

Family Trusts - an Effective Tax Strategy

The last Finer Focus article discussed income splitting with family members using prescribed rate interest loans. This issue continues the income splitting theme; we discuss how a business owner can use a family trust to split income with family members.

Quite often, when people hear “trusts”, they think of the Bronfmans or the Irvings; however, trusts can be used by small and medium-sized family businesses and result in significant tax savings. This article will discuss the following trust topics:

- the legal concepts;
- benefits;
- set-up costs and ongoing costs
- potential pitfalls on implementation;
- the use of a trust in a family business context;
- and a case study illustrating the tax savings opportunities.

What Is a Trust?

A trust is a legal relationship (not a legal entity) whereby one individual (the “settlor”) transfers property to another individual (the “trustee(s)”) who holds and manages property for the benefit of others (the “beneficiaries”) named by the settlor. For tax reasons, the settlor should generally not be a trustee or a beneficiary. The trustees are bound by the terms of a written agreement, called a trust indenture (the “agreement”) which is drafted with the help of a lawyer. In a family business context, a relative or close family friend typically settles a trust with a nominal amount of cash (\$20 bill) or a gold/silver coin for the benefit of the business owner, their spouse, and children. The trustees usually include the business owner, their spouse and another individual. Extreme caution must be used when creating a trust to ensure that it is set up properly to ensure that the attribution rules of the Income Tax Act do not apply.

There are two general categories of trusts, inter vivos and testamentary. Inter vivos trusts are established when a person is living and will be the focus of this article. Testamentary trusts are established on the death of an individual and will be discussed in future articles dealing with post-mortem tax planning.



The basic difference between the two types of trusts is how they are taxed. Testamentary trusts are taxed at the graduated tax rates applicable to individuals; whereas, inter vivos trusts are taxed at the highest marginal tax rate. However, the trustees may choose not to have the income taxed in the inter vivos trust and distribute the income to the beneficiaries and have it taxed in their hands.

The main focus of this article is the tax benefits of an inter vivos trust, but there are other non-tax benefits including creditor proofing, reducing probate fees, and providing financial security for beneficiaries with special needs (spendthrift, disabled, or minor children).

Transferring Ownership to a Trust

In a family business context, a trust commonly acquires shares of a family business in connection with a corporate reorganization. We often recommend that the principal business owner exchange common shares for fixed value, voting preferred shares. The voting characteristic allows the business owner to retain control of the business. This exchange is typically done on a tax-deferred basis using what’s called a “rollover.” The preferred shares will have a redemption value equal to the fair market value of the company at that point in time; hence the business owner has frozen the value of their interest in the company. These preferred shares may be redeemed in the future to provide additional income for the business owner. After the estate freeze, the trust may subscribe for common shares of the corporation for nominal consideration as there is no value to the company over and above the value of the preferred shares. Future growth of the company will accrue to the trust since it owns the common shares. If a person is contemplating starting a new business, the estate

freeze is not necessary and the trust can simply subscribe for the common shares.

After the estate freeze, the company can pay dividends to the family trust. Since inter vivos trusts are taxed at the highest individual tax rate, the trustees typically distribute the income to the beneficiaries who in turn have access to graduated tax rates. This strategy is known as “dividend sprinkling.” If a beneficiary has no other source of income, they can receive up to \$37,500 of non-eligible dividends and not pay any tax.

Family trusts are normally “discretionary” trusts, meaning the trustees have absolute discretion as to which beneficiaries receive distributions and how much they receive. Factors to consider for distributing income to beneficiaries may include age, income level (other sources of income), involvement in family business, and other personal reasons (relationship between parent-child). Minor children should generally not be allocated income from a family trust (see discussion of “kiddie tax” below). Family trusts can be an effective vehicle to fund post-secondary education for non-minor (18+) children of business owners. Students typically have low income levels and can receive significant dividends and pay little or no tax. In addition to children, it is common for business owners to have spouses who are not involved in the operations, are not shareholders, and have little or no significant income. In this regard, income can be allocated to them from the trust to take advantage of their graduated tax rates.

Besides the income splitting advantages of a family trust, there is the ability to multiply the \$750,000 life-time capital gains deduction available to owners of Qualified Small Business Corporation (QSBC) shares. After the estate freeze, if the value of the family business increases and the common shares are sold by the family trust, the capital gain may qualify for the capital gains deduction. The trust can elect to have the gain taxed in the hands of the beneficiaries and each beneficiary may access their own \$750,000 capital gains deduction. It is important to note that unlike dividends from a family business corporation, capital gains may be allocated to minor children and not be subject to the kiddie tax. However, if a capital gain is allocated to a beneficiary, half the amount (taxable portion) must be paid or payable to the beneficiary (i.e. the money legally belongs to the beneficiary).

Another advantage of the family trust is the ability to pass on the family business to the next generation in a seamless fashion. Provided that the next generation are beneficiaries of the trust and the trust is the common shareholder of the family business, when the business owner passes away, the ownership structure does not dramatically change. If the business owner still owns the preferred shares at the time of death, there will likely be taxes owing on the deemed disposition at death, unless they are transferred to his or her spouse. There will be no tax with respect to the common shares because these shares are owned by the trust.

A family trust does not allow for indefinite deferral of tax on the assets owned by the trust. Every 21 years, the trust is deemed to dispose of assets at fair market value. Any accrued gains on assets, including family business shares owned by the trust, are taxed in that year. The trust may avoid this taxable event if elects to distribute the assets to the capital beneficiaries on a tax-deferred basis.

