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THE USE OF FAMILY TRUSTS

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This article provides an overview of various planning matters related to the use of a family trust in the ownership of a business. Some popular benefits of a family trust include:

- control without ownership
- creditor-proofing
- annual reduction in total income taxes
- multiple use of the capital gains exemption to reduce income taxes
- delay of taxation on death

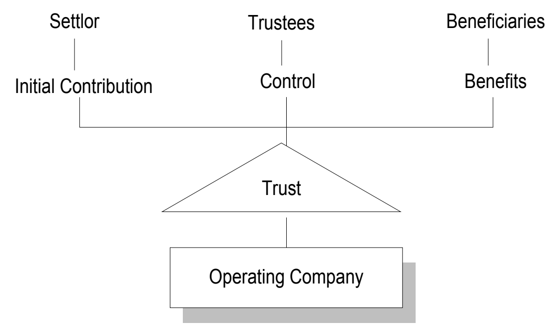
Nature of a Trust

A trust is a relationship between trustees and beneficiaries in respect of specific property. *The Income Tax Act* treats a trust as a separate legal entity for tax purposes.

A trust is established when a person (the settlor) transfers property to the control of trustees to hold for the benefit of one or more beneficiaries. The trustees are responsible for the custodianship of the trust property and have an ongoing obligation to administer the trust in accordance with the terms of the trust. The beneficiaries of a trust are the people who will eventually receive the income and capital of the trust. The trustees must act in the best interest of the beneficiaries, whose rights are defined by the terms of the trust.

Basic Structure

The basic ownership structure of a family trust that owns a business would be as follows:



The settlor would settle the trust, usually for a nominal amount of $10 or an item such as a gold coin. Once the settlor has settled the trust, he/she should have no further involvement with the trust. The settlor could be anyone, and should not be a beneficiary of the trust.

Generally, three to five trustees would act as a group to control the trust, which is usually based on the majority vote of the trustees. Most often, the trustees are family members who are familiar either with the business or with the family members involved in the business. A family lawyer or advisor could also be a trustee.

The trust agreement should name as beneficiaries all persons who should potentially benefit from the assets of the trust. Generally stated, there is no downside for including more beneficiaries as opposed to fewer beneficiaries because of the discretionary ability of the trustees to exclude specific beneficiaries in the future. Usually, the potential beneficiaries are specifically identified; however, they could also include future children or grandchildren.

Corporations as Beneficiaries

A corporation can also be included as a beneficiary of a trust. Any profits of an operating company can be paid to the family trust and then out to the corporate beneficiary. This has several advantages:

- It allows the operating company to eliminate its excess cash to enable it to qualify for the $750,000 capital gains exemption in the event of the sale of the operating company.
- It provides a structure to defer taxes on dividends not required by individual shareholders. Normally, no tax is payable on the dividend payable to the corporate beneficiary.
- It provides additional creditor proofing by limiting excess cash in the operating company exposed to business activities.

Discretionary Trust

A discretionary trust exists when the settlor gives discretionary decision-making rights to the trustees, rather than defining in the trust agreement all of the specific rules related to the operation of the trust. This discretionary power enables the trustees to make decisions related to the allocation of future income and/ or capital to the beneficiaries.

Mechanics of Setup

As mentioned earlier, a settlor is required to start the trust, typically by gifting an asset such as a gold coin or $10 to the trust. This gift amount is segregated from all other assets of the trust and is never used to purchase investments or property.

To provide the cash necessary to buy the shares of the company, the trust would normally borrow the monies from either a bank or other party, with interest paid on the loan amount.

It is important to properly structure the initial settlement, the initial money lent to the trust, and the initial purchase of the company shares. The Canada Revenue Agency (CRA) expects any transfer of value from existing shareholders to family members to be done at fair market value. In addition, the *Income Tax Act* contains an extremely complex set of rules whereby income earned from property may be attributed to and taxed in someone else's hands.

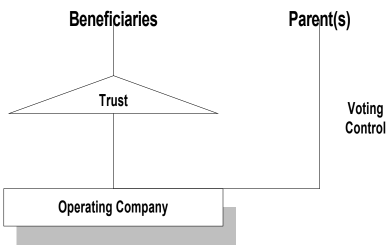
Potential Benefits Available

The benefits achieved by using a family trust include:

a) Control Without Ownership

In a typical family situation, the parent(s) may wish to control the ownership of the operating company, but want the future benefits to go to all family members. This could be accomplished by structuring the ownership, whereby the parent(s) would control the voting shares of the operating company and the value shares would be owned by the trust.

