

# Exempt Market Investments and Discretionary Trusts

## A Match Made in Financial Planning Heaven

BY COLIN RITCHIE

As both a lawyer and a financial planner, I am in love with both numbers and words. Fortunately, there are ample opportunities in my practice to combine both of these passions and, even better, use them to make the lives of good people that much better.

On the numbers side of the ledger, one of my favorite points of discussion are the potential benefits of exempt market investments for part of my clients' investment portfolio for a number reasons. I suspect these reasons are already well understood by those of you who are already one paragraph into this article. In my case, I am very fortunate to work with Klint Rodgers of Pinnacle Wealth Brokers out of Vancouver, who has done a great job for me and my clients

explaining the ins and outs and letting them make informed decisions about what to do next.

On the words side of the same ledger, I love to tell clients about the use of trusts. I have already written about them extensively in the past and will not bother to regurgitate what I have said before in the articles found on my website or in other publications, other than to say: trusts are an extremely useful and flexible tool that can be used in a variety of situations to protect people, balance

competing interests and, what is often overlooked, save them an embarrassingly large amount of tax dollars. It is about this last advantage – and how it can be combined with exempt market investments using one particular strategy – that I want to tell you about today.

“ONE OF MY FAVORITE POINTS OF DISCUSSION ARE THE POTENTIAL BENEFITS OF EXEMPT MARKET INVESTMENTS FOR PART OF MY CLIENTS' INVESTMENT PORTFOLIO.”

One of the tenants of my financial planning practice is that it does not matter so much what an investment makes as what my clients can keep after the tax man has come and gone. Although a lot of exempt market investments are tax-advantaged, which is one of the reasons my eyes often sparkle when reviewing new offerings, many of the high income products I also really like are not so fortunate. Accordingly, without some careful tax planning, that 12% return that sounds so enticing upon first glance might be as little as 6% after tax in my clients' pockets without some further suggestions on my part.

Let's assume that we have a client in the highest tax bracket with a stay-at-home spouse taking care of the family's 4 minor children who aren't yet earning any income of their own. Although our high income client may have the money to invest, the tax results will be a lot better if the investment income shows up on his spouse and children's returns. Unfortunately, our tax rules attribute any income or capital gains earned by the low income spouse back to our client. If invest-



ments are held in the minor's hands, such as through an in-trust account, we are faced with a similar problem. Although the capital gains could be taxed in the children's names, the income would still be dad's problem until each particular rug rat in question turned 18. Even worse, if using an informal in-trust account as are commonly set up in brokerages, once that child is an adult in his province of residence, the child will both own and control that account, which could mean a new sports car and bad parent-child relationship.

This is where creative – and perfectly legal – use of trusts come in, combined with what is commonly referred to a spousal loan for income tax purposes. Dad would have to convince another relative, who I'll call Uncle Buck, that will not otherwise be named in the trust to agree to be the settlor of the trust (which is just a fancy legal way of saying the

creator and funder). Alternatively, a friend or lawyer might do the job instead, although for my purposes I'll assume that Buck is up for the task. Uncle Buck's sole job is to sign the trust document and perhaps contribute a silver coin to it as its first asset and then can be allowed to return to his usual pastimes.

This same trust document would name our client and perhaps his spouse and / or some friends as the trustees of the trust. The trustees are the people who run the trust and decide how to best follow the instructions provided in the trust document. In this case, the instructions would name the spouse, the minor children, and perhaps our client and any other low-income relatives who our client wants to help as the beneficiaries (the people entitled to the benefits of the assets in the trust). The instructions would also leave it completely to the trustees' discretion as to how much of the income or the capital is

paid out and when this happens. In other words, it would ultimately allow our client to do whatever he wanted with the contents of the trust since the language would specifically authorize him to do so.

You may be wondering why everyone has gone to so much trouble just for the sake of a single silver coin, no matter how aesthetically appealing. That's where the next step comes in. The trust would also authorize our client to loan the trust money and he would do just that. In order to avoid the attribution rules I've scared you with earlier, the CRA requires that our client charges at least the minimum prescribed rate that is in force at that time, although this rate can be locked in for life. At this point, this rate is only 1% per year. In other words, our client needs to charge and be paid 1% of the amount he lends to the trust before January 30 each year for the previous year's obligation and declare this on

his tax return. The trust can then deduct this expense as an investment loan and then pay out any resulting income and gains to any of the named beneficiaries without incurring the wrath of our friends in the nation's capital.

