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TAX LETTER

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THE BENEFITS OF ESTABLISHING A FAMILY TRUST

Estate planning is an important consideration for all individuals, irrespective of their level of wealth. Poor planning, or no planning, can result in an excessive proportion of your estate being lost when you die, in the form of either probate fees or taxes, or both.

Luckily, there is a wealth of information available in relation to estate planning, and the various strategies which can be used to ensure that as much of your wealth as possible passes to your beneficiaries when you die (and sometimes before you die). One very common strategy is the use of a family trust.

A trust is essentially a relationship created between various individuals whereby a person (the settlor) contributes assets to the trust, which is managed by one or more separate persons (the trustees) for the benefit of current or future recipients of the assets (the beneficiaries).

By setting up this relationship, the settlor arranges for the passing of his or her assets to the ultimate beneficiaries, either immediately or at some designated time in the future.

Once the assets are passed to the trust, they are usually no longer considered to belong to the settlor and will not form part of their estate when they die. Instead, the assets are legally owned by the trustees and "beneficially" owned by the beneficiaries.

Non-tax benefits

It is generally not advisable to establish a trust solely for the tax benefits which may become available. Thankfully, there are a number of significant non-tax benefits which may take precedence over the purely tax benefits, making the possible tax savings a nice add-on benefit.

For example, a parent may wish to pass assets to a child who is not currently in an appropriate position in life to receive the full value of the assets. This could be due to the child's young age, as a result of a disability, poor spending habits, or a number of other reasons. By transferring the assets to a trust instead, the assets can be managed by trustees until they determine that the time is right to pass value to that beneficiary.

Contributing assets to a trust also creates a great deal of flexibility when it comes to making a decision as to who will eventually benefit from the assets, and in what proportion.

For example, you may wish to eventually pass assets to your children, but may currently be undecided as to how much each child will get. Also, you may be wishing to benefit any future grandchildren that may be born.

When establishing a trust, it is possible to name a "class" of beneficiaries (for example, the children or grandchildren of an individual) rather than specifically name each beneficiary. By having "my children" or "my grandchildren" as a class of beneficiaries and giving the trustees discretion in how much to give each beneficiary, this can allow the trustees to determine, at a later time, how much each child/grandchild will receive. It can also allow for as-yet-unborn family members to automatically be included as potential beneficiaries in the future.

Where the parents of beneficiaries are also the trustees of the trust, a trust structure allows the parents to have control over the trust assets for the time that the assets are in the trust. This allows them to adapt their distribution plans to future events (by, for example, adding and removing beneficiaries, and distributing assets to assist with beneficiaries' major life events).

Trusts can also be used in certain circumstances to provide an individual with a degree of creditor protection. Generally, assets contributed to a trust cannot later be seized if the settlor is subject to bankruptcy, divorce or an adverse outcome of a lawsuit, provided that the adverse event was not known or anticipated at the time of the contribution to the trust.

Procedure for establishing a trust

A trust is established by the settlor creating and signing (usually with the help of a professional advisor) a **trust deed** and contributing assets to the trust. It is common for the settlor to contribute a coin or a small amount of money to the trust in order to create it.

The trust deed directs the trustees as to how the trust should be operated, and provides the trustees with various rights and restrictions for operation. The deed will appoint the trustees, explain what the trustees can and can't do, list the potential beneficiaries and explain when, and under what circumstances, assets can be paid out to them.

As mentioned above, it is common in a family trust for the trustees to be the parents of the beneficiaries. The trustee parents may also be beneficiaries to allow funds in the trust to be paid out to them.

Where only a small amount is contributed upon the creation of the trust, it is common for the settlor to be a grandparent of the beneficiaries or a friend of the family. Due to various rules in the Income Tax Act, it is important that the settlor not also be a trustee or a beneficiary of the trust. Further, the settlor should not have any control over how trust assets should be distributed and they should not be repaid for the amounts they contribute to the trust.

Why would a person only contribute a small amount to a trust? The answer is that trusts are often used as part of wider estate planning, which involves business reorganizations.

For example, a settlor could contribute $10 to a trust, which the trust then uses to purchase shares of a family business once the business has been reorganized to make sure that new shares have nominal value (known as an estate freeze). By doing so, a settlor can make a relatively inconsequential contribution to the trust, which allows the trust to accumulate significant value in future years as the business grows.

Once the trust is established, or "settled", the settlor takes no further part in the trust's administration. Control is handed over to the trustees to operate the trust according to the trust deed.

