Taxation

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The Family Trust: a Tax Planning Tool

By Pascale Blanchet

Many options are available to a private corporation shareholder as to the method of holding his or her shares (corporation, partnership, trust). Each method brings about different tax consequences that have an influence on the choice of the appropriate vehicle. The following summarizes several tax benefits stemming from the holding of shares of a private corporation through a family trust.

In General

For tax purposes, a trust is, as a general rule, an entity that is distinct from its beneficiaries. The income earned by a properly structure trust is taxed either in the trust or in the hands of the beneficiaries. When income is taxed in a trust in any given tax year, it becomes capital for subsequent years and may then be distributed tax free to the beneficiaries. Testamentary trusts benefit from progressive tax rates applicable to individuals whereas inter-vivos trusts are subject to the maximum tax rate applicable to individuals. Family trusts, the subject of the present text, constitute inter-vivos trusts as they are created while the trust settlor is still alive.

Benefits

Splitting income

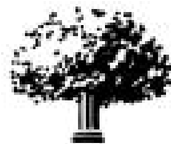
A well-structured family trust allows for splitting the income earned by the trust among the various beneficiaries. Such an income split is effective to the extent that the tax rate of the person who would otherwise larn the income directly is higher than that of the beneficiaries of the trust.

The beneficiaries of a family trust are generally the individual who would otherwise hold the shares directly, his or her spouse and children, the latter generally benefiting from a low tax rate.

It is appropriate to note that dividends from private corporations attributed by a trust to a minor child are subject to income tax on the split income at the highest marginal rate applicable to individuals. Interest and capital gains earned by the trust are not subject to this rule. It is therefore preferable to first attribute this type of income to minor children and to pay dividends to the other beneficiaries. Some types of planning involving a family trust also allow for minimizing tax on dividends paid to minor children.

Reducing taxes at death

At his or her death, an individual is deemed to have disposed of his or her assets, including his or her shares in a private corporation, for proceeds of disposition equal to the fair market value of such property[1]. Any appreciation in the value of the shares is taxed at a rate of approximately 25% (that is, the inclusion of 50% of the capital gain taxable at a rate of approximately 50%), which may represent a significant amount. Holding shares of a private corporation through a family trust may help attenuate the deemed disposition at death rule.



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[1] Excluding assets transferred to the spouse or to a spousal trust.

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Similarly, it is appropriate to note that shares held in a discretionary trust are generally protected against potential claims as the rights of beneficiaries as creditors against the trust are usually of no value.

Exemption for capital gains

Another significant benefit of using a trust is the multiplication of the $500,000 exemption for capital gains. Where the trust has been holding shares of a private corporation for more than 24 months and these shares qualify as "qualified small business corporation shares" (QSBCS), it is possible for the trustees to attribute to each of the beneficiaries a portion of the capital gain realized upon the disposition of such shares and thus allow each beneficiary to receive up to $500,000 in tax-free capital gains (before the application of minimum tax).

Business transfer

We emphasize that the flexibility afforded by using a trust allows for determining the opportune time to deliver the shares of the corporation to the children. The shares held by the trust can be attributed or not to the children depending on their role in the business and their respective professional objectives.

Recommendation

Any individual who wants to set up a corporate structure that involves a family trust should evaluate all the tax consequences, particularly the attribution rules and the deemed disposition of the trust's property every 21 years. A tax advisor can help you make the appropriate choices according to your goals and those of your loved ones.

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