A Story of a Modest Trust and the Prudent Investor Rule

By Philip J. Renaud, QC[1]

I write this article from the perspective of an estates and trusts lawyer, and from the viewpoint of a trustee of a modest trust for a 13-year-old boy. My purpose is to share my experiences as a trustee with my lay-trustee clients who find themselves in the situation of managing a modest trust in the estate of a friend or relative. We take on this task with a feeling of obligation towards our deceased friend or relative, but soon find ourselves overwhelmed with the responsibility and potential liability of being a trustee of another person's entire life savings. This article therefore approaches the task of being a trustee from my personal experiences as a trustee. [2]

My Friend

Dave was my friend. We met at my summer job cutting grass while I was attending law school. He was one of the groomsmen at my wedding. As I developed my practice as an estates and trusts lawyer, Dave also became a client and I prepared wills for him and his wife.

Unfortunately, Dave's health declined, and he eventually ended up on permanent disability. His marriage broke down and he and his wife eventually divorced. His wife remarried, retained custody of both children, and Dave paid child support for his children.

Dave's health declined further, and Dave realized that he needed help to manage his estate for the benefit of his children. I had already redrafted his will after his divorce, but then he approached me to ask if I would be the executor of his estate and the trustee of the trust for his youngest child. I explained that I had a policy never to act as an executor or trustee for my clients and encouraged him to consider appointing a trust company, but the value of his estate was below too small. Eventually I agreed to act as trustee, but only if he also appointed his oldest son as my co-trustee, as he had grown to be a mature, responsible young man.

The Estate

Dave died in 2006 and left him surviving a 13-year-old son, Jason, and a 26-year-old son, Sam. He left a modest estate, including life insurance and a pension, with his entire estate valued at about $400,000. He appointed Sam and me as the personal representatives of his estate and trustees of the trust for Jason. Half his estate was to be distributed to Sam absolutely, and the other half was to be held on trust for Jason until age 23. The will gave us, as trustees, the power to apply the income or capital or both for the "maintenance, education, benefit or advancement" of Jason. At age 18, we were directed to pay Jason 5% of the capital, as then calculated, at age 21 another 10% and the balance at age 23. Jason has now attained the age of 23 years and we distributed the balance of the funds in his trust to him. Jason turned into a responsible young man, with a good education and a bright future, for which his dad would have been proud, and for which much credit is due to the excellent guidance and support of his mother and step-father.

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[2] The names of the parties have been changed to protect confidentiality. I thank the family for allowing me to share their story.

Don’t interfere with my decisions about my son!

Jason’s mother never said to me, “Don’t interfere with my decisions about my son!” But I anticipated that’s what she might have been thinking prior to our first meeting. At the date of Dave’s death there was an outstanding court order that was binding on the estate for the payment of about $400 per month for child maintenance for Jason, and this order was a binding debt of the estate.

As trustees, Sam and I had the discretion to pay money from the trust to Jason. But as a parent, I would be very upset if an independent trustee gave money to my son to buy a car or even a new video game without my permission. Jason’s mother was his guardian, and the only person legally empowered to make personal decisions for him as long as he was a minor. But as trustees of Jason’s money, we had the duty to consider whether to exercise our discretion in his favour whenever we received a request from the beneficiary, or his guardian.

I started our first meeting with Jason’s mother and her husband by stating that I would never interfere with their parental decisions about Jason. If Jason wanted money as a minor, he would have to initiate that request through her, and I would defer to her decision. As trustees, we had to be careful about fettering our discretion. This effectively means that we could not make a decision about a distribution in advance, by stating that we would not pay any money to the beneficiary without his mother’s permission. Our duty in exercising that discretion was to investigate every request for money and decide whether to make advances. The best source of information about the beneficiary is the beneficiary’s guardian, and we needed clear lines of communication in order that we could do our job as trustees. We therefore had a good discussion about our legal duties as trustees, which would be tempered with our respect for her and her husband when making parental decisions for Jason.

What is our legal duty for investment of the trust money?

