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#### Tags

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## The Use of Family Trusts by Business Owners



This article provides an overview of various planning matters related to the use of a family trust in the ownership of a business. Some popular benefits of a family trust include:

- control without ownership
- creditor-proofing
- annual reduction in total income taxes
- multiplying the lifetime capital gains exemption to reduce income taxes
- delay of taxation on death

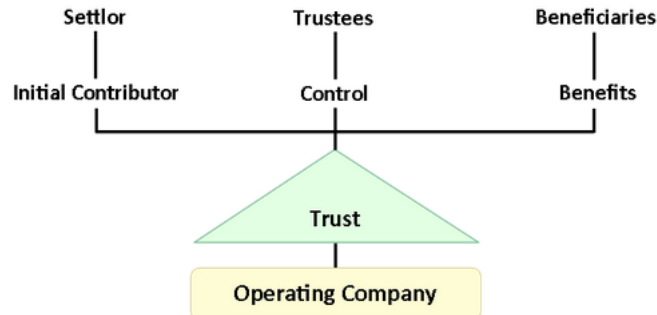
# Nature of a Trust

A trust is a relationship between trustees and beneficiaries in respect of specific property. The Income Tax Act treats a trust as a separate legal entity for tax purposes.

A trust is established when a person (the settlor) transfers property to the control of trustees to hold for the benefit of one or more beneficiaries. The trustees are responsible for the custodianship of the trust property and have an ongoing obligation to administer the trust in accordance with its terms. A trust's beneficiaries are the people who will eventually receive its income and capital. The trustees must act in the best interest of the beneficiaries, whose rights are defined by the trust's terms.

## ➤ Basic Structure

The basic ownership structure of a family trust that owns a business would be as follows:



The settlor would settle the trust, usually for a nominal fee of \$10, or an item such as a gold coin. Once the settlor has settled the trust, they should have no further involvement. The settlor could be anyone, but should not be a beneficiary. Trusted family advisors, such as accountants, lawyers or financial advisors often serve in the role of settlor.

Generally, one or three trustees would act as a group to control the trust. Decisions are usually based on the majority vote of the trustees, which is why you would normally avoid having two trustees. Most often, the trustees are family members who are familiar with the business or with the family members involved in the business. A family lawyer or advisor could also be a trustee.

The trust agreement should name all persons who would potentially benefit from the assets of the trust as beneficiaries. Generally stated, there is no downside for including more beneficiaries as opposed to fewer because of the discretionary ability of the trustees to exclude specific beneficiaries in the future. Usually, the potential beneficiaries are specifically identified; however, they could also include future children or grandchildren.

## Corporations as Beneficiaries

A corporation can also be included as a beneficiary of a trust. Any profits of an operating company can be paid to the family trust and then out to the corporate beneficiary. This has several advantages:

- It allows the operating company to eliminate its excess cash to enable it to qualify for the lifetime capital gains exemption in the event of the sale of the operating company. The exemption for 2021 is \$892,218, but is indexed to inflation.
- It provides a structure to defer taxes on dividends not required by individual shareholders. Normally, no additional net tax is payable on the dividend allocated to the corporate beneficiary.
- It provides additional creditor proofing by limiting excess cash in the operating company exposed to a business' inherent risks from its operating activities.

A discretionary trust exists when the settlor gives discretionary decision-making rights to the trustees, rather than defining all of the specific rules related to the operation of the trust in the trust agreement. This discretionary power enables the trustees to make decisions related to the allocation of future income and/or capital to the beneficiaries.





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### **Mechanics of Setup**

As mentioned earlier, a settlor is required to start the trust, typically by gifting an asset such as a gold coin or a \$10 bill. This gift amount is segregated from all other assets of the trust and must never be used to purchase investments or property.

The trust would normally borrow money from either a bank or other party, with interest, to provide the cash necessary to buy the shares of an incorporated family business.

### Potential Benefits Available

The benefits achieved by using a family trust include:

#### a) Control Without Ownership

In a typical family situation, the parent(s) may wish to control the ownership of the operating company, but want the future benefits to go to all family members. This could be accomplished by structuring the ownership, whereby the parent(s) would own the voting shares of the operating company and therefore control it, and the value shares would be owned by the trust.

