Reference Guide

FAMILY TRUSTS

Family trusts continue to be a legitimate and valuable planning tool that can be very effective in providing solutions to succession planning and addressing various concerns such as tax reduction and asset protection from commercial liabilities and creditors.

The key to successfully using family trusts is understanding how they work, and how they can most effectively fit into an estate plan.

What is a family trust?

A trust is an obligation that binds a person or persons (the trustee(s)) to deal with certain property (the trust property) for the benefit of specified persons (the beneficiaries). In simple terms, a trust is basically a relationship between trustees and beneficiaries.

To create a trust, a person, referred to as a settlor, transfers legal ownership of property to the trustee(s), and provides instructions to the trustee(s) regarding how the property is to be used for the benefit of the beneficiaries.

A commonly-used trust arrangement is a testamentary trust – that is, one generally made in a will which takes effect only on the death of the person who made the will. (Further information on testamentary trusts can be found in our reference guide on testamentary trusts.) Trust arrangements can also be made in a trust agreement that is to take effect during lifetime, and these are referred to as lifetime trusts or by the Latin term inter vivos trusts.

A family trust is simply a form of lifetime trust established for the benefit of a particular family or for certain members of that family.

How can family trusts be used?

One of the most valuable features of trusts is their flexibility. For example, in creating a trust, there is considerable flexibility with regard to matters such as the selection of beneficiaries, how the beneficiaries are to benefit and the ongoing investment and management of trust assets. Other features of trusts include:

- the ability to provide for successive beneficiaries
- the ability to place a wide variety of assets into a trust
- the ability to maintain privacy, and
- the unique tax rules that apply to trusts.

These features combine to make trusts an effective way to meet a wide range of objectives. Family trusts, for example, can be used for both tax and non-tax purposes, as the following illustrations demonstrate:

- Family trusts work well for the owner/manager of a business who would like to split income with a spouse and adult children with low incomes (for example, university students) in order to achieve tax efficiencies. Note that all references to spouse in this reference guide apply equally to common-law partners.

- For those who own significant investment assets or have an investment corporation, family trusts can be used to split income from the investment assets or corporation among adult children.

- For an owner of an active business with children who may or may not be interested in becoming active shareholders, family trusts can be a very useful succession-planning tool, providing a vehicle for ongoing management and control of the business.

- A family trust can be an effective way to provide for a former spouse and/or children of a previous marriage.

- For someone who is concerned about possible financial difficulties in the future, a family trust can help to provide financial security for his or her family.

- A family trust might be a tax-effective vehicle for providing for elderly parents or other adult relatives who require financial support.

How are family trusts taxed?

For income tax purposes, a trust is considered to be a separate taxpayer and is therefore required to file annual income tax returns. In filing these returns, the trust can deduct income and capital gains that are paid or payable to its beneficiaries during the year (as discussed below) – and the beneficiaries must then include these amounts in filing their own tax returns.

Dividends and capital gains received by a trust retain their identity when paid out to the beneficiaries. For example, capital gains received by a trust and paid to a beneficiary will continue to be considered capital gains in the hands of the beneficiary for income tax purposes, so only 50% of the capital gain received by the beneficiary would be taxable. Similarly, a dividend received by a trust and distributed to a beneficiary would retain its character as a dividend and would be taxed as a dividend in the hands of the beneficiary. This is an attractive feature of trusts, as it provides the opportunity for creativity and flexibility in making distributions to beneficiaries.

All of the taxable income of a family trust is taxed at the highest marginal tax bracket in the province in which the trust is resident. Trusts are also not allowed to claim personal tax credits such as the personal credit and the age credit. Because of these rules, the trustees of a family trust typically ensure that all income and capital gains earned by the family trust are paid or made payable to the beneficiaries, to be taxed in the hands of the beneficiaries (subject to the attribution rules outlined below).

There are numerous provisions in the Income Tax Act that restrict or limit the tax benefits of using a trust. For example:

- To prevent the indefinite deferral of tax on capital gains through the use of a trust, a trust is treated as having disposed of its capital property at fair market value every 21 years. This 21-year rule could trigger a taxable capital gain (or loss). A large gain could therefore result in a significant tax bill for the trust every 21 years.

