Tax and estate planning with family trusts

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What is a trust?

A trust is a relationship between three parties. A trust is created by an individual (the settlor or testator) through a trust deed or Will, whereby a trustee is appointed to administer the trust for the benefit of the beneficiaries. There are two basic types of trusts: a testamentary trust is established in a testator's Will and comes into effect as a result of their death; inter vivos trusts take effect during the trust creator's (settlor's) lifetime. This article focuses on income splitting using an inter vivos trusts "family trust".

What is income splitting?

Income splitting in this context involves reducing a family's overall tax burden. This is accomplished via a strategy that allows high-income earners to split income with family members (spouse, children, grandchildren; nieces and nephews may also qualify) who earn little or no income. By taking advantage of basic personal exemptions and graduated taxation rates, the overall family tax burden is less than what would be payable if the full amount were taxed in the hands of the high-income earner.

What is a "family trust" and why is it needed?

Where all of the beneficiaries of an inter vivos trust are family members, the trust is commonly referred to as a "family trust". Properly structured, the trust is essentially the means by which income can be paid or allocated to, and taxed in the hands of, family members, including minors. However, in order to achieve the desired income splitting, care must be taken in order to avoid the income attribution rules.

What are the "income attribution rules"?

These are a set of rules in the Income Tax Act which can cause any income realized on property transferred directly or via a trust to another taxpayer to be assigned back to the transferor, thereby thwarting efforts to split income. At a high level the rules cause income and capital gains to be assigned back to the transferor when the transferee is the spouse. Where the transferee is a minor child, income, but not capital gains, is attributed back.

How does the income splitting work?

Cash or assets are loaned by the high-income earner to a trust established for the benefit of family members. The loaned funds are invested; any income earned in excess of the "prescribed" interest rate is taxed in the hands of the designated family members.

In order to avoid the income attribution rules, the trust must be properly structured, an appropriate trustee selected and all relevant rules and procedures followed. For example:.

- the loan must bear interest of at least the "prescribed rate" – a rate set by the government every three months
- the prescribed rate of interest must actually be paid to the lender each year within the required time frame (byJanuary 30th of the following year)
- only income paid to, or applied for the benefit of, the family members may be taxed in their hands
- all requisite tax reporting and filings must be made

Note: Where the plan involves the transfer of shares of a Canadian Controlled Private Corporation (CCPC), the effects of the "kiddie tax" must be considered. This issue is beyond the scope of this article.

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What is the role of the trustee?

The trustee is responsible for carrying out the terms of the trust. Because the income attribution rules cast a wide net, the choice of trustee for a family trust is critically important. The lender is generally not an appropriate choice as trustee as this may cause the subsection 75(2) attribution rule to apply. The rule applies where the lender is either sole trustee or one of several trustees and the trust dictates decisions are to be made unanimously, or he or she is given a veto power. The rule also applies in situations where the transferred property may revert to the lender or where the lender has the right to designate who may receive the property.

The trustee is ultimately responsible for ensuring the terms of the trust and all rules and procedures are followed and properly documented. Appointing a trustee with the appropriate expertise can help ensure the trust is properly executed and the desired results obtained.

Conclusion

Trusts are a valuable estate planning tool and can be used to achieve a variety of objectives, including income splitting among family members. Trust and tax laws are complex and as at the time of writing this article are in flux. Appropriate professional advice should be sought to determine whether a trust makes sense for you and your family.

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