# 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 of trust planning, they think of the uber wealthy or offshore type planning. However, trusts are and effective and common tax planning vehicle for Canadian business owners. Based on proper planning, trusts may lead to ongoing and meaningful 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") who holds and manages property for the benefit of specific individuals (the "beneficiaries") named by the settlor. A trust may have one or more trustees, it is most common for a trust to have one or three trustees – when there are three trustees, decisions are made by a majority of the trustees. Some trusts will have a corporate trustee, i.e. an entity that is in the business of providing trust services. However, most trusts do not require or benefit from a corporate trustee.

To avoid adverse tax consequences, the settlor should generally not be a trustee or a beneficiary of the trust. 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 value property – a $20 bill, a silver coin or some other limited value property. The trust property is held by the trustee for the benefit of the beneficiaries of the trust which may include a business owner, their spouse, and children. The trustees may 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 estate 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 usually choose not to tax income income in the trust, instead the income is flowed through the trust and taxed in the hands of one or more beneficiaries.

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 is 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. The 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 common shares when the corporation is formed.

After the 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 $40,000 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, other sources of income, involvement in family business, and other personal reasons. Minor children should generally not be allocated income from a family trust (see discussion of "kiddie tax" below). However, trusts can be an effective vehicle to fund post-secondary education for non-minor 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 business, are not shareholders, and have minimal income. Income can be allocated to the spouse via the trust to engage in family income splitting.

Besides the income splitting advantages of a family trust, there is the ability to multiply access to the $800,000 lifetime capital gains exemption with respect to Qualified Small Business Corporation (QSBC) shares. After the estate freeze, if the value of the business increases and the common shares are sold by the family trust, the capital gain may qualify for the capital gains exemption. The trust can distribute the gain to one or more beneficiaries to be taxed in their hands – this provides an opportunity for a beneficiary to use his or her $800,000 lifetime capital gains exemption. 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 then the beneficiary must receive the underlying funds that represent the income allocated.

Another advantage of the family trust is the ability to pass on the family business to the next generation without personal tax. 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. The common shares owned by the trust may be distributed to one or more beneficiaries and this will generally occur without tax.

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 provides both tax and non-tax related benefits, however the costs of establishing and maintaining a trust should be considered. Adding a trust to the corporate structure does not significantly complicate the corporate structure. However, specific tax and legal assistance is required in the implementation phase. A general estimate of the professional fees to establish a trust is a range of $3,000 to $5,000. The fees will largely depend on the complexity of the planning and related issues. Similar to a corporation, annual resolutions are required to formalize trust decisions and an income tax return must be filed annually. Annual compliance costs associated with a trust should be in the range of $500 to $2,000. Again, the fee will be a function of the underlying activity and complexity of the trust.

## 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 acquisition of property by the trust. If the attribution rules apply, due to an improperly drafted trust indenture, then the income splitting benefits of the trust will be negated and all income distributed to the beneficiaries will revert back to the transferor. Further, 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 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 opportunity of passing on the business to the next generation, income splitting through dividend sprinkling, and multiplying access to the capital gains exemption. The trust needs to be properly structured based on input from qualified tax and legal professionals. The case study below provides a practical illustration of trust planning for a 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 $2 MM and Bob expects the company to continue to grow in value. 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 – this allows him access RRSP contribution room; his spouse Val does not have income. BEI has annual income of $250,000 and Bob has received dividends annually of $200,000. Welch LLP has advised Bob that a family trust could be an excellent long-term tax planning vehicle. Following is a general outline of the planning:

- Bob's father, Burt, will settle The Bob Volt Family Trust. Bob, Val, and Bob's younger brother Pete will be the trustees of the trust; the beneficiaries will include Bob, Val, and their three children.

- Bob will exchange his common shares of BEI for voting fixed-value preference shares worth $2 MM – based on proper implementation the share exchange occurs on a tax-deferred basis. The plan has the effect of limiting the future appreciation of Bob's shares, i.e. the preference continue to be worth $2 MM notwithstanding future appreciation in value of BEI. Additional BEI accrues to the common shares which are owned by the family trust. 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 subscribes for the BEI common shares for $100. It is important that the trust borrows the $100 funds from a person not connected to the trust to avoid potential attribution issues. A promissory note issued by the trust would formalize the borrowing, the trust can eventually repay the loan when it receives a dividend from BEI.

- Bob continues to receive remuneration from BEI, however the $200,000 of annual dividends are now paid to the trust. As the trust is fully discretionary, the trustees have the ability to allocate any amount of income to the various beneficiaries. The following dividend allocation plan is adopted:

o $40,000 is allocated to each of the two non-minor children (Jake and John). With limited income because they are in university they will pay little or no tax on the dividends. In the absence of the allocation of trust income to the kids, Bob would have used personal after-tax dollars to assist with post-secondary costs. The trust framework provides a mechanism to legitimately use funds that have only be subject to corporate tax for this purpose.

o Val is allocated $120,000 of dividend income from the trust and pays approximately $20,000 of tax on the income. The low amount of tax arises because Val works through the graduated tax brackets and benefits from the dividend tax credit that reduces tax payable on dividend income.

o The distribution plan leads to cumulative tax of $20,000 on the $200,000 of dividend income. Based on the old framework, Bob would pay approximately $65,000 of tax on $200,000 of dividend income.

o Our planning, based on the fact pattern and assumptions, leads to $45,000 of tax savings. This level of savings could apply for many years.

o The family trust is discretionary such that the trustees have the discretion to determine the amount of income allocated to the various beneficiaries annually. It will generally not be beneficial for the trust to allocate income to a child under 18 because of the kiddie tax.

In the future, if the business continues to grow and the value of the company appreciates, Bob's family can multiply access to the $800,000 lifetime capital gains exemption in the event of a sale. For instance, if the company was sold for $5 MM, the value of the common shares would be worth $3 MM – $5 MM of proceeds less the $2 MM attributable to Bob's preference shares. Provided that BEI meets the capital gains exemption criteria, then the gain could be allocated equally to Val and the three kids - $750,000 per beneficiary and they could each fully shelter the gain with their lifetime capital gains exemption. In the absence of the planning the additional $3 MM of gain would be taxable to Bob and would lead to approximately $740,000 of tax.

This case study illustrates how a discretionary family trust can be a very effective tax planning vehicle for business owners. Please consult your Welch advisor to review of the merits of family trust planning in your specific situation.

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

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