Using a Family Trust for Business Tax Planning

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1. The Use of a Discretionary Family Trust in Business

The discretionary family trust is a tool used by some business owners to reduce tax liability and increase flexibility in the family economic unit by facilitating tax-favourable distribution of funds, business succession and estate planning. Using a discretionary family trust to hold shares in a private company can have significant tax and planning benefits. Because this area is complicated and requires an understanding of tax, estate, corporate/commercial and trust law, many business owners and their advisors lack an understanding of this useful planning option. This paper seeks to provide an overview of the beneficial uses of a trust by the owner of a privately held corporation in Canada and argues that a the patchwork approach to policy development adding new provisions to address Court findings results in undue complexity which could be fixed with better and more coherent drafting.

2. Important Factors in Trust Creation

A trust is an entity created by common law where "property is held by a person or is transferred to another person to be held, for the benefit of one or more persons."[1] Possible origins of the concept include a method of making property available to Franciscan monks who were not permitted to own property; or, as a means of allowing Lords to transfer legal title to land while away during one of the Christian crusades between the 11th to 13th centuries while using land proceeds to care for their family.[2] Trust law is a complex field and a trust can take many different forms, which have been categorized in many different ways.[3] For the purposes of this paper we will be examining a common

scenario: the use of an express, *inter vivos*, discretionary family trust in business planning with a private corporation.

An express trust is a trust that is created with the expressed intention of the settler as opposed to by implication or operation of law.[4] An *inter vivos* trust (also known as a living trust) is a trust that is created within the lifetime of the settler.[5] A discretionary trust is a trust where the trustee is granted discretion to determine the amount of capital and/or income the beneficiaries are to receive and which beneficiaries are to receive it.[6] Finally, a family trust refers to a trust created for the benefit of the settler's family.

The creation of a trust requires a "settler," a "trustee" and one or more "beneficiaries." The settler is the party that transfers assets to the trust, the trustee oversees the trust and its distributions and the beneficiaries are eligible to receive the trust distributions. In some instances a single individual may play more than one role, though doing so could result in adverse inferences for tax purposes and otherwise. To create an express trust the settler must have:

a) legal capacity to transfer an interest in the property;
b) certainty of intention to create the trust;
c) certainty of subject matter (the property to be held in the trust); and,
d) certainty of objects (the beneficiaries).

The trust must then be constituted with the transfer of the property with any required formalities addressed (e.g. ensuring that the trust is in writing). Additionally, the trust

must not be contrary to public policy such as the promotion of morally or socially offensive outcomes. Failure to adhere to these criteria will either fail to create a trust or invalidate it after creation. The Courts have been strict in requiring compliance with the required elements for creating and constituting a trust.[7] To prevent unintended outcomes when creating a trust it is also vitally important that the settler or his or her adviser contemplate the rules against perpetuities and accumulations and the rule in *Saunders v. Vautier*.

2.1 The Rules Against Perpetuities & Accumulations

The rule against perpetuities arose in England in the 1600's. It requires that the terms of a trust must be such that the Court could look at the current and contingent (contingent upon the occurrence of an event) beneficiaries at the time the trust was created and satisfy itself that all trust property would vest in known persons by the time all beneficiaries die plus 21 years. In the event that this is not the case the interests in the trust are void. Similarly, the rule against accumulations arose at common law prohibiting the accumulation of assets in a trust for an indefinite period of time – usually limiting accumulations to 21 years – upon which the assets of the trust must be distributed to the settler and/or the beneficiaries. As a former British colony, Canada adopted British common law as its own including the rules against perpetuities and accumulations. Since then, however, many Provinces have legislatively modified these rules. When creating a trust it is important to be aware of these common law rules and if and how they have been legislatively modified in the applicable Province.[8]

2.2 *Saunders v. Vautier*

The rule of *Saunders v. Vautier*[9] is a common law trust rule stating that "[o]ne or more beneficiaries, all of full legal capacity, and who is, or are collectively, entitled to all the beneficial interest in the trust may apply to have the trust terminated and the assets transferred even though the trust instrument calls for final payment to be delayed." To exercise the rule all beneficiaries must agree, must be of full capacity and have all of the rights to the trust property.[10] This rule is significant because it can result in unintended consequences as, if not structured property, the beneficiaries can dissolve a trust contrary to the wishes of the settler. In the context of discretionary family trusts used in business, issues with this rule can generally be avoided by having the party controlling (directly or indirectly) the ownership interest in the business as a beneficiary whether or not they are the settler. That way, the controlling party's consent would be required to wind up the trust during his or her life.