- To reduce income-splitting among family members, there are attribution rules that can cause income, losses and capital gains from property transferred to a trust to be taxed in the hands of the individual who transferred the property. In the case of trusts, these rules will apply in the following situations:

  - if there is any possibility of the transferred property reverting to the individual
  - if the individual has the ability to exercise some control over the property
  - with respect to income from property transferred through a trust to or for the benefit of a related minor beneficiary (such as a child, grandchild, niece or nephew), and
  - with respect to income and capital gains from property transferred through a trust to or for the benefit of the individual's spouse.

  There are, however, certain exceptions to the attribution rules. For example:

  - The attribution rules do not apply to adult beneficiaries (e.g. adult children or adult grandchildren) in most circumstances. A beneficiary is considered an adult as of the year in which he or she turns 18.
  - The attribution rules do not apply to capital gains earned on assets transferred either directly to minor children or grandchildren or to a trust for the benefit of minor children or grandchildren.

- A special kiddie tax is imposed on dividends from private corporations and certain other income passed through a trust to persons under 18 years old. This effectively eliminates any tax benefits of splitting income with minor children or minor grandchildren through a family trust.

A family trust must therefore be designed with these tax rules in mind.

AMOUNT PAID OR PAYABLE

As indicated above, in computing its income (including capital gains) for a particular year, a trust is allowed a deduction for all amounts which are paid or made payable to a beneficiary in the year. The beneficiary would then report these amounts in his or her tax return for the year, subject to the attribution rules described earlier. For these purposes, an amount is only considered payable in a year if it is actually paid to a beneficiary or if the beneficiary is entitled to enforce its payment in the year.

The current position of the Canada Revenue Agency (CRA) is that expenditure may be considered paid or payable, and therefore deductible by a trust, if it was made for the beneficiary's benefit. This may include an amount paid out of the trust for the support, maintenance, care, education, enjoyment and advancement of the beneficiary, including the beneficiary's necessities of life. For example, it may be acceptable for the trust to pay third parties or to reimburse the parents for specific expenses attributable to the children (or grandchildren) such as clothing, tuition, day or summer camp, day care, airline tickets (for the children or grandchildren), sports lessons and equipment, computers, furniture (for a child's or grandchild's room), music lessons and music equipment, and gifts. The key is to maintain proper documentation and to be able to demonstrate that the money was used for the benefit of the beneficiary.

How is a family trust established?

In very general terms, a family trust, like any other trust, is established by the transfer of certain assets to one or more trustees, along with directions to the trustee(s) regarding how the assets are to be managed and how the named beneficiaries are to benefit. This is all typically set out in a trust agreement (sometimes referred to as a trust deed or trust indenture).

To ensure the validity of the trust for tax and legal purposes, there are certain requirements that must be met. In addition, the income tax implications of the transfer of the assets to the trust must be fully considered. It is therefore extremely important to involve well-qualified professionals in the planning and establishment of a family trust. Some of the issues that must be dealt with in setting up a family trust are outlined below.

THE TRANSFER OF ASSETS

Depending on the purpose for which the family trust is being created, the initial transfer of assets to the family trust may be made by different individuals. The income tax implications must also be considered. For example:

- Where a family trust is created in the context of an estate freeze, a grandparent or family friend might establish a family trust using a gold coin; alternatively, a cash gift (for example, a gift of $500) could be made, which would be used to purchase a coin for the trust and to pay the trust's expenses. Having a grandparent or family friend as initial contributors to the trust would often avoid the potential application of the attribution rules referred to earlier. Further assets would then be acquired by the family trust.

- In the case of a family trust created for income-splitting purposes, an individual who owns considerable assets could establish the family trust by transferring the ownership of the assets to the trustees. (An alternative would be to simply give assets to family members directly, but this would eliminate the ability to take advantage of the benefits that a family trust can provide.)