As trustees, we had a legal duty to invest the funds in Jason’s trust. We were governed by the Alberta *Trustee Act* which adopts the prudent investor rule. (The relevant sections of the *Trustee Act* sections are in the appendix.) The plain English way of describing the prudent investor rule can be summed up by the old adage “don’t put all your eggs in one basket.”

The key to protection from liability is contained in the *Trustee Act* which provides that a trustee will not be liable for a loss to the trust if the loss arises from a decision or course of action that follows the criteria required of a prudent investor. The duty of prudence includes a duty to obtain investment advice. If a trustee obtains investment advice in the manner provided in the Trustee Act, and follows the advice, the trustee is not liable, even if there is a loss to the investments.

The easy route: buy a GIC

Each trust and each beneficiary requires a unique plan. An 85 year old widow will have different needs than a five year old orphan. An 18 year old student about to enter university will require a different investment program than a 60 year old widower. Investment for a 40 year old professional in a high income bracket will require a different approach than for a 25 year old disabled child. As the beneficiary ages, his or her changing needs will require adjustments to the investment plan.

According to the investment advice we received, buying a GIC with the investment funds would not have complied with the prudent investor rule, and in my opinion could have made us liable to the beneficiary for failing to grow the value of the trust funds. Buying a GIC might be a valid short-term investment strategy in some trusts but it was not a valid long-term trust investment strategy in this trust for Jason. This analysis requires legal and investment advice.

Investment Advice

I do not have sufficient expertise to make investment decisions on behalf of another person and I am certainly not qualified to give investment advice. I have used discretionary money managers for over 25 years and rely on them to make all investment decisions concerning my retirement savings. My point here is that trustees must obtain investment advice, no matter the extent of their own personal investment experience.

We would have liked to retain a discretionary money manager to invest the trust funds because of the protection accorded by the prudent investment rule. Section 5 of the Alberta Trustee Act allows a trustee to delegate investment decisions to an "agent" which includes a stockbroker, investment dealer, investment counsel and any other person to whom investment responsibility is delegated by a trustee. Trustees who delegate investment authority must exercise prudence in:

- selecting the advisor;
- establishing the terms of the authority delegated; and
- monitoring the performance of the advisor to ensure compliance with the terms of the delegation.

Section 5(4) of the Trustee Act states:

> **5 (4)** A trustee who has delegated authority to an agent under subsection (2) and has complied with subsection (3) and the regulations is **not liable** for the decisions or actions of that agent.

We sought advice from my personal discretionary money manager who was associated with a major Canadian bank. Unfortunately, he was not able to accept the funds under the purview of my investment contract because my co-trustee could not be added to my plan with the financial institution. For a sole trustee, who uses the services of a discretionary money manager, this might be a solution to investigate, because it might lower the overall fees that would otherwise be associated with mutual funds which typically have management fees in the 2 to 3 percent range.

My financial advisor was however able to give us advice from the perspective of his employment at the bank and he recommended a mutual fund with his financial institution. The factors we considered in making this investment required analyzing each factor under section 5(3) of the Trustee Act as it related to Jason's trust. When you invest funds as a trustee, you must follow this process:

Analysis of the factors in section 3(5) of the *Trustee Act*:

(5) Without restricting the matters that a trustee may consider, in planning the investment of trust funds a trustee must consider the following matters, insofar as they are relevant to the circumstances of the trust:

(a) the purposes and probable duration of the trust, the total value of the trust's assets and the needs and circumstances of the beneficiaries;

- The trust had a term of 10 years (to age 23), with encroachments of 5% of the capital at age 18, 10% at 21 and the rest at 23.
- Jason's mother advised that she could provide for all of Jason's needs and assured us he would not need income or capital from the trust until he started college.
- Jason might have required some of the funds at age 18 when he entered college, but his mother advised that she had a Registered Education Savings Plan (RESP) for Jason, and Dave also had an RESP for Jason valued at approximately $10,000 which we held as trustees. (This RESP was paid out to Jason between age 18 to 21 to assist in his education.)
- We therefore had ten years until the termination of the trust and concluded that it would be prudent to accumulate the income and add it to the capital for Jason's benefit.