3. The Taxation of Trusts

A trust is taxed as an individual taxpayer[11] generally at the highest marginal tax rate.[12] While a trust is required to report and pay tax on its income, with some exceptions, if earned income is paid or payable to a beneficiary during the tax year the distributed income is deductible by the trust and is instead taxed as income of the beneficiary.[13] This allows for a trust to be used as a tax-neutral flow through entity to distribute funds to beneficiaries. Like any other individual taxpayer, trusts are also subject to a minimum tax under Division E.1 of Part I of the *Income Tax Act*[14] (the **"Act"**), unless there is an

applicable provision to the contrary.[15] This can limit the tax advantages that can be received in a given year from certain tax incentives.[16] Unlike other individuals, however, trusts are subject to the 21-year rule under section 104(4) of the Act. This provision deems a disposition of trust assets 21 years after a specified day and then every 21 years thereafter. At the time of such a disposition, taxes will be payable on trust asset capital gains.[17] The manner in which trusts are taxed creates the opportunity to use the entity to flow through tax obligations to beneficiaries to be taxed in a lower tax bracket than the trust, its settler, or the controlling interest would be. A significant potential benefit to having a family trust as a shareholder in a privately held corporation is the use of the trust to distribute monies to family members to reduce total family tax liability. Government attempts to limit such income splitting has resulted in significant complexity in the Act.

4. Income Splitting & Attribution Rules

Income splitting is a tax reduction strategy where an individual in a high tax bracket transfers income to a lower tax bracket individual within the same economic unit – typically a spouse or child. While restrictions on income splitting to reduce tax liabilities have been implemented in the Act, including complicated attribution rules, opportunities still exist to reduce family unit tax exposure through income splitting with adult family members. An understanding of the attribution rules is necessary to ensure compliance and prevent unexpected tax liabilities when transferring funds to related parties through a trust or otherwise.

4.1 Attribution to Settler

If the settler creates a trust where the settler retains control of the trust property, Section 75(2) of the Act attributes income back to the settler when:

a) the property can revert back to the settler;

b) the settler retains the right to decide who will receive the property from the trust;

c) the settler's consent is required for the trust to dispose of the property.

In order to avoid the application of this provision the settler must surrender control of the property when it is settled or contributed into the trust. Failure to do so can have significant tax consequences where the settler pays taxes at a higher bracket than the beneficiaries.[18]

4.2 Transfers to Corporations

Section 74.4(2) of the Act imposes tax consequences for transferring or lending property to a corporation directly or indirectly through a trust. It states that if a main purpose of the transaction is to reduce the income of the party transferring the property and to benefit a designated person (a spouse, non-arms length minor or minor niece or nephew), the transferor will be deemed to have received annual interest in the amount that the prescribed rate on the property's fair market value at the time of transfer exceeds the interest received; and, five fourths of all taxable dividends received in exchange for the transfer. This provision is clearly punitive as it applies even if income is not actually

paid to the designated person. Significantly, however, section 74.4(2)(c) of the Act states that this attribution provision does not apply to transfers made to small business corporations. Small business corporations are defined in section 248(1) of the Act as, broadly speaking, Canadian-controlled private corporations where substantially all of the fair market value of the assets is used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it. Additionally, where the corporation that does not qualify as a small business corporation, if the only interest held by the designated person in the corporation is in a trust, and certain requirements including that the trust is a shareholder of the corporation and there is no entitlement to any income or capital from the trust to the designated person, the transaction can avoid the application of the section 74.4(2) attribution. This allows a taxpayer to freeze an interest in a corporation in favour of adult children without triggering the attribution provision.[19] In the context of using a family trust to hold shares in a corporation, the application of this provision can generally be avoided by ensuring that, if a corporation is a beneficiary, then no revenues are flowed through the trust to it unless it is a qualified small business corporation.