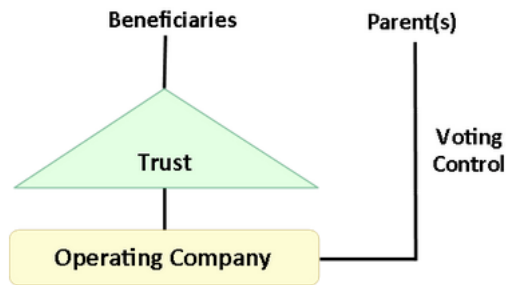
It is important to properly structure the initial settlement, the initial money lent to the trust, and the initial purchase of the company shares. The Canada Revenue Agency (CRA) expects any transfer of value from existing shareholders to family members through the trust to be done at fair market value. In addition, the Income Tax Act contains an extremely complex set of rules whereby income earned from property may be attributed to and taxed in someone else's hands or taxed at the highest rates of income tax

### **The structure would look as follows:**

In such a situation, the parent(s) could be in charge of all decision-making by owning the voting shares. In addition, a parent may be one of the trustees and participate in the decision-making on the eventual distribution of income and capital to the beneficiaries. A parent may also be a beneficiary.

#### **b) Creditor Proofing**

Litigation against individuals comes from many sources, both new and old, including personal guarantees of debts and family



law litigation from former spouses. A discretionary family trust can provide some protection to its beneficiaries. In a discretionary trust, the beneficiaries can be considered to have no direct benefit of ownership of the trust's assets. Therefore, the discretionary interest has no value for creditors. In a worst-case scenario, the beneficiary could declare bankruptcy, while maintaining a discretionary interest in the ownership and value of the assets of the trust.

#### **c) Annual Reduction in Income Taxes**

Another element of tax minimization for a family is to try to allocate income to family members in a lower marginal tax bracket than the

higher income earners. Subject to limitations placed by the complex Tax on Split Income ("TOSI") rules (further discussed below), spouses and adult children in lower income tax brackets may be eligible to receive income from the company. Their ownership of the shares of the company through the trust may allow these individuals to receive dividends to utilize their lower rates of tax and personal credits, including the dividend tax credit.

#### **d) Delaying Taxation on Death**

Upon an individual's death, they are deemed to have disposed of all of their assets at fair market value. Taxes may result from those dispositions. The assets may instead be transferred to a surviving spouse, thereby delaying the taxation until the death of that spouse.

When a family trust owns shares of an operating company, the death of an individual does not create a tax liability, because no individual has ownership of the trust's assets. The individual that died has no value in the company's shares held through the trust, unless they are the last beneficiary of the trust.

#### **e) Multiplying the Lifetime Capital Gains Exemption**

Under Canadian tax law, a lifetime capital gains exemption is available to individuals who sell shares of a Canadian-controlled company that carries on a private active business. If one individual owns the shares, the maximum exemption for 2021 is \$892,218 (and indexed to inflation). If a trust owns the shares and there are numerous discretionary beneficiaries, the exemption amount can be multiplied by the number of discretionary beneficiaries by allocating and paying the gain on the sale to each of those beneficiaries. The potential tax savings to a family could be as high as 26.7% of the exemption amount (in Ontario) for each additional exemption generated.

## Potential Issues with Trusts

#### **a) TOSI**

This special tax is computed at the highest marginal tax rate on certain types of income received directly by or through a trust, including:

- Income or dividends received or allocated to children under 18 years old;
- Taxable dividends, excluding dividends from public companies;
- Business income derived from providing goods or services to businesses owned by a person related to the beneficiary;
- Rental income where a related person is involved;
- Interest income from loans provided to a private corporation, partnership or other trust; and
- Income or gains from dispositions of assets or property associated with any of the above, unless it is a gain from the disposition of qualified farm or fishing property or qualified small business corporation shares.

#### **b) Creating Associated Companies**

If the shares of an operating company are owned by a discretionary family trust, each beneficiary is deemed to own 100% of the shares owned by the trust. If beneficiaries have companies of their own, being a beneficiary of a trust may cause the operating companies to be associated for income tax purposes. This may impact several provisions for small businesses, including small business deductions.

