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TAX MATTERS

How in-trust accounts for your children are taxed

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My son, Win, has been asking for a lot of money recently. "Dad, can I have a hundred bucks?" he asked. "A hundred bucks? What do you need twenty bucks for? Ten bucks is a lot of money. I only have five. Here, have one," I replied.

I'm not sure Win knows it, but when he turns 18 later this year, he'll have a legal right to take the nice sum of money that's accumulated in the in-trust account I set up for him a few years ago – and it's much more than a hundred bucks.

Thousands of parents and grandparents have set up in-trust accounts for the minor children in their lives – usually with the aim of having income in those accounts taxed in the hands of the kids, who will often pay little or no tax.

How, exactly, will an in-trust account be taxed? It depends on the legal nature of the account.

The account will be considered by the taxman as one of three things: a legal trust, a gift made directly to the child (with an adult acting as agent for the child) or no transfer at all (in which case the assets remain that of the adult transferer).

Legal trust
In order for an in-trust account to be considered a legal trust, three conditions have to be met (called the "three certainties"): There had to be an intention to set up a trust when the investments were made, the property of the trust must be identifiable and the beneficiaries of the trust must be clearly defined. In the absence of a formal, written trust agreement, the first certainty above is a tough one to prove.

If the three certainties are considered to be met, the in-trust account will be taxed as a trust. This means that a trust tax and information return – called a T3 return – may have to be filed each year for the account. When was the last time an investor actually filed a T3 return for an in-trust account? Well, it's about as rare as hen's teeth.

If your in-trust account is a legal trust, the attribution rules will apply to income earned in the account. Specifically, any "income from property" (typically interest, dividends, rents or royalties) will be attributed back to you and taxed in your hands if you try to tax this income in the hands of a minor beneficiary. Capital gains, however, are not attributed back to you and can be taxed in the hands of the child.

Finally, subsection 75(2) of our tax law could apply to a legal trust. It's an ugly provision that could cause all income and capital gains of the account to be taxed in your hands if certain conditions are met (a topic for another day).

Gift to the child

If the in-trust account isn't a legal trust, perhaps it will be considered a direct gift of the assets to the child, with you or another adult acting as agent for the child since they're not allowed as minors to control the account. In this case, the same attribution rules apply that will cause income from property to be attributed back to you (again, capital gains can be taxed in the child's hands). In this type of agency arrangement, there would be no need to file a T3 return annually, and subsection 75(2) can't apply. I like it.

No transfer

If your actions suggest that there's neither a trust nor an agency arrangement, the taxman might consider that no transfer of assets has taken place and you'll face the tax each year on any income or capital gains in the account. This would defeat the purpose of setting up the account. The taxman will watch how you've been using the account to make a determination. If you've been using the account as your own personal savings account, for example, you could be caught here. In my case, I'm prepared to argue that I've made a gift of assets and have set up an agency arrangement – because it's simplest. I had no intention of setting up a trust and I let my financial institution know this in writing when I set up the account.

Once my kids reach age of majority, they'll have a right to the assets in the in-trust account. This is true whether it's a legal trust or an agency relationship. The good news? My kids still like me, and I carry some moral suasion, which means they're not likely to take the money and run.

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