(b) the duty to act impartially towards beneficiaries and between different classes of beneficiaries;

- This is known as the "even hand rule."
- Jason was the only beneficiary during his life. If he died before age 23, his brother was entitled to all the capital. His brother (my co-trustee) advised that he was not concerned about preservation of capital for himself and advised that we should invest solely for Jason.

(c) the special relationship or value of an asset to the purpose of the trust or to one or more of the beneficiaries;

- There were no assets allocated to Jason from the estate that fit this factor. (In some situations, a house might fit into this category.)

(d) the need to maintain the real value of the capital or income of the trust;

- We wanted to preserve the capital of the trust, and to grow it for Jason's benefit to provide him with a step up in life at age 23.

(e) the need to maintain a balance that is appropriate to the circumstances of the trust between
  (i) risk,
  (ii) expected total return from income and the appreciation of capital,
  (iii) liquidity, and
  (iv) regularity of income;

- Jason’s mother advised that she could provide for all of Jason’s needs and assured us he would not need income or capital from the trust until he started college.
- We were paying most of Jason’s annuity payments to his mother as his guardian for his maintenance.[3] This represented the cash portion of the investments of the trust. (The annuity came from the rollover of Dave’s RRSP; see Appendix B.)
- Therefore, we could invest the remainder of the trust assets with capital growth as the primary objective.

(f) the importance of diversifying the investments to an extent that is appropriate to the circumstances of the trust;

- Diversification of the investments of the trust was key for us as trustees, and we relied on the investment advisor to choose investments that complied with modern portfolio theory.

(g) the role of different investments or courses of action in the trust portfolio;

- Again, we relied on the investment advisor to choose investments that complied with modern portfolio theory.

(h) the costs, such as commissions and fees, of investment decisions or strategies;

- Given the small amount of the trust we would not qualify for investment with a discretionary money manager. We therefore felt that investment in a mutual fund was best for our trust, even though Canadian mutual fund investments typically charge a management expense ratio of 2% to 3%.

(i) the expected tax consequences of investment decisions or strategies.

- This was not a concern for us as the income and capital gains could be allocated to Jason and taxed in his hands, all of which was likely tax free as fitting within his basic personal exemption under the *Income Tax Act*. (See technical analysis in Appendix A.)

Our financial advisor indicated that 10 years was a medium to long term investment horizon. The annuity from Dave’s RRSP represented about 25% of the assets in the trust (see Appendix B), so that we effectively had a cash to equity ratio of 25/75. He therefore recommended investment of the remainder of the funds in equities, and he referred us to one of the bank’s mutual funds that invested 100% in equities, with good rates of dividends which were reinvested pursuant to the terms of the fund.

[3] In fact, we discovered later that his mother was investing all of his annuity payments in a mutual fund in Jason’s name, which had grown significantly in value since the date of his father’s death.

And then the Market Crashed!

We invested $130,000 in the mutual fund. And then the market crashed in 2008! At the end of the year, the value of the fund had declined to $104,000, and by the end of the next quarter, it was down to $99,908.41.

But we didn't panic (okay we panicked, but…). We sought advice from our investment advisor. We again reviewed the long-term goals and each of the above factors in the Trustee Act and were advised that the investments still met the requirements of the prudent investor rule, the terms of the trust, and the needs of the beneficiary. Had we cashed in the investments and purchased a GIC, the value of the capital would not have grown, and we would only have accumulated interest income. The market recovered, and by the end of the following year, the value of the investments had recovered to just under the initial investment, and by Jason's 21st birthday, the value of the fund had reached $188,199.11.

The need to review the investments

Trustees have a legal duty to review the investments on a regular basis. We made a significant change in the nature of the investments as Jason approached his 21st birthday. By that time, we had distributed most of the cash portion of the investments to Jason's guardian as maintenance, and the final accumulated cash from the RRSP annuity was distributed as part of his 5% at age 18 and 10% at age 21. As a result, we no longer had a cash component to the investments.