As a wrinkle on this scheme, perhaps our client doesn't have the liquid cash to invest. In that case, he might borrow against a line of credit and charge interest equal to his own carrying costs. Put another way, if he charges the trust exactly

what he incurs himself, he should be net neutral for tax purposes, as the interest paid and interest received would cancel each other out and the excess can still be paid out to the beneficiaries. Although the trust would not have as much to pay to the beneficiaries

after paying these higher interest charges, the spread between current interest rates on secured lines of credit and the potential payouts from many exempt products can still mean a hefty payout in the right circumstances.

Ultimately, the trust will be wound up and the loan will have to be repaid at that time, with any remaining capital or income distributed at the trustees' discretion to the beneficiaries. Many trusts get wound up before their 21st anniversary, as there is a deemed disposition, or sale, of any assets subject to capital gains inside the trust at that time. Fortunately, tax law allows any such assets to be transferred to beneficiaries at any point on a rollover basis so that the beneficiaries own the transferred assets with the same unrealized gains or losses on them as was the case when owned inside trust. What is really interesting and useful with many high income exempt assets, however, is that they often are not

subject to capital gains, which means that there is no need to worry about what is known as the '21 year rule.' In other words, there is no need to transfer out assets or sell them to repay the loan since there won't be any capital gains to worry about avoiding!

I suspect that many of you with children have another niggling question circulating through your minds: do I have to actually give the money to my children to make this strategy

work? There is fortunately another silver lining to this strategy. The trust can allow the trustees to pay money to any beneficiaries' guardians or to others for that person's benefit. In other words, as one of their parents, our client could pay himself on behalf of a child, although

he needs to use it for the child's benefit. Thus, the money from the trust could be used to pay for the sort of expenses mom and dad would have paid for out of their own pockets anyway.

At this point, it is time to make placate the numbers side of my brain. Accordingly, let's assume that our client is able to suitably allocate \$500,000 to invest in an exempt market product that pays 12% per year. If our client was taxed on the income directly at 50%, as is now could be the case in many provinces, he would keep \$30,000 and the government would keep the rest. In our example, if none of the spouse and 4 kids were earning any money, the trust would pay our client \$5,000 in interest and would divide the remaining \$55,000 equally among the 5 other beneficiaries. When the dust settled, our client would pay \$2,500 in tax on the interest he charges and the remaining beneficiaries would pay \$0 tax to Ottawa and a

pittance, at most, to their province of residence, depending which it happened to be. Theoretically, this happy family might have perhaps an extra \$25,000 or more to spend each year by implementing this strategy. On the down side, however, the investment and financial advisors working with this family might soon suffer from overwork dealing with the ensuing client referrals.

As a final thought, any potential investors using this strategy with exempt products would need to ensure they can invest under an exemption, usually as 'accredited investors' or 'eligible investors,' to invest in the exempt market (private) products they covet. Although the definitions vary by province, at least in some cases a trust is an eligible or accredited investor if all of the beneficiaries or the majority of the trustees fit the bill. In other words, if our client would have been able to invest on his own, in many cases he would have no problem investing via a trust provided that he ensured that the majority of trustees, including himself, would have been able to purchase directly.

In conclusion, although tax savings should never be driving the bus when it comes to making investment decisions, it is often usually still a very important passenger. By combining some creative tax planning with the right investments, however, a really good investment can sometimes become a thing of wonder.

*Colin S. Ritchie, LL.B., CFP, CLU and FMA is a Vancouver-based fee-for-service lawyer and financial planner who does not sell investment or insurance, just advice. He can be reached at colin-ritchie01@shaw.ca or at 778-371-1994. To find out more, visit his website at www.colinsritchie.com*

TRUSTS ARE AN EXTREMELY USEFUL AND FLEXIBLE TOOL THAT CAN BE USED IN A VARIETY OF SITUATIONS TO PROTECT PEOPLE, BALANCE COMPETING INTERESTS AND, WHAT IS OFTEN OVERLOOKED, SAVE THEM AN EMBARRASSINGLY LARGE AMOUNT OF TAX DOLLARS.