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THE USE OF PERSONAL TRUSTS FOR OWNING A BUSINESS

This article provides an overview of various planning matters related to the use of a personal trust in the ownership of a business that is a qualified small business corporation for the purposes of the *Income Tax Act*. Some popular benefits of a personal 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. Once the settlor has settled the trust, he/she has no further involvement with the trust. 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, as set out in the initial agreement. The trustees must act in the best interest of the beneficiaries, whose rights are defined by the terms of the trust.

If the person (settlor) creates the trust while alive, the trust is an “inter vivos” trust. If the

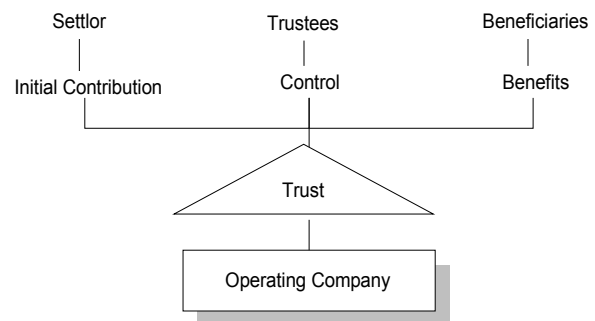
settlor creates the trust on his/her death, the trust is a “testamentary” trust.

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.

Basic Structure

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



The settlor would settle a trust usually for a nominal amount of \$10 or an item such as a gold coin. The settlor could be anyone, although usually they are not 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 family 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 unborn children or grandchildren.

With proper planning prior to the settlement of the trust, it is possible to add beneficiaries to a trust. Also, one may include a corporation as a potential beneficiary to defer taxes on dividends received by the trust.

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, where interest is paid on the loan amount.

It is important to properly structure the initial settlement, the initial money lent to the trust, as well as 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. Also, 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.

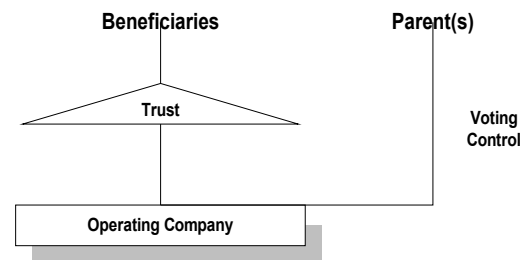
Potential Benefits Available

The substantial benefits achieved by using the 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 controlling 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. Also, a parent may be a beneficiary of the trust.

b) *Creditor Proofing*

Litigation against individuals is coming from many new and old sources, including personal guarantees of debts and family law litigation from former spouses. A discretionary trust can provide protection to its beneficiaries. In a discretionary trust, the beneficiaries have no direct benefit of ownership of the trust assets (i.e., the discretionary aspect of the trust has not been exercised). Therefore, the beneficiary

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 is to ensure that any income is allocated to as many individuals as possible, so that the taxpayers utilize the minimum tax brackets and personal credits to their advantage. 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. Because of their ownership of the shares of the company through the trust, it is possible to pay dividends to these individuals to utilize their low rates of tax, their personal credits, and any dividend tax credit.

Effective January 1, 2000, minor children under 18 years of age are taxed at the highest tax rate on dividends received through a trust 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.

Children 18 and older are not affected.

For example, if a company had \$35,000 of income on which it pays 20% tax (\$7,000), it would have \$28,000 left to pay as dividends to the trust. If the trust paid the \$28,000 dividend to a beneficiary who is

not a minor and has no other income, there would be no income tax on this dividend. Therefore, the beneficiary would be left with \$28,000 to spend.

An alternative would be for a parent to withdraw \$35,000 as payment of salary. There would be no corporate tax on the salary income; however, at the top tax rate, there would be a personal tax cost of approximately \$16,500, resulting in \$18,500 net cash to the parent. Between these two methods, there is a net tax saving in the first scenario of \$16,500.

For an individual with income below \$33,000, the tax rate on any dividends received is approximately 6%. In the previous example, a person with \$20,000 of employment income would pay tax of only \$600 on a dividend of \$10,000.

d) ***Multiple Utilization of the Capital Gains Exemption***

Under Canadian tax law, a \$500,000 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 \$500,000. If a trust owns the shares and there are numerous discretionary beneficiaries, the \$500,000 can be multiplied by the number of discretionary beneficiaries by allocating and paying the gain to each of those beneficiaries. The potential tax savings to a family could be as high as \$116,000 for each additional \$500,000 of exemption generated.

e) ***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.

In a discretionary family trust, the death of an individual does not create a tax liability, because no individual has ownership of the assets. The individual has no value in the company's shares held through the trust, unless he is the last beneficiary of the trust.

Taxation of a Personal Trust

a) *Annual Income*

A personal inter vivos trust is taxed at a tax rate equal to the top marginal tax rate of an individual. Any income left in a trust after the payment of taxes becomes capital of the trust and can be distributed to the beneficiaries tax free.

Usually, all income is paid out of the trust. Income paid to a beneficiary is deductible to the trust. To minimize taxes to a family group, trust income should be paid to beneficiaries who are in the lower tax brackets.

b) *Twenty-One Year Disposition*

In most personal trusts, there is a deemed sale of assets every twenty-one years, so that accrued capital gains can be taxed. 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 the twenty-one years, many planning strategies can be implemented.

c) *Canada Revenue Agency Filings*

A personal 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 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 (i.e., 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 is to 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.

Types of Payments

Where family trusts are utilized, and amounts are paid to children for their benefit, this value belongs to the child. Certain expenses may be paid by the children directly, as opposed to being the responsibility of the parents.

Using personal 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 personal trust.

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