The TaxLetter®

Vol. 31, No. 9 Your Guide to Tax-Saving Strategies September 2013

TAXMATTERS

The key to estate and tax planning is understanding the…

Anatomy of a family trust

Samantha Prasad LL.B.

Last month I wrote about the demise of the one per cent prescribed rate for income splitting strategies.

You may remember that I discussed the need for a discretionary family trust as a tool for the prescribed loan strategy with minor children.

It occurred to me that some readers may be curious about what a discretionary family trust is all about. How are they formed? And how do they work?

To answer these questions, I thought it would be worthwhile to go through the "ABCs" of a discretionary family trust, an important tool in estate and tax planning. And I'll get into some of the tax planning tips and traps to be aware of when forming a family trust.

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

Beneficiaries – who are they?

A typical family trust is drafted as a discretionary trust for the benefit of a class of beneficiaries. That could include yourself (although there are some tax issues to keep in mind which are discussed below), your spouse and your children.

People often include an additional class of beneficiaries, such as other family members or registered charities. These secondary beneficiaries would typically kick in if the primary beneficiaries were no longer alive.

One tax planning tool I use is to also allow for a corporate beneficiary – this could include a corporation in which the shares are owned by any one or more of the primary beneficiaries.

The use of a corporate beneficiary allows for some tax planning on the eventual distribution out of the trust; for example, if a beneficiary becomes a non-resident of Canada (see below).

If you want to set up a family trust and transfer property to the trust, then you cannot be a beneficiary. There is an attribution rule under the Tax Act which would be triggered if property that is transferred to the trust could potentially revert back to you, the transferor, by virtue of you being a beneficiary of the trust.

This attribution rule will also apply if the transferor is able to determine how the trust property is to be distributed (i.e., if you are the sole trustee or have a veto power as a trustee).

It's important to ensure that the flow of funds matches the trustees' decisions

And to make matters worse, if this attribution rule is triggered at any moment in time (even if it's cured after it has applied), a second tax rule jumps in to prevent the ability to distribute the capital of the trust to a beneficiary without triggering capital gains tax.

There are, of course, certain ways to get around this rule. For example, case law has held that if you were to lend money or sell property to the Trust at fair market value, then the attribution rule will not apply.

A second event that could trigger capital gains tax on a distribution of capital out of a family trust is if the beneficiary is no longer a Canadian resident.

The general rule is that distributions of capital out of a family trust will not trigger any tax provided that the beneficiary receiving the distribution is a resident of Canada at that time.

These days, however, what with kids going to school in the U.S. and staying south of the border, this problem can arise more often than not.

Hence, the use of a corporate beneficiary will allow you to get around this problem: simply incorporate a Canadian resident company of which the non-resident kid is a shareholder, and distribute the trust capital to the company.

I should add that it will be important for the U.S. resident child to get proper U.S. tax advice, just in case the IRS has other ideas.

Trustees - Who should they be?

The choice of trustees is usually a personal decision. This is due to the fact that trustees, who hold the trust property on behalf of the beneficiaries, will have a fairly active role in managing the trust property and determining distributions.

A discretionary trust typically gives the trustees "absolute discretion" when it comes to distributions to the beneficiaries.

They can determine when distributions are to be made, and to whom – including favouring any one beneficiary to the exclusion of the others. So choose your trustees wisely.

I would also typically recommend that three trustees be appointed. It may be that you want to transfer property to the trust; if so, in order to avoid that attribution rule discussed above, you should be one of three trustees in making any decisions regarding the distribution of that transferred property.

If you are one of only two trustees, then arguably you have a negative veto (since majority rule is required).

Although CanRev has provided some administrative largess in cases where there are just two trustees, it's better to be prudent and ensure you are one of three so there is no uncertainty.

And to the extent that the trustees make any decisions regarding the trust property or distributions, it is important that they document those decisions in writing.

In addition, if any income or funds are distributed out of the trust to the beneficiaries, the trustees must ensure that the funds are actually paid out to the appropriate beneficiaries, and not scooped by the parents.

This is an issue that has apparently been targeted by the CRA on audits, so it's important to ensure that the flow of funds matches the trustees' decisions.

Is the Trust Properly Formed?

The "settlor" plays an important role in establishing the family trust. He or she formally establishes the trust by "settling" the trust with property (i.e., cash or a gold coin has been typically used).

It is important that this property, known as the "settlement instrument," be properly held on to by the trustees. CanRev has been known to ask for proof of the initial instrument's existence – one tip might be to tape or attach the settlement instrument to the original trust agreement so it doesn't get lost.

But the settlor's role is not as simple as handing over a gold coin. He or she must actually have the intention to form the trust, and should understand the terms of the trust agreement.

The settlor cannot be a beneficiary of the trust, or else the attribution rule discussed above will kick in.

However, he or she should be the person who instructs the advisor preparing the trust deed, or at the very least (as that may not always be practical), review and confirm the terms of the trust prior to its finalization and execution.

The settlor's role also includes the confirmation of the trustees, so they should not always be a choice of convenience.

Once the settlor has formally created the trust deed, his or her role is generally done. The settlor has no ongoing duties in respect of the Trust – that is the trustees' duty.

Tax Considerations

The various roles discussed above are not the only considerations when establishing a family trust. Tax planning is also very important when drafting the trust agreement.

As well as the attribution rules I've already mentioned, there are some additional regulations which may apply in certain circumstances. For example, if you transfer or gift property to the trust for no consideration, and that property produces income. In this situation, any such income that is to be allocated to your spouse or your minor kids could be attributed back to you.

There are exceptions to the application of these attribution rules, such as the prescribed loan strategy that I have written about before, or ensuring that the trust agreement contains the appropriate anti-attribution clause (the latter would prevent distributions of income and capital to your spouse or minor child).

It is important to speak to your tax advisor to ensure that the proper steps are taken or included in the trust agreement at the time the trust is formed.

I would highly recommend that you speak to your advisor before you finalize the trust agreement, because is very difficult to amend a trust agreement. And, in some instances, simply fixing the problem after the fact won't save you from a tax problem.

Finally, an important tax rule to remember with family trust: they only have a tax shelf life of 21 years. That's because under the Tax Act, a discretionary family trust is deemed to have sold all of its assets on its 21st anniversary (and every 21st anniversary thereafter).

This means that if the trust owns assets with a large pregnant gain, it could be stuck with a huge tax bill if nothing is done. So the rule of thumb with discretionary family trusts: ensure that the trustees distribute the trust capital to the beneficiaries just prior to the trust's 21st birthday. ❒