2 More Basic Trust Concepts

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While Chapter 1 covered some trust basics, this chapter will walk through some of the other important terms and concepts you may run into when dealing with trusts.

For executors, when learning a new concept it helps if they also understand some of the new language. It will help them gain respect from others when they discuss trust matters and also prepare them better for dialogue with other professional advisors, such as lawyers and tax specialists.

2.1 Discretionary Trusts

Trusts (including testamentary and *inter vivos* trusts) can be discretionary or non-discretionary. A ***discretionary trust*** (which is more common for *inter vivos* trusts) is a trust that gives the trustee discretion as to when and how he makes distributions from the trust. For example, a trustee with discretionary powers can decide whether to:

- pay out some or all of the income,
- distribute some or all of the capital, or
- pay some beneficiaries but not others.

If the trust is meant to protect assets from the beneficiary's creditors, or where the beneficiary is financially irresponsible and can't be trusted to use funds wisely, the trustee should be given discretion over the payment of income and capital.

Even if the trustee is given absolute or sole discretion, he must act wisely. He cannot make arbitrary decisions, but must think them through and ensure that they are in the best interests of the beneficiary. The trustee should always document his rationale. While he is not obligated to explain his reasoning to the beneficiary, he can protect himself from future claims of misconduct by being able to demonstrate his thought processes.

A ***non-discretionary trust*** gives the trustee specific direction regarding distributions, such as paying a fixed amount to a beneficiary each year, or prohibiting the distribution of capital.

Trusts can also be a mixture of both discretionary and non-discretionary. For example, a trustee could be allowed to pay some or all of the income to the surviving spouse if he determines that she needs this income to maintain her standard of living, but he could be prohibited from distributing any of the trust capital until the spouse dies. A trust for children can specify that distributions of income are discretionary, but that fixed amounts or percentages of capital are to be paid out when the children reach a specified age.

2.2 Encroachment on Capital

Often a trust deed will specify that any income earned by the trust is to be paid out to an income beneficiary, but that the capital is to be maintained intact, for the benefit of the capital beneficiary or remainderman. Sometimes, however, the trustee is given discretion to ***encroach*** on the capital, which means to distribute some of the capital. Usually, the trust deed will specify the conditions under which encroachment is permitted. For example, the trustee may be given the discretion to encroach on trust capital to help pay for a grandchild's post-secondary education. The encroachment clause may specify a dollar limit, such as "not to exceed $10,000 per year" or "at the discretion of the trustee, but not to exceed a total of $200,000 over the trust's lifetime".

"Enjoy the eggs but leave the goose alone" is a popular analogy for the concept of avoiding encroachment on capital.

The "eggs" are the income produced while "the goose" is the capital.

2.3 Vested Interest

Property ***vests indefeasibly*** in a person when that person obtains the right to absolute ownership of that property, in a manner that cannot be defeated by any future event, even if that person is not immediately entitled to enjoy all the benefits arising from that right.

Estate property vests indefeasibly with a beneficiary either when title is transferred to her outright, or when it is transferred to a trust where it is clear that the property is being held in trust for her sole benefit until death. If no other person has any right to benefit from that property, then that property vests indefeasibly with the beneficiary, and she is said to have a ***vested interest*** in the trust while she is alive.

A trust can also specify a ***contingent interest***, which is an interest that is only created upon the occurrence of some future event, where it is not certain that this future event will take place. The residual beneficiaries of a discretionary trust have a contingent interest, because they will only benefit from the trust property if trust property remains after the death of the life tenant.

> ***Example:*** *In an earlier example, James specified in his will that that his second wife, Annette, be allowed to continue to live in their house until her death, when title to the house would transfer to Christine. Annette has a life interest and Christine has a vested interest because there is no condition that she has to personally meet to realize her interest. Annette has absolute interest in using the house during her lifetime, and Christine has an absolute interest in receiving the title to the property once Annette dies.*
>
> *However, if James had specified that if Christine predeceases Annette, Christine's children would inherit the house, they would have a contingent remainder interest.*

We'll discuss the implications of vested and contingent interests later in this Module.

2.4 Irrevocable Trusts

An ***irrevocable trust*** is one where the assets cannot revert to the settlor.

Testamentary trusts are irrevocable by nature. *Inter vivos* trusts may or may not be irrevocable, depending on the objectives of the settlor. If a trust is being used to avoid income attribution, it must be irrevocable. Some court awards, particularly in the case of spousal or child support, are required to be in the form of an irrevocable trust.

2.5 When the Deceased is a Beneficiary

In many cases, the beneficiary of a trust fails to contemplate or plan for what happens to his interest in that trust upon his death. If the deceased did not mention the trust in any of his estate planning documents, his executor may only stumble across the trust when examining the deceased's bank statements or tax returns, or in discussions with the surviving spouse.

