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Family Trusts in Wealth Planning

A family trust refers to a trust created by an individual ("the settlor") for the benefit of family members. Family trusts are frequently established as inter-vivos discretionary trusts and are often used for the purposes of income-splitting or as part of an estate freeze structure. This article will take a closer look at the role of the inter-vivos discretionary family trust in wealth planning and some of the considerations to be kept in mind when utilizing them.

Terminology

An **inter-vivos trust** is a trust set up during the settlor's lifetime.

By contrast, a testamentary trust arises on and as a consequence of an individual's death, usually through provisions in a Will.

A **discretionary trust** refers to a trust in which the trustees have the power to make certain decisions, such as when to make income and capital payments, beneficiaries to whom assets will be distributed, and the amount of distributions.

By contrast, in a non-discretionary trust, the interests of the beneficiaries are fixed and the trustees have no discretion as to whom and when to make distributions.

Family trusts tend to be discretionary in nature because the various beneficiaries have different needs. By giving the trustees broad latitude to determine the timing and amount of payments, the trustees may be able to distribute payments in the best interest of the beneficiaries.

Major uses of Discretionary Inter-vivos Family Trusts

Family income-splitting

How it works

As a result of the graduated tax rates in Canada tax savings that may sometimes be realized if individuals at high income levels transfer beneficial ownership of income-producing assets (e.g. shares of a corporation) to family members who are at lower marginal tax rates (e.g. a stay-at-home spouse and children).

The problem is that the owner of those assets may not yet be prepared to give control over the assets to the beneficiaries, perhaps due to the beneficiaries' young age and inexperience, lack of financial acumen, or even doubts as to the stability of marital relationships.

In such situations, the family trust is a mechanism that allows an individual to transfer beneficial ownership of assets to family members without giving them control over those assets.

An additional potential benefit is creditor protection. In a discretionary trust where the trustee has full discretion over the distribution of income and capital, the beneficiaries are generally not considered to have a vested interest in the trust assets. As such, until the trustee exercises discretion and distributes assets to the beneficiaries, creditors of the latter may not be able to lay claim on the trust assets.

Limitations

1. Since 2000, planning opportunities that involve the use of family trusts in income-splitting have been severely curtailed by the imposition of the "kiddie tax" provisions in the Income Tax Act ("ITA"). These provisions effectively impose the highest marginal tax rate on individuals under 18 years old who receive certain types of income, including dividend or business income received through a trust.

   Income-splitting however can still be achieved with beneficiaries who are 18 years or over and do not have significant other income.

2. To successfully minimize the overall household tax bill, it will also be necessary to avoid application of the attribution rules in the ITA, which penalizes income-splitting through the gifting or loaning of property between family members, including gifts or loans through a trust. Please consult your professional tax advisor to find out more about how to properly apply your strategy.

Estate freezes

The family trust structure is probably most commonly used as part of an estate freeze by owner-managers of corporations.

The estate freeze is a popular mechanism in business succession planning. In essence, the objective is to "freeze" the current value of the business in the hands of the owner-manager and transfer the future growth potential to the next generation. The interposition of a family trust provides the flexibility required in developing a business succession plan, enabling the owner-manager to retain control over business decisions, even as the future growth in value of the business is transferred to the next generation.

How it works

- Prior to implementing an estate freeze, the owner-manager usually owns all the common shares of the corporation.
- The owner-manager exchanges his or her common shares in the corporation in exchange for fixed-value preferred shares. These special shares will not grow in value but have voting control over the corporation. They are often referred to as "freeze shares".

It is imperative that you consult your professional legal and tax advisors before implementing this strategy, as certain requirements must be adhered to for the exchange to be done on a tax-deferred basis.

- A discretionary trust, with family members as beneficiaries, ("Family Trust") is established. The Family Trust subscribes for common shares of the corporation for nominal value.
- As a result, all future appreciation in value of the corporation will now accrue to the Family Trust (through its ownership of the common shares).
- The owner-manager may be able to extract value from the business in the future in various ways. One method is to have the corporation purchase the preferred shares for cancellation, resulting in taxable dividends for the owner-manager or (if the payments are made by the corporation from the capital dividend account) tax-free payments. Alternatively, the owner-manager may sell his or her shares of the corporation to a purchaser. The capital gain from the sale may be tax-exempt if conditions for the $750,000 capital gains exemption are fulfilled.

Limitations

Implementing an estate freeze can be complicated and expensive; therefore, it is most beneficial if the business has considerable worth and is also expected to experience significant growth in future.

Additional tax considerations

1. Inter-vivos trusts are taxed at the top personal tax rates, but income of the trust paid out to the beneficiary is deductible to the trust and taxable to the beneficiary. For this reason, trust income is generally distributed to the beneficiaries, who are presumably taxed at lower rates.
2. An inter-vivos trust must file an annual T3 tax return, which is due 90 days after the year-end. Since an inter-vivos trust must use December 31 as its year-end, the tax return is due on March 31 (or March 30 in a leap year).
3. As a measure to prevent a trust from being used to indefinitely defer tax, the ITA provides that a trust is deemed to dispose of its capital property every 21 years (some exceptions apply, as in the case of spousal trusts and alter ego and joint partner trusts). To avoid this deemed sale and realization of capital gains, trust assets can be distributed to the beneficiaries on a rollover basis.

Summary

The family trust can have many practical applications in wealth planning. Properly structured and used in appropriate circumstances, it can provide immense tax and non-tax benefits. To ensure that the desired goal – whether it is business succession planning or income-splitting with family members – can be accomplished, proper legal and tax advice should be obtained prior to implementation.

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