As noted earlier, a wide variety of assets can be held by trusts, including real estate, cash, a portfolio of securities such as shares, bonds and mutual funds, and shares of privately held corporations. It should be noted, however, that for tax purposes, a transfer of assets to a family trust (or to family members directly) is treated as a sale of the assets at their fair market value as at the time of the transfer. Accordingly, any accumulated gains in the transferred assets would be taxable to the transferring individual in the year the transfer was made. Because of this, it is often best to transfer assets with a cost base, for tax purposes, that is approximately equal to the value of the assets. Alternatively, cash could be gifted to the trust. Registered assets should not be used for this purpose because of the tax liability that would be triggered on the withdrawal from the registered plan.

THE TRUSTEES

There are a number of factors, both tax-related and non-tax-related, that should be considered in selecting the trustees of the family trust.

Given the often long term nature of a family trust, the trustees selected should be willing and able to act, and should have the necessary knowledge and ability to be able to handle the assets to be held in the trust as well as all of the other obligations required of trustees. A mechanism should also be included for the appointment of replacement trustees in case the trustees named are unwilling or unable to act or to continue to act.

While an individual who transfers assets to a family trust may be a trustee of the trust if desired, he or she should not be the sole trustee and should not be in a position to control the distribution of the income and capital of the trust. As noted above, if that control is maintained, then any income or capital gains earned by the family trust will be taxed in the hands of the transferring individual, which would defeat an important benefit of the family trust.

Another important factor to consider in selecting the trustees of a family trust is the residence of the trustees. In general, for income tax purposes, a trust is considered to be resident in the jurisdiction in which the majority of the controlling trustees reside. As significant unintended tax consequences could result if the residence of trustees causes a family trust to be a non-resident of Canada for tax purposes, you should seek advice if you are considering naming an individual who lives in a foreign country as a trustee.

THE BENEFICIARIES

The trust document names or identifies which family members are to be potential beneficiaries of the family trust. For example, adult children and grandchildren are often named as beneficiaries. The beneficiaries could also include any future grandchildren, and, if desired, present or future spouses or common-law partners of children and grandchildren.

Corporations are also often included as a beneficiary of the family trust. A corporate beneficiary may be owned by one or more of the beneficiaries of the family trust.

The individual who establishes the trust or transfers assets to the trust may or may not be named a beneficiary, depending on the reasons for the establishment of the family trust. To avoid the application of the attribution rules, that individual should at most be named only as a possible income beneficiary, and not a capital beneficiary. Careful tax and legal planning is necessary in selecting trust beneficiaries.

PAYMENTS OF INCOME AND CAPITAL

In most cases, a family trust gives the trustees complete discretion to decide whether, how much and to whom income and capital are to be distributed in any year. This allows for maximum flexibility, so that the trustees can decide each year, based on current circumstances, what amount, if any, of the income and/or capital is to be paid to the beneficiaries, and in what proportions.

However, as noted above, care must be taken to ensure that the individual who transfers assets to the family trust cannot in any way obtain any of the capital of the trust.

Note that for tax purposes, capital gains are generally treated as income. Under trust law, however, capital gains are considered to be capital, so that the trustees could only distribute these to capital beneficiaries of the trust. If desired, however, the trust document can define what is to constitute income of the trust for trust purposes. Accordingly, depending on the particular objectives of the trust, the income of the trust could be defined to include capital gains. This would make the treatment of these amounts the same for both trust and tax purposes and could also facilitate desired distributions to beneficiaries.

What are the tax benefits of a family trust?

Despite what may seem to be onerous tax rules relating to trusts, there are still tax benefits to be gained by using a family trust. For example, in certain situations:

- A family trust can allow the income generated by investment assets or by a family business (generally one that is incorporated) to be split among adult family members to achieve tax savings if family members are in lower tax brackets. Capital gains may also be split among family members.

- A family trust can be used as a means of transferring the growth in value of a family business to the next generation on a tax-deferred basis.

- A family trust can be used to assist in asset protection along with purification of passive assets prior to the sale of the family business.