The executor's first step would be to notify the trustee of the beneficiary's death, and obtain a copy of the original trust deed.

2.5.1 Life and Remainder Interests

Next, the executor should determine the extent of the deceased's interest in the trust. For example:

- Was the deceased entitled to receive some or all of the trust income during the year, or was this left up to the discretion of the trustee?
- Does the trust deed specify what is to become of this income interest upon his

death? For example, it could specify that

  - the deceased's income will be shared by other income beneficiaries
  - the deceased's income will go to a new alternate beneficiary
  - the income interest will cease entirely, with trust property now vesting solely with the capital beneficiaries.

- Did he have a vested capital interest in the trust, or does the trust name one or more residual beneficiaries upon expiry of his life interest? And if a residual beneficiary is named, did that beneficiary survive the deceased?

If the deceased only had an income interest in the trust, the executor should inform the trustee of the death and arrange for payments to cease. If the trust had provided a significant source of income for the deceased and his family, the cessation of this income could be a shock for his surviving family, and the executor would have to break this news to them. Ideally, the deceased would have planned for this cessation of income as part of his own estate planning.

2.5.2 Amounts Owed

If the deceased had a vested income interest in the trust, the executor should determine if any income was owed at time of death, and make arrangements for that income to be paid to the estate, or to the estate's beneficiaries, either directly or through a promissory note. The executor should also request T3 tax slips for that income, because they will be required when preparing the deceased's tax return(s).

If the income is from a testamentary trust, the executor has the choice of reporting it either on the deceased's final (or terminal) tax return, or on a special optional tax return that is just for income from a testamentary trust. This special tax return is basically an additional T1 personal tax return with "104(23)(d)" written on the top right corner, which refers to the appropriate section of the Income Tax Act.

The advantage of filing the special 104(23)(d) return is that it provides an opportunity for income splitting, because the executor may be able to claim tax credits for the following amounts on each return:

- the basic personal amount,
- the age amount,
- the amount for a spouse or common-law partner, and
- amounts for eligible dependents.

Other amounts (such as tax credits for tuition, education, public transit, or medical expenses tax) can be split among the returns according to where they provide the most benefit. For example, it may be beneficial to claim medical expenses on the return that has the lowest income, because this will maximize the amount that can be claimed.

It's important to note these benefits will end on December 31st, 2015. The 2014 federal budget introduced changes which take effect in 2016. Among other changes, which will be discussed in future chapters, testamentary trusts will be taxed in the same way as inter-vivos trusts with two exceptions: Graduated Rate Estates (GREs) and Qualified Disability Trusts (QDTs). A detailed overview of the changes can be found in chapter 9 of this module.

This is a complicated area and executors would be well advised to consult with a tax specialist. Taxation of trusts is covered in Chapter 8 and the terminal tax return and the various optional tax returns are covered in more detail in Module 5.

2.6 Residue of the Estate

When a testatrix defines the terms of the trust, she can specify that certain property, investments, or dollar amounts be the subject of that trust. However, she could also specify that the trust is to receive some or all of the residue of the estate.

The ***residue*** is what is left in the estate after all final expenses have been paid, debts have been discharged, tax liabilities have been met, and any specific legacies or bequests have been distributed. Thus, the value or make up of the residue will not be known until the rest of the estate is settled.

2.7 Per Capita vs. Per Stirpes Distributions

When a trust includes a number of different beneficiaries (especially if these beneficiaries are the testator's descendants) and the trust income or assets are to be distributed among them, the trust should specify whether the distribution is to be done *per capita*, or *per stirpes*.