The structure would look as follows:



In such a situation, the parent(s) could control all decision-making by owning the voting shares. In addition, a parent may be one of the trustees and participate in the decision-making on the eventual distribution of the income and capital of the trust to the beneficiaries. A parent may also be a beneficiary of the trust.

b) *Creditor Proofing*

Litigation against individuals is coming from many sources, both new and old, including personal guarantees of debts and family law litigation from former spouses. A discretionary family trust can provide some protection to its beneficiaries. In a discretionary trust, the beneficiaries can be considered to have no direct benefit of ownership of the trust assets (i.e. the discretionary aspect of the trust has not been exercised). Therefore, the discretionary interest has no value for creditors to attack. In a worst-case scenario, the beneficiary could declare bankruptcy, while maintaining a discretionary interest in the ownership and value of the assets of the trust.

c) *Annual Reduction in Income Taxes*

A major element of tax minimization for a family is to try to allocate income to family members in a lower marginal tax bracket than the higher income earners. In many family situations, spouses and children who are not active in the day-to-day business are not eligible to receive employment income from the company. Their ownership of the shares of the company through the trust allows these individuals to receive dividends to utilize their lower rates of tax and personal credits, including the dividend tax credit.

For example, if a company had $40,000 of income before tax, there are several alternatives:

- The company could pay a salary of $40,000 to family members involved in the business. There would be no corporate taxes payable. The total Canada Pension Plan (CPP) premiums for the employee and the employer would be approximately $4,000 (approximately $3,000 after tax credits). Other payroll costs may also apply. The total amount payable would be:

	Salary no other sources of income	**Salary top tax bracket**
Tax on salary	$ 7,500	$ 18,500
CPP premiums	3,000	3,000
Total	$ 10,500	$ 21,500

- The company could pay corporate tax of approximately 15% ($6,000). The remaining $34,000 could then be paid as a dividend to the trust. The total amount payable would be:

	Dividend no other sources of income	**Dividend top tax bracket**
Corporate tax	$ 6,000	$ 6,000
CPP premiums	- - -	- - -
Personal tax	- - -	11,000
Total	$ 6,000	$ 17,000

Based on the above figures, it appears that dividends would usually attract less tax. However, the figures above do not take into account the following:

- Salaries create RRSP room, whereas dividends do not.
- By making CPP contributions, it entitles the family member to receive CPP benefits upon retirement.
- The employee portion of CPP premiums may be refunded if the employee has paid CPP through another job.

d) *Delaying Taxation on Death*

When individuals die, they are deemed to have disposed of all of their assets at fair market value. Taxes may result from those dispositions. The assets may instead be transferred to a surviving spouse, thereby delaying the taxation until the death of that spouse.

When a family trust owns shares of an operating company, the death of an individual does not create a tax liability, because no individual has ownership of the assets. The individual that died has no value in the company's shares held through the trust, unless he/she is the last beneficiary of the trust.

e) *Multiple Utilization of the Capital Gains Exemption*

Under Canadian tax law, a $750,000 capital gains exemption is available to individuals who sell shares of a Canadian-controlled company that carries on a private active business. If one individual owns the shares, the maximum exemption is $750,000. If a trust owns the shares and there are numerous discretionary beneficiaries, the $750,000 can be multiplied by the number of discretionary beneficiaries by allocating and paying the gain on the sale to each of those beneficiaries. The potential tax savings to a family could be as high as $174,000 for each additional $750,000 of exemption generated.

Potential Issues with Trusts

a) *Kiddie Tax*

Effective January 1, 2000, children under 18 years of age are taxed at the highest tax rate on dividends received from a related company. This special tax is computed at the highest marginal tax rate on certain types of income, including:

- Taxable dividends received directly or through a trust, excluding dividends from public companies.
- Income from a trust, if the income is from providing goods or services to businesses owned by a person related to the beneficiary.