On review with the financial advisor, we changed from the all equity mutual fund, to a balanced fund which had a cash component. The other reason for the change was that we were nearing the end of the trust and would have to distribute all the money on Jason's 23rd birthday. We did not want to have to make a distribution when the market was down. We consulted with Jason, and included his mother and step-father in the discussion. Jason advised that he preferred to take the mutual fund investment at age 23. We therefore felt comfortable in keeping the funds invested in a balanced mutual fund.

Summary of Payments made to Jason

Feb 2008 through Dec 2008	Monthly child maintenance payment of $395.00 from the estate funds	$3,950.00
Jan 2009 through July 2011	Monthly annuity payment to Jason's mother as guardian for Jason in the amount of $400.00, taken from the annuity purchased with RRSP proceeds to age 18	$12,400.00
Sept. 9, 2011	5% distribution of inheritance at age 18	$7,975.47
July 2, 2014	10% distribution of inheritance at age 21	$19,024.74
Mar 30, 2015	Payment of 2014 income allocation	$6,573.95

Mar 24, 2016	Payment of 2015 income allocation	$10,772.76
	Total distributions to Jason to June 2016	**$60,696.92**
	Value of Mutual Fund on date of transfer to Jason	$163,800.98
Total value of assets transferred to Jason over the course of the Trust:		$224,496.92

Even after the 5% and 10% encroachments on the mutual fund at ages 18 and 21 and income payments to Jason after he attained age 21, the fund had a value of $163,800.98 at the time of the final distribution in June 2016, when Jason attained the age of 23 years. Jason elected to have us transfer the ownership of the mutual fund to him, which as his father wished, provided him with a leg up in life.

Because of the investments of Jason's trust over the course of 10 years, we transferred to him a total of $224,496.92 a significant amount considering the total value of his half of the estate was less than $200,000. And that was after payment of professional fees and trust expenses.

Conclusion

This article is not intended to be investment advice to trustees. Rather, it is intended to urge trustees to obtain expert legal and investment advice, and to follow that advice in the administration of the trust. Your experience as a trustee may well be very different than ours. In summary, I hope you will find the following steps useful:

- Seek legal advice if necessary concerning the proper interpretation of the trusts in the will and how the interpretation impacts on the factors in the *Trustee Act*.

- Choose a competent investment advisor. If you do not have an advisor who is qualified to advise you in this area, interview a number of advisors. Review their qualifications and the support that their companies can provide. Allow them to review the trust and the needs of the beneficiaries. Get them to explain how they will develop an investment plan for the trust. Choose an advisor that you are confident will provide you with competent advice on an ongoing basis.

- Develop an investment plan with your investment advisor having regard to the criteria listed above from section 3(5) of the *Trustee Act*. These criteria must be consistent with the terms and relevant to the circumstances of the trust. For example, if there is a likelihood that you will need to disburse funds to beneficiaries at unpredictable times, this could demand a greater emphasis on liquidity within the portfolio than would be warranted if the income demands were more predictable. A well-qualified investment advisor may be able to suggest other criteria that will be relevant to the trust.

- Have your advisor outline the investment plan in writing. This should include a written investment policy statement which should be reviewed regularly with you. As the plan changes, have your advisor record the changes to the plan in writing.

- It would be prudent to take notes on the development of the investment plan and be prepared to justify decisions. Use of a trustee's diary could prove useful if decisions are later challenged by the beneficiaries. The consideration of each of the criteria in section 3 of the *Trustee Act* should be documented showing whether the factor was relevant to the circumstances of the trust and how each factor effected the investment plan.

- All investments or investment accounts must be registered in your name as trustee. You must keep the assets segregated from any of your personal investments.

- Monitor the performance of your advisor on a regular basis. Volatile times require more frequent reviews. Again, the review should be documented.

- Regularly review your administration of the trust with your lawyer and consult your lawyer if ever in doubt. The legal fees are payable from the funds in the trust. In some cases, it might be necessary to seek the advice and direction of the court.