4.3 Transfers to Minors

Section 74.1(2) of the Act states that were an individual transfers property to a trust for the benefit of a non-arms length person, or to a niece or nephew, under the age of eighteen, all income or losses are deemed income of the transferor. This provision only applies where the income is attributed to the minor and not when such income is taxed in the trust or is designated to be taxed in the trust.[20] Additionally, section 120.4 of the Act,

the so called "kiddie tax," imposes the highest rate of Federal tax on income earned by minors including:

a) Taxable dividends from private companies;

b) Shareholder benefits or loans from a private corporation;

c) Taxable capital gains from a specified individual or trust;

d) Most income from a trust carried on by a related party.[21]

This broad provision effectively prevents tax splitting with minor children but also applies to child actors, athletes and entrepreneurs, resulting in the application of the top tax rate even when the minor earns such income independently.

4.4 Non-Arms Length Transfers & Indirect Payments

Section 56 of the Act contains attribution rules to prevent income splitting between related parties, as defined in section 251(2) and 252. Specifically, section 56(4) attributes property transferred to a non-arms length party back to the transferor for tax purposes for the period of the year in which the taxpayer was a Canadian resident unless the income is from property and the taxpayer has also transferred the income generating property. Section 56(2) additionally prohibits income splitting using indirect payments. It states that a payment or transfer made pursuant to the direction of, or with the concurrence of, a taxpayer or another person for the benefit of the taxpayer to the extent that it would be if the payment or transfer had been made to the taxpayer.[22] These provisions are significant because they act as a general prohibition against income splitting with non-arms length parties. The Supreme Court of Canada has found, however, that Section 56(2) does not

apply to all instances, opening the door for income splitting with adult non-arms length parties using corporate dividends.

4.5 Income Splitting with Dividends

The two Supreme Court of Canada rulings of *McClurg v. Canada*[23] and *Neuman v. M.N.R.*[24] found that income splitting by issuing dividends to shareholders is not contrary to Section 56(2) of the Act and is therefore permissible. Both cases involved a husband issuing dividends to his wife through a privately owned corporation. The Court determined that Section 56(2) implicitly requires that the taxpayer would otherwise have an entitlement to the transferred property, and that in fact there was no such entitlement because the dividends could instead be kept in the corporation as retained earnings.[25] The Court's finding in *Neuman* further asserted that the wife was not required to have any involvement in the corporation for the dividend to avoid the Section 56(2) attribution rules as the relevant issue was whether or not the taxpayer otherwise had a right to the distribution.

In response to the Court's findings in *McClurg* and *Neuman* the legislature passed the section 120.4 "kiddie tax" discussed above, but has not otherwise amended the Act to prohibit income splitting or, as it is also known, "dividend sprinkling," to non-arms length adult family members. Consequently, subject to the aforementioned attribution rules, income splitting can lawfully be carried in the context of a private corporation. This can be done in one of three different ways:

a) hiring a family member to perform work for the business at the fair market rage;

b) distributing dividends in different proportions to shareholders holding differing classes of shares;

c) Holding shares with a family trust and distributing dividend payments to the beneficiaries.

Using a family trust as a shareholder can be the most appealing of these options where the non-arms length parties have no desire to work for the business, where it is awkward or impractical to have numerous classes of shares held by family members and to pass directors resolutions to issue dividends as desired (e.g. where there are numerous other shareholders, the Board is not controlled by the would-be-settler and/or it is not desirable to mix the corporate structure and payment of dividends with family matters).[26] Furthermore the use of a family trust can have benefits beyond facilitating dividend sprinkling including facilitating the allocation of capital gains upon the sale of the business to maximize the use of family member's lifetime capital gain exemptions.

5. Capital Gains Exemption

Having a discretionary family trust as the shareholder of your private company not only allows for the distribution of dividends to adult beneficiaries to income split, it also creates the opportunity to maximize the use of the lifetime capital gains exemption by spreading capital gains income to multiple family members. The lifetime capital gains exemption is found in Section 110.6 of the Act. It provides for a lifetime capital gains

exemption on the sale of shares in a qualified small business corporation at an indexed rate, which is $813,600 at the time of writing.[27] In order to qualify for the lifetime capital gains exemption the corporation must meet the section 110.6 criteria, which require that:

a) The shares can not be owned by anyone other than the individual or a person or partnership related to the individual;

b) More than 50% of the fair market value for the assets must be used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it through out the immediately proceeding 24 months;

c) All or substantially all of the fair market value of the assets must be used principally in an active business carried on primarily in Canada at the determination date.[28]