In addition to these tax saving opportunities, family trusts also save on probate fees, which run as high as 1.5% in some provinces. This is because property held in a family trust would not form part of the estate of the individual who transferred the property to the trust and would therefore not be subject to probate fees.

How are the tax benefits achieved?

The tax benefits of a family trust arise in different ways, depending on the family situation and on the primary objectives of the trust. The following examples illustrate how a family trust can be used to achieve tax savings.

EXAMPLE #1 - OWNER/MANAGER INCORPORATED FAMILY BUSINESS

Here is a general outline of the steps involved in using a family trust to save on taxes in the case of an owner/manager of an incorporated family business:

- The family trust would be created in the manner noted above, with the owner/manager usually named as one of two or more trustees. Other trustees could include friends or extended family, but a majority of the trustees should not also be beneficiaries.

- The existing shareholders of the incorporated family business would exchange their common shares in the corporation for new shares of a different class. These new shares are usually preferred shares that have a fixed redemption price (based on the value of the original common shares), as well as a fixed maximum rate of return. Control is usually retained by the existing shareholders.

- The family trust would then subscribe for new common shares of the corporation for a nominal subscription (or purchase) price. Typically, the family trust borrows the necessary funds from a bank or other third party, and later repays the loan once it receives a dividend from the corporation.

The result of these arrangements is that the family trust becomes the owner of the common shares of the incorporated family business. As the owner:

- The family trust would benefit from the future growth in the value of the business.

- The family trust would also receive dividends on the shares it owns. These would be paid to it out of the active business income earned by the incorporated business.

The tax benefits of this arrangement would be achieved as follows:

- The family trust would pay the dividends it receives from the incorporated family business to the beneficiaries of the trust, who would typically be lower-income family members.

- Because dividends paid out of the trust to beneficiaries retain their identity (as described earlier), the dividends would qualify for the dividend tax credit, a special tax credit available for taxable dividends from Canadian corporations. The effect of this tax credit is that an adult beneficiary of the family trust with no other income could receive significant non-eligible dividend income through the trust each year and not pay any tax on this income.

In this way, having a family trust as a shareholder of a corporation carrying on an active business effectively allows expenses for an adult child, such as education or travel expenses, to be paid with income that is taxed at the corporate level on active business income, instead of being taxed at the parent's personal tax rate if they would have received the income directly as a salary or bonus.

- Another strategy, in the owner/manager incorporated family business scenario, is the use of a corporate beneficiary. In situations where family members are not in a low tax bracket in a particular year or family members are too young to receive distributions from the family trust, the introduction of a corporate beneficiary can defer the tax burden.

- Any profits of the owner/manager incorporated family business could be paid to the family trust as a dividend and then allocated to the corporate beneficiary. As dividends between two connected taxable Canadian corporations flow tax-free, tax is deferred.

- The use of a corporate beneficiary could also assist with the owner/manager incorporated family business in eliminating any excess cash not deemed necessary in the day-to-day operations of the company. The elimination of the excess cash could help enable the company to qualify for the capital gains exemption in the event of a sale, provide asset protection and allow for tax planning on the eventual distribution of the funds.

EXAMPLE #2 - INVESTMENT CORPORATION

Similar potential tax savings can be achieved by using a family trust in the case of an investment corporation. If the dividend income from the investment corporation flows through the family trust and is distributed to an adult beneficiary who has no other income, a family could again save significant amounts of income tax.

Over time (and subject to the 21-year rule mentioned earlier), as the family trust's shares in the business or investment corporation grow in value, the trustees of the family trust can distribute the shares to Canadian resident children at an appropriate time (for example, on the death or retirement of the parent). This distribution can be on a tax-deferred basis, so that the taxes on any capital gains accrued on the shares up to that time are deferred until the child disposes of the shares. Without the family trust, the capital gains would have continued to accrue in the parent's hands and would be taxable on the death of the surviving parent. The family trust therefore allows for a potentially longer, inter-generational deferral of this income tax liability.

