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TAX PLANNING AND THE FAMILY TRUST

INTRODUCTION

Under current income tax legislation, it is difficult to reduce income tax liabilities within a family group via techniques commonly referred to as “income splitting”. Income splitting attempts to ensure that income earned within a family is evenly distributed for income tax purposes so that by ensuring that tax benefits allowable for each family member are utilized (i.e., low tax brackets, personal tax credits, capital gains deduction), the family’s overall tax burden can be reduced. One of the few methods of income splitting still available is through a family trust arrangement. Although the effectiveness of income splitting via a family trust was significantly reduced by the introduction of the so called "Kiddie Tax" in the 1998 Federal Budget, important tax savings may still be generated via a family trust. Details are discussed below.

WHAT IS A FAMILY TRUST?

A family trust, in this context, is an arrangement whereby an individual may allow family members to share in the growth and value of an incorporated active business without that individual losing control over the operations of the business. In the typical situation, an individual (the “trustee” of the family trust), will hold property (shares of the active corporation) “in trust” for the benefit of family members (the beneficiaries of the trust). Although title to the property is in the trustee’s name and the property (the active corporation’s shares) are under the trustee’s control, the income and capital growth attributable to the shares accrues to the beneficiaries. To the extent that income earned by the trust is paid to its beneficiaries, the income is taxed in the beneficiaries’ hands. Where these beneficiaries earn little of no other income and are not subject to the "Kiddie Tax", they may pay little or no income tax on those distributions. Note, that a typical family trust agreement is drafted so that the trustee may pay that income out to, or for the benefit of, any or all beneficiaries at his discretion as he sees fit. In that way, future problems associated with issuing shares directly to children may be avoided.

A family trust is established when a person referred to as the settlor (usually a relative) gives a gift to the trustee for the benefit of (usually) other family members. At the same time, a written agreement is drafted which sets out the terms whereby the trustee will hold and manage the property on behalf of the beneficiaries. As it is this agreement which gives the trustee the power to distribute funds from the trust at his discretion, the trust agreement is a critical part of any family trust arrangement.

Example of the Operation of A Family Trust

Scenario 1: Income Splitting

Mr. X establishes a trust for the benefit of himself, his spouse, Mrs. X, and their three children, A, B and C. A and B are over 17 years of age and attending university. C is a minor living at home.

The participating shares of Opco, Mr. X's active business corporation, are owned 100% by the trust.

After salaries are paid to Mr. X, Opco is earning $100,000 before tax and $82,000 after tax.

Based on current tax rates, if Mr. X wishes to pay out the net after corporate tax income of $82,000 to himself to enable him to use it personally, he would pay additional taxes of over $26,000 if he were the sole shareholder of the company.

Using the family trust arrangement and paying the income earned by the trust equally to the adult beneficiaries (except Mr. X.), the trust's dividend could be split evenly between Mrs. X, A, and B. The tax liability on the dividend would thus be taxed as follows:

	Mr. X	Mrs. X	A	B	Total
Dividend		$27,334	$27,333	$27,333	$82,000
Tax liability*	-	–	–	–	-

* Assumes that Mrs. X, A, and B have no other sources of income.

Note, that dividends allocated to the minor child would be subject to tax at top marginal rates with no personal tax credits applicable, pursuant to the "Kiddie Tax" provisions.

By using a family trust arrangement, Mr. X has just saved the family unit about $26,000 in tax.

Scenario 2: Capital Gains Splitting

Mr. X has received an offer to sell the shares of Opco (which are "qualified small business corporation shares") for $2,000,000. The shares were acquired for a nominal amount ($100). If Mr. X were to receive the sale proceeds as sole shareholder of the business, his tax liability might be computed as follows:

Proceeds	$ 2,000,000
Cost	(100)
Capital Gain	1,999,900
Capital Gains Exemption	(500,000)
Capital Gains Subject to Tax	$ 1,499,900
Taxable Capital Gain	$ 749,950
Tax	$ 328,000

Under the family trust arrangement, the trust would receive the total $2,000,000 proceeds. The trust's capital gain could be paid out to trust's beneficiaries (if desired by the trustee) and the beneficiaries could shelter the gain with their own $500,000 capital gains exemptions. In this case up to the entire $328,000 in tax calculated above could potentially be saved (subject to alternative minimum tax considerations).