Section 108(5) of the Act states that income flowed through a trust to a beneficiary will be considered income from property unless otherwise stated elsewhere in the Act. The Act permits a number of different types of income to retain their character when flowed through a trust including for taxable dividends in section 104(19), capital dividends in section 104(20), and notably, capital gains in section 104(21). This means that when the shares of the corporation are eligible for the lifetime capital gains exemption, when the shares are sold, each beneficiary could have the proceeds distributed to them through the trust and claim all (or part) of their lifetime capital gains exemption, multiplying the total tax savings by the number of beneficiaries. Though a corporation and partnership can

also be used to maximize capital gains in a similar manner, similar considerations arise as compared to determining whether or not to use a trust for income splitting. Unlike with payments of dividends there are no “kiddie tax” provisions preventing minors from receiving capital gains income through a trust and using their lifetime exemption.[29] As significant as they are, facilitating dividend sprinkling and maximizing the lifetime capital gains exemption upon the arms length sale of the company are not the only benefits associated with using a family trust in business.

6. Business Succession & Estate Planning

A discretionary family trust can also be an extremely useful tool for business succession and estate planning. Two common instances are in estate freezes and the use of an *inter vivos* trust to avoid probate fees upon death.

6.1 The Estate Freeze

An estate freeze is a transaction that transfers the future growth in the value of a business or other asset into the hands of a future generation from the current owners (usually from parents to children) which generally uses a discretionary family trust. The purpose of such a transaction is to limit the value of the parent’s estate to maximize the transfer of wealth to the children by avoiding capital gains and other taxes due to a deemed disposition at death. Such a freeze only makes sense if the value of the business is expected to appreciate.[30] Because a simple transfer of an asset from parent to child or grandchild usually results in a disposition for tax purposes and resulting tax liability, an

estate freeze is commonly carried out with a reorganization of the existing corporation and a discretionary family trust. For example, a freeze can be carried out with a corporate reorganization where freeze shares and thin voting shares in the Corporation are issued to the parents while equity shares are issued to the discretionary family trust with the children as beneficiaries. Freeze shares are shares that are generally redeemable and retractable at the value of the pre-existing shares, are preferred on liquidation, have a price adjustment mechanism to address potential dispute with the CRA and have dividend rights as desired but which lock in a fixed entitlement. Thin voting shares can be issued to sequester voting rights in separate shares from freeze shares and may be redeemable and retractable for only a nominal amount. Generally they will provide for the ability to change control of the corporation without triggering tax on the freeze shares and provide increased flexibility to avoid post-mortem reorganizations for tax reasons. The growth shares issued to the benefit of the children would then contain the right to residual equity and growth participation after the rights of the parent's shares have been satisfied. A discretionary family trust can be used to hold the growth shares with the children as beneficiaries to afford control and protection against mismanagement by the beneficiaries and to provide flexibility in determining who will ultimately receive what.[31]

6.2 Avoiding Probate

An *inter vivos* trust such as a discretionary family trust can be also be used to bypass probate for the settler upon death and provides greater privacy. Probate is the process of a Court affirming that a will is a valid public document and the last testament of the deceased. This is the first step in administering an estate. Probate fees are the taxes levied

on an estate that goes through probate by the relevant Provincial or territorial government. They differ by jurisdiction. At the time of writing, for example, probate fees in Ontario are $5 for each $1,000, or part thereof, of the first $50,000 of the value of the estate, and $15 for each $1,000, or part thereof, of the value of the estate exceeding $50,000.[32] Not all property in an estate must pass through probate, however. Some property can pass directly to a beneficiary without a Court Order through operation of law or pursuant to a legal document that transfers the property. Transferring assets to an *inter vivos* trust is one method that can be used to transfer property without going through probate or incurring probate fees. Additionally, while probate is typically public, trusts and related transfers of property are typically private. Consequently, an additional benefit of using a trust in such circumstances is increased privacy.[33] As a review of applicable provisions of the Act has demonstrated, the rules associated with the use of a trust in business are very complex. While some complexity is necessary to adequately address what can be complicated arrangements, there is opportunity for increased clarity.