Tax consequences

A trust is considered to be a separate person for the purposes of the Income Tax Act. This means that any income or gains that arise from trust property are taxed in the hands of the trust (unless allocated to beneficiaries, as explained below).

A trust pays tax on all income and gains at the highest rate of tax possible in the trust's province (in Ontario, 53.53% on general

income and 26.76% on capital gains), and so it does not benefit from the marginal tax brackets available to individuals.

This tax treatment generally makes earning income and gains within a trust inefficient from a tax perspective. However, when a trust distributes income or gains out to a beneficiary, these amounts can be taxed in the beneficiary's hands instead. (The trust must recognize the income for tax purposes, but generally gets an offsetting deduction for amounts that are paid or payable to beneficiaries.)

This can be beneficial if a beneficiary has low-marginal tax bracket room available in the year. In this way, and subject to the "Tax On Split Income" rules discussed below, income can be distributed among beneficiaries in a way that results in the least tax possible being paid in the year.

The trust must file a T3 tax return every year by 90 days after year-end, to report the income and gains arising, and to deduct amounts distributed to beneficiaries, where the beneficiaries are to pay the tax instead. The trust will also prepare T3 slips to give to the beneficiaries, which provides them with the relevant information to include in their personal tax returns. Starting with reporting for the 2023 year, the T3 must report a significant amount of detail in identifying all the beneficiaries and possible beneficiaries of the trust, to allow the CRA to audit the trust and the beneficiaries.

Income splitting

Historically, family trusts have been used to split income among family members, and to take advantage of the marginal tax brackets of each beneficiary. Income splitting is possible because a high-earning family member can contribute funds to a trust, and the trustees can decide to distribute income and gains arising from those funds to one or more beneficiaries who pay tax at lower rates.

As this planning became very popular, new Tax on Split Income (TOSI) rules were introduced in 2018 to try to prevent such income splitting, particularly where dividends are paid out by a business operated by an individual to that individual's family. These rules apply both to dividends paid directly to family members, and to dividends paid indirectly through a trust.

For example, if Dad operated a business and added Mom and Son as shareholders, he could effectively split dividend income between them, rather than suffer all of the tax himself at a higher tax rate. This is partly what the TOSI rules were designed to stop.

The effect of the TOSI rules, when they apply, is that any income caught is taxed on the recipient at the highest tax rate in effect at that time, even if that recipient is not in the highest tax bracket.

There are various exceptions to TOSI that still permit a limited amount of income splitting. Professional advice should always be sought prior to making any kind of gifts or payments to family members, to ensure that you do not unintentionally trigger TOSI or another of the many anti-avoidance rules in the Income Tax Act.

Prescribed rate loan planning

Another common, although currently not very attractive, planning technique involving trusts is known as prescribed rate loan planning.

This planning is another way to benefit family members through a trust while keeping tax to a minimum. Essentially, a higher-rate family member can provide a loan to the trust, which the trust can use to invest and generate income that is then distributed to lower-rate family members.

This would normally trigger a variety of anti-avoidance rules in the Income Tax Act. However, with a few particular actions, this planning can be advantageous without triggering any adverse tax rules.

Firstly, the lender must require the trust to pay interest on the amount loaned. Provided that this interest rate is at least equal to the "prescribed rate" at the time of the loan, a group of anti-avoidance rules, known as the attribution rules, can be nullified.

The prescribed rate is a rate set quarterly by the CRA based on a three-month average of Treasury Bill rates. The current rate is 6%, but with interest rates expected to drop, it is likely to go down this year.

The other significant group of anti-avoidance rules are the TOSI rules. As described above, amounts paid out to beneficiaries that originate from a family member may be caught by TOSI. However, a valuable exception relates to dividends received from companies listed on a stock exchange.

Therefore, the trust could use the amount borrowed to invest in public companies. Any dividends received from these companies should not be subject to TOSI and may be available for distributing to lower-taxed adult family members.

The benefit from this planning arises due to the difference between the prescribed rate of interest (which historically was relatively low) and the rate of return available on portfolio investments. Therefore, with the current rate of prescribed rate interest of 6%, this type of planning is relatively unattractive at present. However, the planning remains available should the prescribed rate return to lower levels in the future, as seems likely to happen. (For two years through June 2022, the rate was 1%.)

Multiplying the capital gains exemption

Although the income-splitting uses of trusts have been restricted in recent years, there is still one significant benefit of holding assets, particularly shares, in a trust – the potential multiplication of the lifetime capital gains exemption ("LCGE").