Note that this benefit can be achieved even if the beneficiary is a minor child, since the "Kiddie Tax" does not apply to capital gains.

Any trust income not actually paid or payable to a specific beneficiary in a given year would be taxable in the trust at the highest marginal tax bracket (thus eliminating the benefits of using the trust).

Amounts will be paid or payable to a beneficiary in the year under the following scenarios:

1. An expense report detailing the year's expenses incurred by the parent on behalf of a beneficiary is submitted by the parent to the trustee. The trustee initials the report to evidence the exercise of his discretion pursuant to the terms of the trust agreement, and a trust cheque is issued to the parent before the end of the year.

2. The parent requests the trustee in writing to make certain payments to a third party for the benefit of the beneficiary. The trustee initials the written request to evidence the exercise of his discretion and makes the payments to the third party before the end of the year.

3. The trustee declares an income distribution using a trustee's minute and either issues a trust cheque payable to the beneficiary before the end of the year, or issues a demand promissory note to the beneficiary as evidence of payment before the end of the year.

4. Where the amount of trust income earned is not known in the year (e.g., where a trust owns units in a mutual fund trust) the trustee resolves to make an income distribution to a beneficiary equal to a certain percentage of the undistributed income earned by the trust in the year using a trustee's minute, and issues a demand promissory note to the beneficiary as evidence of payment before the end of the year.

Under the most recent guidelines released by Canada Revenue Agency, the trust can pay for, or reimburse a wide variety of expenses for a child as long as the payment of the expense clearly benefits the child. Such expenses may include (but are not necessarily limited to):

- Education and tuition expenses
- Recreation expenses and equipment
- The child's share of restaurant meals and family grocery bills
- Clothing
- Medical and dental expenses
- Spending allowances
- Toys
- Car expenses, including per kilometre reimbursements for driving to and from the child's activities
- A proportionate share of vacation costs

Asset purchases (e.g., cars, boats, vacation properties) and mortgage payments which cannot or will not be legally registered in a child's name are problematic and we generally suggest that they not be reimbursed by the trust.

In all cases, receipts should be retained that document the fact that trust funds were spent on the beneficiary's behalf.

ADDITIONAL CONSIDERATIONS

1. The income attribution rules of the Income Tax Act must be carefully considered in structuring a family trust. These rules can cause income earned by a taxpayer to be taxed in the hands of another (thus potentially eliminating the advantages of establishing the trust). For example, the trust must purchase shares of the operating company at fair market value in order for dividends to be paid to the trust. If cash is gifted by the settlor of the trust to establish the trust and that cash is used to purchase the company's shares, the income earned by the trust may be attributed to the settlor (unless the settlor is a non-resident of Canada). To avoid this situation, it is preferable that an arm's length party loan the trust the cash to purchase the company's shares. The loan (which can often be a nominal amount) would bear interest and would be repaid (together with interest) shortly after the purchase of shares from the dividends earned by the trust. This type of arrangement should normally successfully avoid the income attribution rules.

2. As a general rule, the family trust arrangement will work best where the trust purchases shares of a "small business corporation" which carries on an active business in Canada. Several anti-avoidance rules in place in the Income Tax Act make it difficult (if not impossible) to advantageously structure a family trust arrangement where the family trust holds shares of a non small business corporation unless the trust is set up solely for the benefit of <u>adult</u> children.

SUMMARY

The foregoing is only a brief overview of the benefits and mechanics of utilizing a family trust in income tax planning. The use of competent professional advisors in establishing and maintaining a family trust is mandatory if the many pitfalls associated with this complex form of tax planning are to be avoided.

Revised 06/2006