THE GLOBE AND MAIL

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TAX MATTERS

More things to know about in-trust-for accounts for children

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED SEPTEMBER 03, 2020

Two weeks ago, I shared a primer on in-trust-for accounts (ITFAs). Today, I want to finish that conversation. As a reminder, ITFAs are accounts opened by parents or grandparents for minor children, usually for the purpose of saving for the child's future. The funds can be used for any purpose. The intention is typically to save taxes by having as much income and growth in the account taxed in the child's hands as possible.

THE STATUS

As the name implies, these accounts are intended to be legal "trusts." The problem? The Canada Revenue Agency (CRA) may not agree, in which case all income and capital gains of the trust will be taxable in the contributor's hands. This may defeat your purpose for setting up the account in the first place.

For an ITFA to be considered a legal trust, three certainties must exist: First, there must be the certainty of intention to create a trust. Second, there must be certainty as to who the beneficiary is. Finally, there must be certainty as to what property or assets are being held in trust for the beneficiary. While these certainties may exist in your mind, there's no formal written trust agreement with ITFAs to ensure the CRA will agree.

THE ASSETS

If the ITFA is considered a legal trust, then the contributor cannot simply take the funds back. In the case Koons v. Quibell (1998), a woman had set aside funds in an ITFA for a minor child and subsequently took back the assets. The child sued and the court held that a valid trust had been created and ordered the woman to pay the funds that had been held in the account, plus interest.

I mentioned last time that control of the assets in the ITFA must eventually be handed to the child once the child reaches the age of majority. As a practical matter, most parents and grandparents assume that the children won't recognize their right to the assets and would respect their wishes if they did – but there are no guarantees.

With an ITFA, you won't be able to simply reallocate the funds in the ITFA to other children or distribute the funds in an unequal manner when there is more than one child named as beneficiary on the ITFA. Further, you can't simply transfer the ITFA assets to a registered education savings plan (RESP) since this place's new terms and restrictions on the trust funds.

Since there's no written trust agreement for the ITFA, there are no guidelines for how the funds should be invested. The onus will be on the trustee (who might also be the contributor) to manage the assets as a prudent person would. If the beneficiary thinks the assets have been mismanaged, the trustee could face the risk of the beneficiary taking legal action against them.

THE TAXES

I mentioned last week that any interest or dividends earned in the ITFA will be attributed back and taxed in the hands of the contributor. Capital gains, on the other hand, can be taxed in the hands of the child. This does assume that the ITFA is considered a legal trust. If this is not the case, all the income and capital gains will be taxable to the contributor.

But there's another tax rule that applies to trusts: Subsection 75(2) of our tax law will cause all the income and capital gains from the account to be taxed in the contributor's hands if the contributor is also the trustee or if the account has been set up so that the assets can only be disposed of at the direction of the contributor. To avoid this problem, it's best to have someone other than the contributor named as the trustee on the ITFA.

Finally, the child will face on all income and capital gains from the account in the following situations: 1) the contributor to the account dies; 2) the funds in the ITFA are from the Canada Child Tax Benefit or an inheritance; 3) the income is second-generation (that is income on the income in the account); or 4) the child reaches age of majority.

THE TIPS

If you're going to set up an ITFA for a minor child, consider the following ideas:

- Consider having a lawyer draft a formal trust agreement if the dollar numbers in the ITFA are big enough.
- As a minimum, document your intention to permanently transfer the funds to the minor child named as beneficiary, and make sure there's certainty around who the beneficiary is and what assets are being held in trust.
- Invest for growth, not for income, to minimize the attribution of income back to the contributor.
- Avoid a problem under 75(2) of our tax law by ensuring the contributor is not also the trustee.

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