Minors can continue to receive capital gains without being subject to the special tax.

b) *Creating Associated Companies*

If the shares of an operating company are owned by a discretionary family trust, each beneficiary is deemed to own 100% of the shares that are owned by the trust. If beneficiaries have companies of their own, being a beneficiary of a trust may cause the operating companies to be associated for income tax purposes. This may impact small business deductions, provincial capital tax, and several other provisions for small businesses.

c) *United States Citizens*

United States citizens living in Canada may have reporting requirements as a beneficiary of a Canadian trust. There may also be U.S. taxes payable by a U.S. citizen, depending on the activities carried on by the Canadian company.

d) *Non-Resident Beneficiaries*

If some of the beneficiaries of a trust are not residents of Canada, there are complications that can be very technical depending on the country of residence. Many trust agreements include a clause that beneficiaries of the trust cannot receive income or capital from the trust while they are non-residents.

Taxation of a Family Trust

a) *Annual Income*

Since inter vivos trusts are taxed at the top personal tax rate, the income of the trust is usually paid out to the beneficiaries. Income paid to a beneficiary is deductible to the trust and taxable to the beneficiary. Usually, an inter vivos trust has no taxable income.

b) *Twenty-One Year Disposition*

In most family trusts, there is a deemed sale of its assets, such as the shares of the operating company, every twenty-one years. This deemed sale and resulting tax within the trust could be avoided by distributing the assets of the trust to the beneficiaries prior to the deemed disposition, thereby deferring the tax until the beneficiaries sell the assets. In situations where control of the assets must remain in the trust beyond twenty-one years, many planning strategies can be implemented.

c) *Canada Revenue Agency Filings*

A family trust must have a December 31 year-end and must file a tax return (T3). The tax return is due 90 days after the year-end, which would be March 31, or March 30 in a leap year.

Payment of Income to Beneficiaries

The majority of the tax benefits related to the use of discretionary trusts are from paying to beneficiaries the income that would otherwise be taxable in the trust. Under the rules of the *Income Tax Act*, the income must be paid or payable to the beneficiaries as of December 31 of the year, so that the income is taxed in the beneficiaries' hands rather than in the trust.

An amount is not considered payable to a beneficiary in the taxation year unless the beneficiary was entitled in the year to enforce payment thereof. To be payable to a beneficiary, the amount must "vest" with the individual.

The Canada Revenue Agency interprets the words "to vest" as meaning to give immediate, fixed right of present and future possession as distinguished from a contingent right. It is advisable for trustees to document the fact that the income is being made payable to a beneficiary. This can be done by way of minutes of a meeting of the trustees, of which a copy could be acknowledged by the beneficiary or the guardian of the beneficiary, or by issuing a promissory note payable on demand in an amount equal to the income that has become payable.

It may be difficult for the trustees to determine what income may be payable at year-end in situations where the trust has not received all reporting information as of December 31 (such as a mutual fund). The trustees may declare all trust income payable and issue a promissory note for an estimated amount, with an adjustment clause.

To ensure that the taxation of income lies with the individual beneficiary, the trustees should make the payment prior to December 31. However, if payment cannot be made, documentation should be put in place to enforce the amount payable to the beneficiary.

The trust can pay a beneficiary's expenses directly from the trust by way of a trustee's cheque, written on a trust bank account, or by using the credit card for the trust. Receipts should be maintained for all expenses. Also, parents may be reimbursed from the trust for expenses they incur on behalf of the beneficiaries. Copies of these receipts should be maintained with the trust accounts.

Where family trusts are utilized, and amounts are payable to children:

- The amounts must be used for the benefit of the children.
- Any amounts paid to the children will reduce the amount owing to them.
- The amounts received by the children from the family trust could be used to pay certain expenses, which would otherwise have been paid by the parents.

Maintaining Proper Books and Records

It is critical that a family trust maintain proper books and records:

- Bank statements should be retained for the trust, along with returned cheques.

- Proper resolutions should be prepared and kept on hand to document decisions relating to the trust.
- An electronic accounting file should be maintained. This will help in the event of an audit of the trust by the Canada Revenue Agency.

Summary

Using family trusts for owning a business offers many benefits; however, the process requires proper planning.

We would be pleased to offer our expertise to help ensure all the necessary steps are taken to set up your family trust.

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