Costs Relating to a Trust

A family trust has many benefits, both tax and non-tax, however the related costs of establishing and maintaining a trust should be considered. Adding a trust to the corporate structure does add a level of complexity to corporate group. Additional legal and accounting advice is required, especially in the planning phase. Initial legal and accounting fees to establish a trust are likely in the range of \$2,000 to \$5,000, depending on the complexity of the situation. Similar to a corporation, annual resolutions need to be completed on a regular basis and an income tax return must be filed. Inter vivos trusts are required to have a December 31st year-end. Annual compliance costs associated with a trust should be in the range of \$500 to \$2,000.

Potential Pitfalls

A family trust must be properly implemented from inception. The attribution rules of the Income Tax Act need to be carefully addressed with respect to choosing a settlor, trustees and beneficiaries and on the transferring of property (shares) to the trust. If the attribution rules apply (due to an improperly drafted trust indenture), all of the income splitting benefits of the trust will be negated and all income distributed to the beneficiaries will revert back to the transferor (family business owner). As well, once a trust is “off-side” with respect to the attribution rules, it may be difficult to rectify the problem without dismantling the trust. We often encounter trust agreements that have not properly addressed attribution issues. Besides the various attribution rules in the Income Tax Act, there are additional provisions which attempt to discourage income splitting with minors. Specifically, the “kiddie tax” taxes dividends received by a minor from a family business (owned directly or through a trust) at the highest marginal tax rate, rendering dividend sprinkling ineffective for minor children. The kiddie tax does not apply to capital gains.

Family trusts provide many benefits for a small to medium sized business owner including the flexibility of passing on the business to the next generation, income splitting through dividend sprinkling, and multiplying the capital gains deduction. Be sure to set it up properly by using the assistance of a trusted advisor. The case study below illustrates how the use of a trust can be beneficial for a family business owner.

Case Study

Bob Volt is the sole shareholder of Bob's Electric Inc. ("BEI"), a successful operating company that he started 10 years ago. The company is currently worth \$2M and Bob expects the company to continue to grow in the next 10 years. Bob has a wife, Val, and 3 children, Jake and John who are currently attending university, and Sally who is 10 years old. Bob's older children are interested in being a part of the family business. Bob receives an annual salary of \$125,000 to maximize his RRSP contribution room from BEI; his spouse Val does not work for the company and she has no other sources of income. BEI has taxable income \$250,000 and Bob has been paying himself annual dividends of approximately \$200,000. Bob has been advised by Welch LLP that a family trust should own the common shares of BEI. After consulting with his family and his lawyer, Bob agreed to the plan.

Bob's father, Burt, will settle The Bob Volt Family Trust for the benefit of Bob, Val, and Bob's children. Bob, Val, and Bob's younger brother Pete will be the trustees. Welch LLP will work closely with a lawyer who specializes in trust law to ensure that the trust meets Bob's needs and is tax effective.

Bob will exchange his common shares of BEI for fixed-value, voting shares which have a redemption value of \$2M on a tax-deferred basis. Bob will essentially limit the value of his BEI shares owned directly. By virtue of owning fixed value shares, Bob's terminal tax liability in respect of his BEI shares will not increase in the future. The Trust will subscribe for common shares for a nominal amount (\$1).

In the following year, Bob pays himself \$125,000 in salary and BEI earns \$250,000. BEI pays \$200,000 of dividends to the Trust. As the trust is fully discretionary, the trustees have the ability to allocate any amount of income to the various beneficiaries. In the current year, Bob (and the other trustees) choose to allocate \$25,000 to each of his non-minor children (Jake and John). Given they have limited income because they are in university; they should pay little or no tax on the dividends. Bob would have used after tax dollars on funding their education; instead he is using corporate funds which are subject to the low small business rate (16.5%). Val is allocated \$75,000 of dividends and only pays \$8,000 in tax because she has no other source of income, the graduated tax rates, and the favourable tax treatment of dividends. The remaining \$75,000 of dividends is allocated to Bob and will be taxed at a rate of 31% which is the marginal tax rate for dividends. If Bob had paid the full \$200,000 of dividends to himself directly, he would have paid approximately \$63,000 of tax. By using the dividend sprinkling technique, the total tax paid on the same \$200,000 of dividends was only \$33,000, tax savings of \$30,000. The same strategy may be used in subsequent years to produce similar tax savings.

When Bob's children have graduated, he may choose

not to allocate any income to them. Or perhaps they do become actively involved in the business and he allocates more income to them. Because the Trust is discretionary, the trustees have great flexibility.

In the future, if the business continues to grow and the value of the company appreciates, Bob's family can multiply access to the capital gains deduction. For instance, if the company was sold for \$5M, the value of the common shares would be worth \$3M (\$5M proceeds, less \$2M preferred shares owned by Bob). Since the cost of the trusts common shares is nominal, the Trust would have a capital gain of \$3M. Bob could choose to allocate \$750,000 of the gain to each beneficiary (spouse and 3 children) which could potentially result in little or no tax owing assuming the shares were qualified small business corporation shares. Bob may not want to allocate any of the gain on the common shares to himself personally because he may choose to use his \$750,000 capital gains deduction on the sale of his preferred shares.

This case study illustrates how a discretionary family trust can be a very effective way to own a family business. Please consult your Welch advisor to explore the option of using a family trust to own your business.

For more information about family trusts contact a professional at Welch LLP or visit us at: www.welchllp.com

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