#### **c) United States Citizens**

United States citizens living in Canada may have reporting requirements as a beneficiary of a Canadian trust. There may also be U.S. taxes payable by a U.S. citizen or Green Card holder, depending on the activities carried on by the Canadian company.

#### **d) Non-Resident Beneficiaries**

There are complications that can be very technical depending on the country of residence if some of the beneficiaries are not

residents of Canada. Many trust agreements include a clause that beneficiaries cannot receive income or capital from the trust while they are non-residents.



## Your Guide to Estate Planning

This guide provides an overview of the things you should consider when making an estate plan including tax strategies and dual wills for business owners.

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## Taxation of a Family Trust

### ***a) Annual Income***

Since inter vivos trusts (“living trusts” – trusts that are not created on the death of a person) are taxed at the top personal tax rate, the income of the trust is usually paid out (or allocated) to the beneficiaries. Income paid to a beneficiary is deductible to the trust and taxable to the beneficiary. As such, an inter vivos trust usually has no taxable income.

### ***b) Twenty-One Year Disposition***

Every 21 years there is a deemed sale of assets in most family trusts. This deemed sale, and resulting tax within the trust, could be avoided by distributing the assets of the trust to the beneficiaries prior to the deemed disposition, thereby deferring the tax until the beneficiaries sell the assets. In situations where control of the assets must remain in the trust beyond 21 years, many planning strategies can be implemented.

### ***c) Canada Revenue Agency Filings***

A family trust must have a December 31st year-end and must file a tax return (T3). The tax return is due 90 days after the year-end, which would be March 31, or March 30 in a leap year.

### ***Payment of Income to Beneficiaries***

The majority of the tax benefits related to the use of discretionary trusts are from paying the income that would otherwise be taxable in the trust to beneficiaries. Under the rules of the Income Tax Act, the income must be paid or payable to the beneficiaries as of December 31st of the year, so the income is taxed in the beneficiaries’ hands rather than in the trust.

An amount is not considered payable to a beneficiary in the taxation year unless the beneficiary was entitled in the year to enforce payment thereof. To be payable to a beneficiary, the amount must “vest” with the individual.

The CRA interprets the words “to vest” as meaning to give an immediate, fixed right of present and future possession as distinguished from a contingent right. It is advisable for trustees to document the fact that the income is being made payable to a beneficiary. This can be done by way of minutes of a meeting of the trustees, of which a copy could be acknowledged by the beneficiary or the guardian of the beneficiary, or by issuing a promissory note payable on demand in an amount equal to the income that has become payable.



It may be difficult for the trustees to determine what income may be payable at year-end in situations where the trust has not received all reporting information as of December 31 (such as a mutual fund). The trustees may declare all trust income payable and issue a promissory note for an estimated amount, with an adjustment clause.

To ensure the taxation of income lies with the individual beneficiary, the trustees should make the payment prior to December 31st. However, if payment cannot be made, documentation should be put in place to enforce the amount payable to the beneficiary.

The trust can pay a beneficiary's expenses directly from the trust preferably by way of a trustee's cheque, written on a trust bank account, or by using the credit card for the trust. Receipts should be maintained for all expenses. Also, parents may be reimbursed from the trust for expenses they incur on behalf of the beneficiaries. Copies of these receipts should be maintained with the trust accounts.

Where family trusts are utilized, and amounts are payable to children:

- The amounts must be used for the benefit of the children.
- Any amounts paid to the children will reduce the amount owing to them.
- The amounts received by the children from the family trust could be used to pay certain expenses, which would otherwise have been paid by the parents.

## Maintaining Proper Books and Records

It is critical that a family trust maintain proper books and records:

- Bank statements should be retained for the trust, along with returned cheques.
- Proper resolutions should be prepared and kept on hand to document decisions relating to the trust.
- An electronic accounting file should be maintained. This will help in the event of an audit of the trust by the CRA.

[Click here for details on trust reporting requirements.](#)

## Summary

Using family trusts for owning a business offers many benefits; however, the process requires proper planning and proper ongoing maintenance.

We would be pleased to offer our expertise to help ensure all the necessary steps are taken to set up your family trust.

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