MONTHLY NEWSLETTER

Understanding Family Trusts

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SEPTEMBER 2016

Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

There are a number of different types of trusts, each with their own advantages and disadvantages as well as their own unique income tax attributes. People are generally not aware of family trusts or assume that they are something only the wealthiest 1% use. However, this is a misconception as family trusts are an important planning tool in many private corporation settings. This newsletter will focus on family trusts and some of the tax planning reasons they are used.

What is a Trust?

A trust is a legal relationship between three different parties. Trusts are not created pursuant to specific business protocols in the same way corporations are created. Rather, it is the relationship or arrangement that establishes the trust.

First, the person who sets up the trust and contributes property to it is known as the settlor. The settlor also sets out instructions on how the assets are to be used or managed and who will benefit from the assets. These instructions are known as the “trust arrangement” or “trust deed”, while the assets that are contributed are known as the “settlement property”. The assets that are contributed can vary. Often a $5 or $10 bill will constitute the settlement property as they are easily distinguishable due to their unique serial codes. Settlement property can really be anything. The key concept is that the settlor must contribute something upon which the trust relationship is established.

The person or group of people that the settlor appoints to control and manage the assets of the trust is known as the trustee(s). The powers of the trustees are specifically documented in the trust deed based on the wishes of the settlor. In order to allow maximum flexibility in future income tax planning, the trustees are most often empowered to distribute income and capital of the trust at their discretion.

Finally, the person or group of persons who will benefit from the assets contributed by the settlor are known as the beneficiaries. The trust deed can either specifically name the beneficiaries or state that they will come from a defined group. For example, future children or grandchildren would permit unborn family members at the time of settlement of the trust to benefit from the trust assets. It is important to note that it is very difficult to add a beneficiary to the trust subsequent to the original drafting of the trust deed. It is often advisable to name more beneficiaries than less for this reason. There is no requirement to let the beneficiaries know that they are beneficiaries unless income or capital is distributed to them.

The settlor, trustee(s) and beneficiaries can be the same person or can all be different. To avoid a number of punitive income tax provisions, it is generally advisable that the settlor not be a trustee or beneficiary of the trust. The settlor is often a close family friend or family member who is not otherwise involved in the trust for this reason.

Taxation of Family Trusts

Trusts can be created on the death of a taxpayer pursuant to the deceased's will or during someone's lifetime with the contribution of settlement property as described above. Family trusts are generally created during the settlor's lifetime and are referred to as inter-vivos trusts. For income tax purposes, the trust relationship is viewed as a separate taxpayer. Consequently, the trust must file an income tax return to report its income earned during the year and pay the related income tax owing in much the same way as individual taxpayers do. However, inter-vivos family trusts are subject to the following special rules:

1) they are not allowed to claim personal tax credits in the same way individuals can;
2) generally income tax is payable at the top federal and provincial income tax rates for individuals. In other words, there are no graduated income tax rates available; and
3) provided that the income is distributed or payable by the trust by December 31 of a given taxation year, trust income can be allocated to the beneficiaries and taxed in their hands rather that at the trust level.

Benefits of Family Trusts

Generally, it is advisable to allocate all of the income of the trust to the beneficiaries to permit the individual beneficiaries to access their personal income tax credits and lower graduated income tax rates. Provided the trust deed permits the trustee(s) full discretion in allocating income, income can be allocated to select beneficiaries to the exclusion of other higher income beneficiaries to maximize the potential income tax savings.

For example, consider a small business owner with other low income family members who are not currently shareholders of the corporation. In the absence of any planning, any income earned by the corporation could only be distributed to the owner and would be taxable at their marginal income tax rate. By introducing a family trust as a shareholder of the corporation, income from the corporation could be distributed to the trust and then to the lower income family members. In this manner, after-tax cash retained at the personal level would be maximized for the family.

It is important to note that distributions of income to minor children are not advisable. The 1999 federal budget introduced a set of rules referred to as the kiddie tax rules which result in the child being taxed at the highest marginal federal and provincial income tax rates, thereby negating any potential benefit of income splitting. Income splitting works best with age of majority children in college or university with limited other income, or other low income family members.

Family trusts allow the trustee(s) to retain control over the settlement property. By acting as a trustee or appointing trusted friends or relatives as a trustee(s), settlors can ensure that the trust is managed in accordance with their wishes without relinquishing control of the trust assets to the beneficiaries of the trust. Where the trustee(s) has (have) discretion, the beneficiaries have no control over the income or capital that they will receive from the trust and there is no value attributable to their interest. If, for example, our small business owner introduces his trust as a shareholder of his corporation and his child is a beneficiary of the trust, the child's interest in the trust would be a nominal amount. This can be important if, for instance, the child undergoes a breakdown in their marriage. The trust owns the shares of the corporation, not the child. This would help minimize equalization payments required on cessation of the child's marriage, protecting the small business owner and his family.

Another significant advantage offered by family trusts is the ability to multiply access to the capital gains exemption. Shares of private corporations that meet certain conditions with respect to the percentage of their assets that are used in an active business can qualify for a capital gains exemption. The capital gains exemption reduces the capital gain which is otherwise included in the vendor's income on a sale of the shares of the corporation. Each individual shareholder is entitled to a lifetime cumulative capital gains exemption of $824,176 as of 2016. The exemption is indexed to inflation and will increase in the future. The income tax savings offered by each capital gains exemption is approximately $215,000 assuming the capital gain would otherwise be subject to the highest personal tax rate of 53.5% in 2016 for a resident of Ontario.

Let's consider our small business owner again. If the shares of the corporation were sold, and the necessary criteria were met, the business owner would be able to shelter up to $824,176 of the resultant gain from income tax using the capital gains exemption. With the introduction of the trust as a shareholder of the corporation, access could be obtained to each beneficiary's capital gains exemption. In effect, each additional beneficiary would permit an additional $824,176 of gain to be sheltered. On a large dollar sale, the tax savings can be extraordinary.

A final benefit of family trusts is that they can be used in a common planning technique known as an "estate freeze." When a taxpayer passes away in the absence of a surviving spouse, they are generally required to report a deemed disposition of their assets for income tax purposes on their final tax return. This disposition occurs at fair market value and includes the value of private company shares. As the value of the private corporation increases, so too does the ultimate tax liability on the taxpayer's passing.

For estate planning reasons, having greater certainty as to what the terminal income tax liability will be is helpful to provide peace of mind in terms of insurance coverage and liquidity to fund the payment of the terminal income tax liability. In an estate freeze, growth shares of a taxpayer are exchanged for fixed value preferred shares on a tax deferred basis. The redemption value of the new preferred shares would be equal to the fair market value of the growth shares, thereby locking in the current value of the company in the preferred shares. A trust could then subscribe for new growth shares such that any future growth in the fair market value of the corporation would be realized by the trust rather than the taxpayer. In other words, the value of the taxpayer's shares (and related terminal tax liability) is frozen. Trusts allow the taxpayer to retain control over the corporation and future distributions of income and capital while also capping their terminal tax liability.

Conclusion

Family trusts offer a number of benefits which can work quite effectively in a number of private corporation settings. It is critical that the trust agreement be established properly to avoid a number of punitive income tax traps. If you think a family trust might be beneficial in your circumstances, please do not hesitate to contact our office.