Informal or “In-trust” Accounts
Friend or Foe

August 2021

Grandparents and other loving relatives often wish to make a gift of money to a minor child, whether it’s to start an education fund, purchase that first car or just allow the workings of time and money to benefit the child in the long term. To keep things “simple,” these gifts are frequently set up as informal trusts in “in-trust” or “in trust for” accounts (“ITF”). While these accounts are less complex and expensive than traditional trusts, there are certain things that should be considered when these types of accounts are set up.

This article focuses on the structure of an ITF account and its participants, reviews the nature of the distributions and their taxation, and details other considerations when setting up an ITF account for a minor child.

Structure

It is important to understand the participants and the role of each individual in the workings of an in-trust for account.

1. The “**Close Relative**,” or contributor of the funds is often a family member but could also be a close friend.
2. The “**Beneficiary**,” who in these situations is always a minor child. This is the person who will eventually receive the funds from the account.
3. The “**Trustee**,” is responsible for the management of the funds in the ITF for the sole benefit of the Beneficiary. It is very common for the Close Relative contributor and the Trustee to be the same person, which can be problematic from a tax perspective. The Close Relative chooses the Trustee.

The very nature of these accounts is embodied in their lack of formal documents. While this keeps things simple and is less costly, it can create uncertainty around the Close Relative’s intentions especially when unexpected events occur. Typically little guidance is provided about how the trust funds are to be managed, how long the fund is to continue and how assets can be distributed to the Beneficiary.

In order to establish a legal trust and to compel the duties and benefits that accompany it, there must be evidence of three certainties:

1. The <u>intention</u> to create a valid trust relationship,
2. The <u>property</u> that makes up the trust, and
3. The intended <u>Beneficiaries</u>.

Absence of any of these certainties can jeopardize the ITF as a valid trust resulting in unintended tax and control consequences. In effect, the structure may be seen more as an agency relationship for investment purposes between the Close Relative and the child Beneficiary rather than a trust.

Assuming these three certainties are present, once the Close Relative expresses the intention to create a trust and transfers the funds for the benefit of the specified Beneficiary, the Close Relative has “settled” or created an in trust for account. The trust is irrevocable, which means the money no longer belongs to the Close Relative, even if they are also the Trustee of the ITF. By transferring the money into the ITF, they have relinquished all ownership of the money (beneficial and legal). The named Trustee now has legal ownership, while the Beneficiary has beneficial ownership. The money transferred to the ITF now belongs to the Beneficiary, even though distribution will occur sometime in the future.

Distributions

The timeline of distributions to the Beneficiary will depend on the terms of the trust and, while the child is a minor, is determined by the Trustee who must always act in the best interests of the child (Beneficiary). Typically, distribution of income is discretionary, and distribution of capital can be graduated, deferred or discretionary.

A key feature of these informal trusts is the requirement that the control of the trust passes to the child once they reach the age of majority. This means the child can demand a distribution after that time for any purpose and can require the Trustee to comply, even if the Close Relative intended to hold the funds longer.

Taxation

New rules relating to the taxation of trusts may require the Trustee to file an annual trust tax return. The return reports the trust's income and would note the income being paid or payable to the child or for their benefit. With a few exceptions, the following tax rules apply to ITF accounts while the Beneficiary remains a minor:

- Interest or dividend income is taxed to the Close Relative as a result of income attribution rules in the Income Tax Act, which deem income on property transferred to a related minor to be income of the transferor.
- Capital gains is taxed to the Beneficiary. This presents an income-splitting opportunity to manage an investment portfolio for the Beneficiary with significant tax advantages on capital appreciation. If, however, property can revert to the Close Relative or can only be disbursed from the ITF by direction from the Close Relative (i.e., where the contributor is also the Trustee), a separate attribution rule may cause the capital gain to also be taxable in the hands of the Close Relative contributor.

Subject to the latter rule, once the Beneficiary reaches the age of 18, the attribution of income to the Close Relative ceases, and the Beneficiary, who has attained the age of 18, is the taxpayer responsible to pay the tax on income generated by the trust capital[1].

Where the minor child contributed themself to the ITF (for example, from gifts received or from summer employment), the issue of income attribution does not arise, as the source of the funds was the child, not the Close Relative.

The account may be subject to an audit by the Canada Revenue Agency and, if there is any doubt about the intention of the ITF being a trust, the Close Relative can become retroactively responsible for the tax on all trust income by attribution including capital gains. The best way to protect your intentions is to have a written document indicating the permanent transfer of the funds for the Beneficiary. The Trustee will need to keep good records showing the sources of all the trust's assets.

Hazards or caveats of ITF accounts

In spite of the many benefits of these ITF accounts, there are other factors that should be considered. The greatest of these is the unexpected death of any of the parties which may shift the tax liability and the distributions of the trust funds.

If the deceased is the:

- Close Relative – all income after the death of the contributor will be taxed in the hands of the Beneficiary. No probate will be paid by their estate on the funds, provided their intention to set up a trust for the Beneficiary was clear. That money does not comprise part of the estate of the Close Relative at their death and; therefore, probate tax is not charged.
- Trustee – the Trustee's Will can nominate a replacement for the duration of the trust. If the Trustee did not make a nomination, their own executor falls into this role and their estate must manage the trust until the Beneficiary reaches age of majority. No probate is payable on the ITF assets as they were not personal assets of the Trustee.
- Beneficiary – the ITF funds will fall into the Beneficiary's estate and probate will be paid based on the rates of their province of residence. As minors are generally not permitted to make Wills, the trust assets will be distributed according to their applicable provincial intestacy laws. This may result in the funds passing to parents, siblings or more remote relatives. If the Beneficiary dies after reaching the age of majority and had made a Will, distributions follow the Will.

There are other key considerations that dictate the need for caution. The gifts made by the contributor may trigger capital gains tax for the Close Relative unless they were sourced from cash. Also, if the Close Relative should ever need to recoup the money for their own care or to help another child, the funds are locked-in and irretrievable. And, it should also be noted that the Beneficiary can access the ITF assets upon reaching the age of majority regardless of the integrity of the purpose or the erstwhile intentions of the Close Relative.

Seek advice

Motivations for establishing these informal ITF accounts are common – simplicity, income-splitting, investing for a child's future and cost savings. Although these accounts present a streamlined and simpler way to set aside some money for a minor child, it should be done with the guidance of your BMO financial professional and tax/legal advisors to ensure it is properly structured and that you avoid unexpected surprises. Careful planning will ensure your children reap the benefits you intended for them for these accounts.

For more information, speak with your BMO financial professional.

[1] Under Quebec civil law an "in-trust" account for minors does not legally exist, even if it is commonly referenced. In civil law there is no deemed trust, as a trust must be created by contract or by operation of law. A minor does not have legal capacity and their parent or legal tutor (guardian) acts on their behalf as a representative until age 18.

BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. Estate, trust, and custodial services are offered through BMO Trust Company. BMO Private Wealth legal entities do not offer tax advice. BMO Trust Company and BMO Bank of Montreal are Members of CDIC.

® Registered trademark of Bank of Montreal, used under license.

All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth.

ID5559 (08/21)