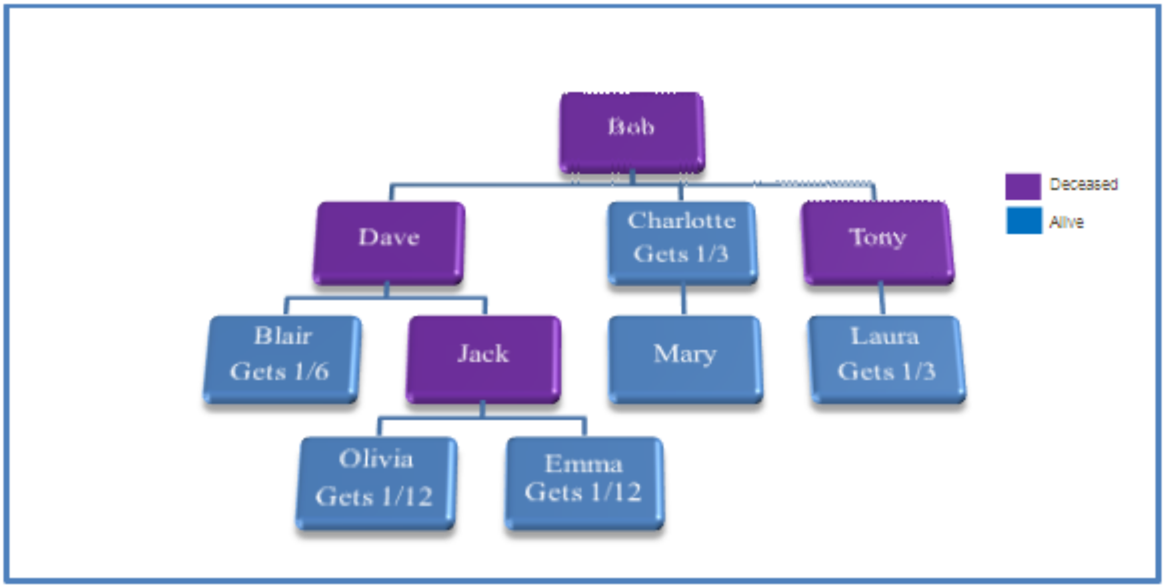
2.7.1 Per Stirpes Distributions

Per stirpes (pronounced "purr stir-peas") is a Latin term that means "per branch". A ***per stirpes distribution*** requires that the assets or income be divided equally among each family branch or line, resting with the most senior generation alive in each branch at the time of the decease's death.

This is best illustrated with an example (see chart below). The family patriarch, Bob, had transferred assets into an *alter ego* trust (*alter ego* trusts are described more fully in Chapter 4). Bob retained life and income interests in the trust property, but the deed specified that upon his death, the trust assets were to be distributed among his three children (Dave, Charlotte and Tony) on a *per stirpes* basis. Unfortunately Dave and

Tony, as well as Dave's son Jack, have all predeceased Bob.

Figure 1: Per Stirpes Distribution



Under a *per stirpes* distribution, each branch of Bob's family will receive 1/3rd of the estate, in the following manner:

- Bob's daughter, Charlotte, is still alive, so she gets the 1/3rd that flows through her family line.
- Because Dave predeceased his father, his 1/3rd share will be split equally between the family lines of his two children (Blair and Jack). This means that Blair will get 50% of 1/3rd of his grandfather Bob's estate, or 1/6th. Jack also predeceased his grandfather Bob, so his 1/6th share will be divided between his two children. As a result, Bob's great-granddaughters, Olivia and Emma, will each receive 1/12th of his estate.
- Because Tony also predeceased his father, his 1/3rd share will pass to his daughter, Laura.

Note that this results in different amounts for individuals within the same generation. Blair, Mary and Laura are all first cousins, but Blair gets 1/6th, Mary gets nothing, and Laura gets 1/3rd.

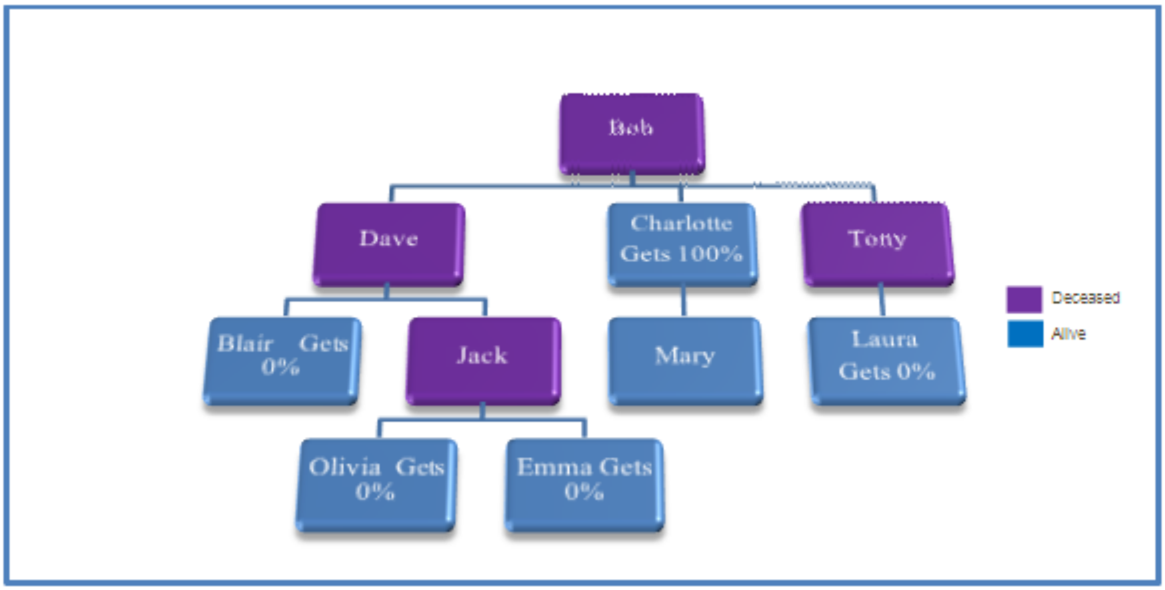
Note also that spouses are completely ignored in these distributions unless they are specifically named as a beneficiary of the estate or trust. For example, if Tony is survived by his wife, Janet, she will not be entitled to any amount of Bob's estate under the *per stirpes* distribution. Instead, Tony's share passes to his daughter, Laura.

