TAX PLANNING CONSIDERATIONS RELATED TO FAMILY TRUSTS

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The past few years have seen a number of significant income tax changes for small businesses and their owners. Taxpayers who own corporations should review their ownership structures to ensure that previous tax planning still makes sense in light of all of these significant changes. The remainder of this newsletter will focus on family trusts and the key considerations in deciding whether they should continue to own shares of a given corporation or be wound up. If we have not recently discussed your family trust with you and reviewed its merits, we would be pleased to do so upon receiving your direction to proceed.

Tax Planning Considerations Related to Family Trusts

Historically, it was generally advisable to allocate all of the income of family trusts to the trust's beneficiaries. This permitted the individual beneficiaries to access their personal income tax credits and lower graduated income tax rates. It was common for trust deeds to be worded to permit the trustee(s) full discretion in allocating income to select beneficiaries, to the exclusion of other higher income beneficiaries, to maximize the potential income tax savings. In this manner, family trusts allowed small business owners who might otherwise be subject to high rates of income tax to effectively split their income with their family members and to maximize their after-tax cash retained by the family.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter 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 and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

Income tax provisions were amended effective January 1, 2018 to eliminate the benefits offered by income splitting by taxing dividends paid to family members at the highest marginal tax rate unless specific exceptions are met. This special tax is referred to as the Tax on Split Income (TOSI). One exception to the application of TOSI is if the shares on which the dividends are paid meet the "excluded share" definition. The excluded share definition contains

a number of very specific conditions, namely that the recipient must own 10% or more of the shares of the corporation in terms of both votes and value. Shares of a corporation that are owned indirectly by a beneficiary of a family trust do not qualify for the purpose of this exception, meaning that it is not possible for shares held by a family trust to meet the excluded share definition.

If none of the other exceptions to TOSI can be met, it may be advantageous to distribute shares held by a family trust to the beneficiaries such that they own 10% or more of the shares to allow for income splitting to continue without the application of TOSI. Such a distribution can occur on a tax deferred basis. Taxpayers seeking to rely on the excluded share definition for the 2018 taxation year will have until the end of 2018 to meet all of the conditions, regardless of when dividends are paid during the year.

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 $848,252 as of 2018. The exemption is indexed to inflation and will increase in the future. The income tax savings offered by each capital gains exemption is approximately $220,000, assuming the capital gain would otherwise be subject to the highest personal tax rate of 53.53% for a resident of Ontario.

If a taxpayer sold the shares of their corporation, and the necessary criteria were met, the taxpayer would be able to shelter up to $848,252 of the resultant gain from income tax using the capital gains exemption. With the introduction of a family 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 $848,252 of gain to be sheltered. On a large dollar sale, the tax savings can be extraordinary.

The recent tax changes have not altered the ability to multiply access to the capital gains exemption in this manner. This remains a significant advantage of family

trusts where it is likely that shares of a corporation will be sold in the future and the sale proceeds are expected to be significant.

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 at the time of the exchange, 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.

Another consideration is that family trusts are a distinct entity for income tax purposes and they are required to file an income tax return each year. The Canada Revenue Agency (CRA) has had a long standing administrative policy that so long as the trust's total income is less then $500 in a given year and certain other conditions are met, the trust is not required to file a return.

Despite this policy, in recent years the CRA has begun querying taxpayers as to why a trust return has not been filed in these cases. These queries result in back and forth with the CRA to explain the situation and confirm that a return was not required.

Further, the 2018 federal budget proposed to require reporting for family trusts to provide additional information on an annual basis, including the identities of all trustees, beneficiaries, and settlor of the trust. The proposed new reporting requirements will apply to returns required to be filed for the 2021 and subsequent taxation years. Penalties will apply for non-compliance.

As a result of the CRA's increased review in cases where trust tax returns are not filed and the proposed detailed reporting requirements that are set to take effect in 2021, we now recommend that a trust return be filed every year regardless of what the trust's income is in a given year. This reporting represents a small additional cost to family trusts that might not have had to file in the past. Nonetheless, the annual cost and reporting requirements should be considered when evaluating the merits of retaining a family trust going forward.

Conclusion

We recommend that all taxpayers who own the shares of a private corporation through a family trust review their structure, if they have not already done so, to determine whether to leave the trust in place or to wind the trust up. There are a number of important considerations as outlined above and the recommendation in each case will vary depending on the circumstances. If you would like us to review your situation, please do not hesitate to contact our office.

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