I still miss my friend Dave and I am sad he missed seeing his son grow up. But I know he would be proud of how his son turned out. I hope the legacy he left his son will help ease the pain of losing his dad, and I am grateful for the opportunity to have been one of the keepers of his legacy.

Appendix A

Technical Note on taxation of the trust: Section 104(18) Trust

Jason's trust qualified as a section 104(18) trust under the *Income Tax Act*. The trust was for the benefit of Jason alone during the term of the trust, and we had the discretion to pay the income or capital for his maintenance, education, benefit or advancement. The only vesting condition was that if Jason died before age 23, all the remaining capital and accumulated income would be paid to his older brother pursuant to the terms of the will. Therefore, under section 104(18), until Jason attained the age of 21 years, any accumulating income would be taxed in Jason's hands. Also, under section 104(13) any income that was paid or payable to Jason would be taxed in Jason's hands.

At the time of Dave's death, the first $40,000 or so of income retained in a testamentary trust was taxed in the trust at the rate of 25% (combined Alberta and federal tax rates). By using section 104(18), we could accumulate the income in the trust, but have the income taxed in Jason's hands. Since his income at the time was under the basic personal exemption under the *Income Tax Act* (approximately $11,000), he would not pay any tax on the accumulating income. We therefore allocated the trust's income to Jason on the trust's annual T3 returns and issued a T3 slip to him so that his mother could report the income on Jason's personal income tax return. We continued this practice until the year Jason turned 21.

After a beneficiary attains the age of 21, section 104(18) no longer applies to the trust and any income retained in the trust is taxed in the trust at the trust's rates of tax. This might not have been a problem when trusts were taxed at graduated rates of tax, but the lowest tax rate in a trust at the time was 25%, which was higher than Jason's effective tax rate as a student. Further, effective January 1, 2016, the *Income Tax Act* changed to provide that all income retained in a testamentary trust is taxed at the highest marginal rate of tax, which in Alberta was 48% in 2016. We therefore had to ensure that all the income and capital gains of the trust were paid or payable to Jason if we wanted to use his lower graduated rates of tax. We therefore took the following steps:

- We estimated the amount of income and capital gains accumulating in the trust by the end of the year;
- Prior to the end of the year, we, as trustees, resolved in writing to make all the income and capital gains of the trust paid or payable to Jason;[4]
- In the new year, once the financial institution issued the tax slips, we discovered the exact amount of the income and capital gains earned in the year, and we allocated it to Jason. In order to comply with the *Income Tax Act*, which requires that the income be "paid or payable"[5] to him, we had two choices:
    - We could actually pay the money to Jason; or

[4] A distinction is made between income and capital gains because in trust law, 'income' includes interest, dividends, rent, etc., but capital gains are part of the capital. Therefore, a trust which only allows payment of "income" to a minor, will result in the capital gains being taxed in the trust. Where there is a power to pay income and capital gains to the beneficiary, it may be prudent to specify that the capital gains will also be paid to the beneficiary, in order to take advantage of the beneficiary's lower tax rates.
[5] Section 104(13) ITA

- We could sign a promissory note payable to Jason, on the terms that Jason could demand the money at any time.

In consultation with Jason and his mother, we decided to pay the money to Jason, so he could apply it to his college education costs. By this time, Jason was an adult and could have made his own choices, but with Jason's acknowledgement, we continued to include his mother in the consultations.

Appendix B

Technical note: Registered Retirement Savings Plan; Rollover to a Minor

Dave designated his estate as the beneficiary of his Registered Retirement Savings Plan (RRSP). At the date of his death, Dave's RRSP had a value of about $52,000. Since Dave was divorced, there was no rollover to a spouse, and therefore his RRSP was fully taxable as income on his terminal tax return.

