital gains transactions will then be taxed in the hands of the now-adult beneficiary, and the donor will no longer face any tax implications.

## What happens if the donor or trustee dies before the beneficiary reaches the age of majority?

If the donor dies, attribution ceases and all future income of the account will be taxed in the child's hands. If the trustee dies, the situation may get more complicated. It may be appropriate to name a replacement trustee to ensure the account continues to be managed if one trustee dies. A simple way to do this is to make the in-trust account a joint account, naming both trustees when the account is set up.

## Are there any risks in contributing or transferring assets to an in-trust account?

As discussed above, if the account is not set up properly, the CCRA may challenge the income-splitting arrangement. This may result in capital gains as well as income being attributed back to the donor.

## Conclusion

In-trust accounts are increasingly popular because of their investment potential, as well as the opportunity to split the capital gains portion of the total return on the investment with a minor. The opportunity to provide a savings plan for a child can offset future education costs or provide a nest egg for the beneficiary when he or she reaches the age of majority.

**This bulletin provides only an overview of in-trust accounts. The rules are complicated and AIM recommends that anyone interested in establishing an in-trust account obtain financial, legal and/or tax advice and assistance to ensure the in-trust account is set up properly.**

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