

inBrief

Canada edition



A Matter of Some Discretion: Controlling your Trust

By James Bowden | 1 February 2022

Two common reasons for the use of trusts in estate planning are to achieve tax efficiencies and to protect assets from potential creditors and claims. These are by no means the only reasons that trusts are utilized, but they are important benefits and are sometimes the primary focus of trust structure. Generally speaking, trusts that provide tax and asset protection benefits need to be structured so as to grant the trustees very wide discretion as to when distributions are to be made, to which beneficiaries, in what amounts, and in which circumstances. The language used in trust deeds usually gives trustees “absolute discretion” or “unfettered discretion” or similar. Consider the following two examples of why discretion is important:

Example A (tax efficiency): If a family trust is established with many family members as potential beneficiaries (*e.g.*, “all of my issue”, which would include children, grandchildren, and you may include corporations owned by them, etc.), one of the goals of the trust is probably to take advantage of income splitting opportunities among the beneficiaries. The trustee needs to be able to assess the individual tax brackets of the beneficiaries so they can “income sprinkle” across the beneficiaries in a tax efficient manner. If the beneficiaries had fixed entitlements to a specified proportion of trust income or capital, the trustees could not achieve a tax efficient result. Thus, discretion is needed.

Example B (asset protection): Consider the same example again, but this time one of the beneficiaries has been successfully sued and his/her assets are subject to attachment by the judgment creditor. If the beneficiary has a fixed entitlement under the terms of the trust, the creditors will be able to attach that interest as well and that beneficiary’s interest is effectively lost. If the beneficiary’s entitlements are entirely subject to the trustee’s discretion, then the beneficiary has no vested interest at all unless and until the trustee declares each new distribution. The trustee can confirm before making a distribution whether any beneficiary is subject to creditor claims, and if so, it can exercise its discretion in favour of another beneficiary (or none at all), until the claims are

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dealt with, keeping the trust assets out of the creditor's hands. Accordingly, discretion is again an essential component.¹

With the necessity for a trustee to be granted such broad discretion, the question is often asked: how do you know the trustee is going to exercise its discretion in the manner you would have intended? There are essentially three approaches available: include terms in the trust instrument itself, issue a letter of wishes, and/or the appointment of trust "protectors". We will briefly discuss each in turn.

i) Terms of the Trust Deed

Some terms can be included in the trust deed itself without unduly constraining the trustee's discretion. These may include directions to the trustee not to make distributions to beneficiaries whose assets are subject to attachment; or a term which excludes the trust property from any beneficiary's net family property to help protect it from being included in equalization payments upon marriage breakdown; or even a direction that requires certain minimum payments or expenses to be paid out of the trust so that the broad discretion only applies to the funds remaining after that. A trust deed is a very flexible instrument and can be prepared with as many, or as few, specific constraints on a trustee as desired. However, for the most part, if tax and asset protection benefits are to be maintained, the hard constraints need to be kept to a minimum. It is more common to do the opposite; that is, explicitly oust duties that trustees would otherwise have as a matter of law that would potentially constrain them.

ii) Letter of Wishes

A letter of wishes is separate from the trust deed and is just what its name suggests: a letter from the settlor to the trustee setting out guidance for the trustee as to how the settlor wishes the trustee to exercise its discretion. The trustee is not legally bound by the letter of wishes, but in practice trustees do give effect to them, and if a beneficiary challenges the trustee's choices a court will take letters of wishes into account as relevant context. Letters of wishes are sometimes very brief and provide simply that the trustees should take into account the views of another person when exercising their discretion (and that person is sometimes the settlor). This is a potentially acceptable approach in the short term, but it has its drawbacks: a court may find that the settlor is the person who is "in fact" making trust decisions as a de facto trustee, a finding that would almost certainly have detrimental consequences for any plan for which the trust was needed; and, upon the settlor's death (or to whomever the letter of wishes referred), the settlor obviously then loses whatever influence he/she had. Thoughtful, detailed, foresightful letters of wishes are strongly recommended. Note that the trust deed should oust any default duties that trustees must comply with as a matter of law which may prevent compliance with a letter of wishes (the obligation to treat all beneficiaries equally, for example, should be ousted in the trust deed, along with others).

iii) Appointing a Protector

Finally, there is the role of the trust "protector". A protector is someone (or multiple persons) who is granted a number of key powers in the trust deed, but who is not a trustee and, typically, has no fiduciary duties to beneficiaries.² They are supposed to provide oversight of trust administration and decision making from the perspective of someone close to the settlor who presumably knows what the settlor would have wanted. Protectors are often granted powers to approve certain decisions of the trustees, to veto certain decisions, to remove and replace the trustee, or to terminate the trust, among other key powers. The protector provides a significant check on trustee discretion. The choice of

¹ For asset protection trusts, note that it is important that the beneficiary whose interest is being protected is not also the sole trustee (or ideally even one of multiple trustees), as a court may order the beneficiary/trustee to exercise its control over the trust to satisfy the creditor's claim. The beneficiary must not have any control over trust decisions.

² The issue of whether a protector does have, or should have, fiduciary obligations to beneficiaries similar to the obligations of trustees is an unresolved issue in Canadian law. Care should be taken to specify the settlor's intent in the trust deed as to the duties expected of a protector.

protector is therefore important: not only should the protector be someone close to you and who understands your wishes, they should be trustworthy and reliable, and without a conflict of interest (*e.g.*, a beneficiary, or a spouse of a beneficiary). Care must be taken so as not to usurp the role of the trustees altogether, either in the trust deed or in practice, or there will be a risk that the protector will be found to be the *de facto* trustee, with potentially disastrous consequences.³

In addition to the above, where a trust is created as part of a plan intended to have specific tax consequences, it is common for trustees to obtain professional advice before making a distribution, to ensure that it is being made in a manner that will not upset the plan. This is not a limit on the discretion of the trustees, *per se*, but it does function as one. Sometimes, detailed tax-driven instructions are provided to the trustees by professional advisors when the trust is created, setting out guidelines for how distributions are to be made, when, and also to whom they must not be made. Such advice has similar status to a letter of wishes, but is arguably even more likely to be adhered to as the trustees will not wish to be responsible for triggering negative tax consequences in the face of having received such advice.

The above tools to control the discretion of a trustee are very useful, but they still leave some discretion to the trustee, which is unavoidable if the structure is to be robust enough to withstand a challenge by tax authorities or disgruntled beneficiaries.⁴ On a practical level, these tools are quite effective as professional trustees are motivated to serve their clients (*i.e.*, settlors) as best they can, and to avoid litigation that may arise from ignoring letters of wishes, or professional advice, or contravening a protector's decision. ■

³ *Garron Family Trust v. Her Majesty the Queen (2012 SCC 14)* is the leading case in Canada on trust residency. In that case, the courts "looked through" the exercise of powers by a protector, where the protector was in turn subject to replacement by the beneficiaries, and this was one of the reasons that court found that the beneficiaries were effectively functioning as the trust decision makers, with negative consequences for the trust in that case.

⁴ This note focussed on trustee discretion with respect to distributions of trust income and capital. It is important to bear in mind that a trustee's discretion with respect to managing the trust's investments can be controlled as well, to a greater degree of certainty and detail than controlling discretion as to distributions.

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