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TAX AND ESTATE PLANNING BENEFITS OF FAMILY TRUSTS FOR BUSINESS OWNERS

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Wealthy families have been using family trusts to reduce their taxes, preserve their wealth and transition it to the next generation for years.

Family trusts can arise upon death (testamentary trusts) or can be inter vivos (used while alive). In both cases they can provide significant tax benefits for families that establish them. Here we are going to explore the tax benefits of inter vivos family trusts.

The Three Main Parties to a Trust

Any trust, including a family trust, requires three main parties. These include a settlor, trustee(s) and beneficiaries.

The settlor is the person who establishes the trust and contributes the first asset. A trust can be established with a nominal contribution such as $100.

– The trustee is the person who manages and administers the assets of the trust on behalf of and for the benefit of the beneficiary.
– The beneficiary is the person who benefits from the income and capital of the trust.
– The roles of the settlor, the trustee and the beneficiary are stipulated in the trust deed.

Tax Benefits of Family Trusts

A family trust can be used for the following purposes:

Passing on a business to the next generation in a fair manner.

Income splitting by paying dividends to each of the children of the business owner, as well as to the business owner.
Ensuring that the business owner maintains control over the business until the children are ready to run the business.

Protecting the interest of each child in the business from future potential claims by creditors as well as potential spousal claims.

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Effecting an estate freeze by locking in the tax liability on the growth of the business at the time the estate freeze is implemented and transferring the future growth to the children of the business owner.

Role of the Family Trust in an Estate Freeze

An estate freeze can be done with or without a family trust. However, using a family trust, can help ensure a fair distribution of business assets, provide an opportunity for the business owner to split dividend income with the children, and protect the children’s interest from future spousal or creditor claims (especially if the trust is fully discretionary).

In an estate freeze using a family trust, typically there is an operating company that is owned by a holding company (usually a numbered company). All common shares of the holding company are owned by the family trust.

The business owner will own 100% of the voting preferred shares of the holding company, which allows him/her to retain control of the business. This will also transfer future growth of the business to their children. The children will be the beneficiaries of the family trust, with the business owner acting as trustee. If the trust is fully discretionary, the business owner can retain control of the business and make decisions about business operations and declaration of dividends, as well as the allocation and distribution of income to the children.

This can be especially valuable if one or more of the adult children have no other sources of income, as the business owner can pay them tax-free dividends. Assuming that the child has no other income or deductions other than the basic personal amount and dividend tax credit, these tax-free dividends could range from $14,360 in PEI to $33,305 in Ontario.

Another benefit of doing an estate freeze by using a family trust is that the future growth of the business will be attributed to the common shares held by the family trust. This will allow the lifetime capital gains exemption of each of the beneficiaries to be used to shelter future capital gains from taxation.

Using the Family Trust for Tax Smart Investing

If the business owner has minor children and has accumulated cash in a non-registered portfolio, he/she can establish a family trust and be the trustee of the trust and name his minor children and his/her spouse as equal beneficiaries of the family trust. Then he can lend money to the trust through a prescribed-rate loan. The trust can then invest the cash proceeds of the loan in a balanced portfolio.

The trust must pay the annual interest on the loan to the business owner no later than January 30th of the year following the year the interest accrued. As of June 30th 2017, the interest rate on prescribed loans was only 1% per year. Therefore, as long as the balanced portfolio can earn more than 1% per year this strategy can be beneficial for saving taxes.

The business owner must claim the prescribed-rate loan interest as taxable income on his tax return. The interest payment is deductible from the family trust’s income and the net income can be allocated or paid to the beneficiaries. This will result in the income being taxed in the hands of the beneficiaries with little or no taxes payable. Since in this case the beneficiaries of the trust are all minor, by using the family trust structure and lending the money necessary for investment directly to the trust, the income and capital gains earned on the invested funds are not attributed back to the business owner, resulting in significant tax savings.

If the business owner were to earn the portfolio returns directly his taxes would likely be significantly higher as he is in a much higher tax bracket than his minor children (who may earn little or no income). Most probably over time, the taxable returns on the balanced portfolio would be higher than the 1% interest rate on the prescribed loan.

This strategy also allows the business owner to retain control of the assets, make the investment decisions and determine the allocation and distribution of income to the beneficiaries of the trust.

Consultation Paper Released on July 18, 2017 and Possible Impact on Family Trusts

Federal Budget 2017 indicated that several tax planning strategies related to private corporations would be reviewed. Also, the proposed tax measures released on July 18th 2017, by the Department of Finance containing draft legislation amending the Income Tax Act to address tax planning measures commonly used by owners of private corporations, included changes that would directly affect tax planning using family trusts including:

– Income sprinkling – the payment of dividends from a private corporation to shareholders who are family members of the original owners.

– Holding of a passive investment portfolio within a private corporation.

Therefore, any type of legislative changes with regards to the above two strategies would affect the tax planning strategies discussed in this article and need to be taken into account before considering these strategies.

A family trust can be a valuable tax planning tool for wealthy families and business owners to reduce their taxes and achieve their succession planning and estate planning objectives. Implementing tax planning strategies using family trusts can be complicated and you should discuss your options with your tax and financial planning advisors to determine their suitability for your individual circumstances.

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