However, under the *Income Tax Act*, there is a limited rollover of an RRSP to a minor child who is financially dependent on his parent at the date of the parent's death. We could therefore make a joint election with Jason to allocate the RRSP to him as part of his share of the estate. This would have resulted in the income being taxed in Jason's hands as a refund of premiums, but we could defer the payment of income tax by purchasing a term certain annuity to age 18. This allowed us to purchase the annuity as an investment of the trust, and the annuity payments then became taxable as income in the trust from age 13 to 18, thus spreading the tax burden over five years. By allocating all this income to Jason, it became taxable in Jason's hands, and no tax was paid because it all fit within Jason's basic personal exemption (approximately $11,000 per year at the time).

Appendix C

Alberta Trustee Act, Prudent Investor Rules

Investments

Application

2(1) Sections 3 to 8 are subject to a contrary intention expressed in the instrument creating a trust.

(2) Sections 3 to 8 apply to a trust regardless of whether the trust was created before or after this section came into force.

Powers and duties with respect to investment

3(1) A trustee may invest trust funds in any kind of property if the investment is made in accordance with this section.

(2) A trustee must invest trust funds with a view to obtaining a reasonable return while avoiding undue risk, having regard to the circumstances of the trust.

(3) A trustee must review the trust investments at reasonable intervals for the purpose of determining that the investments continue to be appropriate to the circumstances of the trust.

(4) A trustee who has invested trust funds in property may exercise for the benefit of the trust any right or power that a person who was both the legal and beneficial owner of the trust's interest in the property could exercise.

(5) Without restricting the matters that a trustee may consider, in planning the investment of trust funds a trustee must consider the following matters, insofar as they are relevant to the circumstances of the trust:

(a) the purposes and probable duration of the trust, the total value of the trust's assets and the needs and circumstances of the beneficiaries;

(b) the duty to act impartially towards beneficiaries and between different classes of beneficiaries;

(c) the special relationship or value of an asset to the purpose of the trust or to one or more of the beneficiaries;

(d) the need to maintain the real value of the capital or income of the trust;

(e) the need to maintain a balance that is appropriate to the circumstances of the trust between

(i) risk,

(ii) expected total return from income and the appreciation of capital,

(iii) liquidity, and

(iv) regularity of income;

(f) the importance of diversifying the investments to an extent that is appropriate to the circumstances of the trust;

(g) the role of different investments or courses of action in the trust portfolio;

(h) the costs, such as commissions and fees, of investment decisions or strategies;

(i) the expected tax consequences of investment decisions or strategies.

Trustee liability

4(1) A trustee is not liable for a loss in connection with the investment of trust funds that arises from a decision or course of action that a trustee exercising reasonable skill and prudence and complying with section 3 could reasonably have made or adopted.

(2) A court assessing the damages payable by a trustee for a loss to the trust arising from the investment of trust funds may take into account the overall performance of the investments.

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Delegation of investment authority

5(1) In this section, "agent" includes a stockbroker, investment dealer, investment counsel and any other person to whom investment responsibility is delegated by a trustee.

(2) A trustee may delegate to an agent the degree of authority with respect to the investment of trust funds that a prudent investor might delegate in accordance with ordinary investment practice.

(3) A trustee who delegates authority under subsection (2) shall exercise prudence in

(a) selecting the agent,

(b) establishing the terms of the delegated authority, and

(c) monitoring the performance of the agent to ensure compliance with the terms of the delegation.

(4) A trustee who has delegated authority to an agent under subsection (2) and has complied with subsection (3) and the regulations is not liable for the decisions or actions of that agent.

(5) Where investment authority has been delegated to an agent by a trustee and the trust suffers a loss because of the agent's breach of the terms of the agency contract, damages for the loss may be recovered from the agent in an action

(a) by the trustee, or

(b) by a beneficiary of the trust if the trustee fails to commence an action within a reasonable time after acquiring knowledge of the breach.

Purchase of mutual fund units and delegation

6 Investment in a mutual fund or segregated fund or in a similar investment set out in the regulations is not a delegation of investment authority with respect to the investment of trust funds.

Recording of trust status

7(1) A trustee must ensure, so far as it is practicable to do so, that any record evidencing the trustee's ownership of securities also indicates the trust relationship.

(2) Subsection (1) does not apply when the trustee is a trust corporation or the Teachers' Pension Plans Board of Trustees.