2.7.2 Per Capita Distributions

Per capita means "per person". A ***straight per capita distribution*** requires that the assets or income be split equally among the stated beneficiaries who are alive at the time of the testator's death. If one of the beneficiaries has died, that person's share will be divided between the remaining beneficiaries; it does not pass to that person's surviving spouse or children.

Dealing once again with Bob's family, if he had specified a straight per capita distribution among his children, the fact that Dave and Tony have predeceased him means that Charlotte would receive the entire estate (see chart below).

Figure 2: Straight Per Capita Distribution

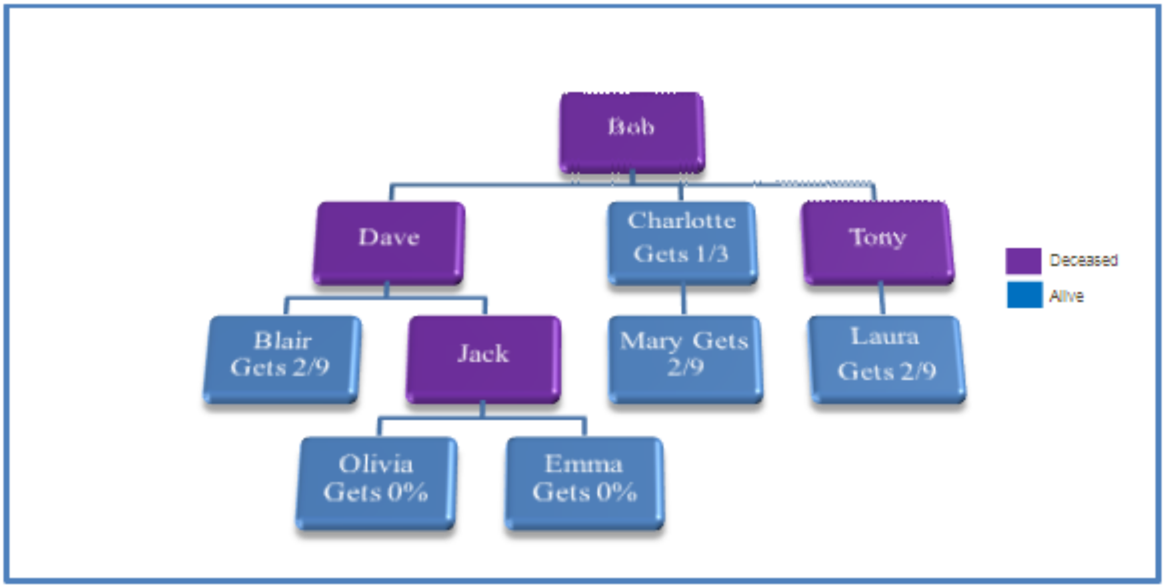


2.7.3 Per Capita by Generation

A per capita distribution by generation requires that the amount initially be divided equally between the testator's children, but if any of these children predeceased the testator, their share will be distributed on a per-capita basis among the living members of the next generation.

Under the per capita per generation distribution (see chart below). Charlotte would get 1/3rd of the trust assets, because she was one of three siblings. Dave's 1/3rd and Tony's 1/3rd will be combined and split equally between Bob's grandchildren. Because only three grandchildren survived Bob, they will each get 2/9^{ths} of Bob's estate (1/3rd of 2/3^{rds}).

Figure 3: Per Capita by Generation Distribution



Summary

Now that you've completed this Chapter, you should understand the following:

- Trusts can be discretionary, non-discretionary or a combination of the two, with respect to the trustee's freedom to decide when and how to pay out trust income or distribute trust capital.
- If no other person has any right to benefit from trust property, the beneficiary is said to have a vested interest in the trust while she is alive. In contrast, she will only have a contingent interest if her right to benefit is only created upon the occurrence of some future event.
- Assets cannot revert to the settlor of an irrevocable trust.
- If the deceased is the beneficiary of someone else's trust, her interest in that trust normally ends upon her death. If she received significant income from the trust, losing this income could be a significant hardship for her surviving family.
- The residue of an estate is the amount that is left over after all expenses and debts have been paid, and all of the legacies and bequests made under the will have been carried out.
- When property is to be divided equally among several children, the trust should specify whether the distribution should be per capita or per stirpes.