7. Opportunities for Increased Legislative Clarity

The complex series of attribution rules, Court interpreted limitations and new sections seeking to, in part, correct such deficiencies has created a complicated area of law that requires significant specialized expertise in order to navigate. This undue complexity increases confusion, non-productive business expense and risk of taxpayer non-compliance. This patchwork approach to legislative development unnecessarily complicates the law to the detriment of business and economic productivity. Specifically, when *McClurg* and *Neuman* found that section 56(2) does not apply to dividend

sprinkling, rather than amending or clarifying the provision, government created the section 120.4 “kiddie tax” in a different section of the Act, which unfairly penalizes legitimate minor income earners, fails to fully address the alleged shortcomings found in the wording of section 56(2) and, through omission, requires reference to common law to understand what the section in fact permits. This is an example of a missed opportunity for clear and simple drafting. Amending the affected section to, on the face of the text, state what is and is not prohibited by the provision would simplify the state of the law and promote increased compliance while reducing associated business and economic costs. While prioritizing clarity and accessibility is important for the entire Act, it is especially so when small business is concerned because of its importance for job creation and economic growth and its comparatively limited capacity to divert resources to non-productive expenses like administrative compliance.

8. Conclusion

The use of a discretionary family trust with a privately held corporation can have numerous benefits including reducing the tax liabilities of the family economic unit through income splitting, maximizing family capital gains exemptions and assisting with business succession and estate planning. Because of the patchwork approach to relevant provisions under the Act, however, there is significant and undue complexity. Better and more coherent legislative drafting could streamline the relevant provisions reducing complexity and, by implication, increasing the likelihood of taxpayer awareness, compliance and productivity.

9. End Notes

[1] Mark Gillen. *Law of Trusts, Second Edition*. STEP Canada, 2009. Page 3.

[2] *Ibid*.

[3] For a succinct overview see: Landry Macgillivray Barristers, Solicitors, Notaries. "The Discretionary Family Trust." <http://www.landrymcgillivray.ca/brochure_trust.html>. Accessed August 8, 2016.

[4] Gillen. *Supra*. Pages 4 & 363.

[5] *Ibid*. Page 11 & 363.

[6] *Ibid*. Page 10 & 362.

[7] *Ibid*. Chapters 1-4.

[8] Grace Chow, Pryor, Ian. *Taxation of Trusts and Estates, A Practitioner's Guide 2016*. Carswell (Toronto: 2016). Page 29-32.

[9] *Saunders v. Vautier (1841) EWHC Ch J82*.

[10] Gillen. *Supra*. Page 94.

[11] *Income Tax Act*, RSC 1985, c 1 (5th Supp). Section 104(2).

[12] *Ibid*. Section 122(1).

[13] Section 104(13)(a) as cited in Chow. *Supra*. Page 54.

[14] *Income Tax Act*, RSC 1985, c 1 (5th Supp).

[15] Chow. *Supra*. Page 52.

[16] Canada Revenue Agency. "Minimum Tax." January 1, 2016. <http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns409-485/mntx/menu-eng.html>. Accessed August 9, 2016.

[17] Chow. *Supra*. Page 181-182.

[18] *Ibid*. Page 212.

[19] Martin Rochwerg, "Using Trusts as an Income-Splitting Tool," Report of Proceedings of Fifty-Fifth Tax Conference, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 18:1-28. Page 17.

[20] Chow. *Supra*. Page 345.

[21] Ibid. Page 354.

[22] Rochwerg. *Supra*. Page 12.

[23] *McClurg v. Canada, [1990] 3 S.C.R. 1020.*

[24] *Neuman v. M.N.R., [1998] 1 S.C.R. 770.*

[25] Rochwerg. *Supra*. Page 13.

[26] Don Goodison. “Owner Manager Remuneration, Part 2.” Chartered Professional Accountants Canada. November 2003. <https://www.cga-pdnet.org/Non_VerifiableProducts/ArticlePublication/OwnerManagerRemuneration/OwnerManagerRemuneration_p2.pdf>. Accessed August 10, 2016.

[27] Canada Revenue Agency. *What is the deduction limit?* January 5, 2016. <http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns248-260/254/lmt-eng.html>. Accessed August 11, 2016.

[28] Goodison. *Supra*. Page 4.

[29] Chow. *Supra*. Page 139-140.

[30] David Louis. *Implementing Estate Freezes*. CCH (Toronto: 2011). Page 3.

[31] *Ibid*. Page 4-8.

[32] Ontario Ministry of Finance. “Estate Administration Tax” <http://www.fin.gov.on.ca/en/tax/eat/>. Accessed August 13, 2016.

[33] Chow. *Supra*. Page 360.

10. Author Information

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11. Bibliographical Information

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