EXAMPLE #3 - INVESTMENT ASSETS

A family trust can also be used to achieve tax savings even where there is no business or corporation involved. Here is an example of how this could be achieved:

- A parent or grandparent in the highest tax bracket could place investment assets into a family trust for the benefit of one or more adult children and/or adult grandchildren who are in lower tax brackets. As noted earlier, it would be desirable to use either cash or assets with a high cost base so that no gains are triggered on the transfer of the assets. Also, these assets should be surplus assets – that is, the parent or grandparent should not require these assets for his or her own needs.

- The income earned by the trust on the investments would then be paid or made payable to the children or grandchildren, where it would be taxed at their lower rate.

This can be a very tax-effective way for a parent or grandparent to provide financial assistance to lower income adult family members.

What are the non-tax benefits of a family trust?

BUSINESS SUCCESSION

In the case of an incorporated family business, family trusts can also be used to provide for the smooth succession of the business from one generation to the next. In this case, the trustees of the family trust could hold the shares of the corporation for the benefit of the entire family until details regarding the succession of the business have been determined. This is particularly important where, for example, it is uncertain whether, or which, children will participate in the family business. The family trust provides the flexibility to determine which children will participate as shareholders, and in what proportions the trust's holdings in the family business and the trust's income will be divided.

PROTECTION FROM CREDITORS

Family trusts can also help to protect assets from possible future creditors. If all distributions of income and capital are at the discretion of the trustees, the beneficiaries' creditors should not generally be able to seize any of the family trust's assets.

In addition, under an appropriately established family trust, the use of a family trust may help to provide some protection of assets from future marital or family property claims involving a beneficiary. It should be noted, however, that as a result of several court cases, protection from marital or family property claims by the use of a trust may not be quite as certain as protection from other creditors.

PROVIDING FOR FINANCIALLY DEPENDENT ADULT BENEFICIARIES OR THOSE WITH SPECIAL NEEDS

If an individual is providing financial support for an adult relative, such as elderly parents or a child or sibling with special needs, a family trust can be an effective way to provide for their ongoing financial needs.

Note that in the case of special needs adults, there are special considerations in planning and establishing a trust for their benefit. For example, the trust document must be carefully drafted where there is a desire to ensure that social assistance payments that special needs adults are typically eligible to receive will not be adversely affected. In addition, where a trust beneficiary is eligible to claim the disability tax credit (due to mental or physical disability), a special election is available so that dividends could be received and retained by the trust but taxed as if they had been received by the beneficiary, where they would attract little or no tax. The income retained in the trust would then become capital which could be distributed tax-free to a capital beneficiary of the trust, such as the parents. More detailed information about planning for a special needs beneficiary is provided in a separate reference guide, planning for a disabled beneficiary.

PRIVACY

Unlike a will, which becomes public once it is probated, a family trust need not be disclosed to anyone other than the parties directly involved. This makes a family trust very useful for a person who wishes to make private arrangements to provide for others.

What are the risks and costs of using a family trust?

In addition to the rules and requirements already mentioned that should be carefully considered when establishing a family trust, there are also some hazards that must be avoided when setting up a family trust. For example:

- In order to avoid a corporate attribution rule, using a family trust in the case of a business corporation to split income with a spouse is generally recommended only in situations involving corporations whose investment assets (or any assets not used primarily in an active business in Canada) account for less than 10% of the value of all the corporation’s assets.

- If there are a number of different corporations held in the family group, the use of a family trust may inadvertently result in one or more of them being considered to be associated, which could reduce the availability of the lower corporate tax rate for the corporations within the group.

Accordingly, any strategy involving the use of a family trust in the context of a family business should be made only with the involvement of a professional advisor who is familiar with family trusts and the family's business interests.

It is also important to be aware of the costs that would be involved in planning and establishing a family trust. For example, there would be professional fees for setting up the trust and drafting the trust document, as well as ongoing costs for matters such as the filing of annual tax returns for the trust and the payment of trustee fees. This should be considered when determining if the use of a family trust would be worthwhile.

Conclusion

In the right circumstances, and with proper planning, a family trust is a useful tool and may provide significant tax savings and other benefits.

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