When shares of certain corporations ("qualified small business corporation shares") are sold by an individual, any gain arising on the sale may be effectively exempted from tax through the use of the individual's LCGE. This exemption can also apply to certain farming and fishing assets.

For 2024, just over $1 million of capital gains may be exempted from tax if the individual has not previously used any of their LCGE. The use of the LCGE in relation to QSBC shares was discussed in our January 2024 tax letter.

Trusts cannot claim a LCGE, but individual beneficiaries can. Due to the trust's ability to allocate gains to beneficiaries, to be taxed in their hands, the trust can allocate portions of qualifying gain to one or more beneficiaries. If those beneficiaries have LCGE available, they can use it to shelter some or all of the gain from tax.

Therefore, instead of one individual realizing the gain and claiming their LCGE, multiple individuals can do this, and multiple LCGE amounts can be claimed. In Ontario, the possible tax savings from claiming the LCGE exceed $270,000 per taxpayer!

Disadvantages

Although trusts have both tax and non-tax advantages, there are also some significant disadvantages which must be understood.

Firstly, there is an annual tax return compliance requirement for most trusts. This comprises of a T3 annual tax return to report income, gains and distributions in the year, and T3 slips to provide to beneficiaries to assist with their personal reporting obligations.

The T3 return must be filed within 90 days of the trust's year end and there are penalties for non-compliance both in relation to the tax return and the T3 slips.

Also, trustees are under a duty to keep adequate records in relation to income and trust property. Where there are significant assets in the trust, this can be a burdensome, and expensive, duty.

Beginning in 2024 (for the 2023 year), a further administrative requirement has been added in the form of new trust reporting rules, as noted earlier. These rules also increased the number of trusts that need to file an annual T3 return.

Trusts now have to report a significant amount of personal information in relation to the trust itself and the various persons involved, including the settlor, the trustees and the beneficiaries. Information such as names, addresses, dates of birth and social insurance numbers are all required.

These new rules impose significant penalties if a return is not filed, or if incorrect information is given, especially if this omission/error is considered to be made knowingly or in circumstances amounting to gross negligence. The penalty can be 5% of the highest value of the trust assets in the year!

Another slight disadvantage of using a family trust is that it has a limited shelf life. Trusts can exist for only 21 years before tax has to be paid. On the 21st anniversary of the trust, it is deemed to sell and re-acquire all of its assets at their current market value. This means that any accrued gains are realized and taxed.

One way to avoid this tax charge is to distribute the trust assets to beneficiaries before the 21st anniversary. It is often possible to transfer the assets to beneficiaries at cost, meaning that the accrued gains remain unrealized and tax is paid only when the beneficiary subsequently sells or transfers the asset. Tax is then paid by the beneficiary and not the trust. (However, the rules in this respect are very complex and there are situations where this "rollover" is not available.)

Practically, this usually results in trusts being wound up just before their 21st anniversary, forcing the trustees to make the final decision as to which beneficiary gets which asset. Depending upon the situation of the beneficiaries at that time, this can sometimes mean a difficult decision between transferring assets at an inappropriate time and suffering a significant tax charge.

Conclusion

Although recent anti-avoidance rules have significantly limited the tax benefits of family trusts, tax benefits still exist. More importantly, the non-tax benefits of a family trust, and the general flexibility in terms of estate planning that such structures provide, ensure that trusts are still a valuable estate planning tool in the right circumstances.

LAST CALL FOR 2023 TAX PLANNING – RRSP CONTRIBUTIONS

Although we are now into the second month of 2024, there is still an opportunity to influence the amount of tax you pay for 2023 through contributions to your Registered Retirement Savings Plan ("RRSP").

Unless you turned 71 by the end of 2023, RRSP contributions made **before March 1, 2024** can be claimed in your 2023 return, and the amounts contributed can be deducted from your 2023 income, thereby reducing your tax for the year, and potentially giving you a tax refund!

You must be careful not to contribute more than you are allowed to. Your contribution "room" for 2023 is generally 18% of your **2022** "earned income" (up to a maximum of $30,780) plus any unused contribution room from previous years. You can find details of your available contribution room through the CRA "My Account".

The CRA usually starts to allow the filing of personal tax returns in mid-February, and most tax-filing software should be updated for 2023 returns by then. This can be used to your benefit.

For example, once tax-filing software has been updated for 2023, you can enter all your relevant information for the year and get a sense of the tax you are likely to pay (or the refund you are likely to receive). You can also find out the highest tax bracket that you fall into for the year.

RRSP contribution deductions work by reducing your taxable income for the year. So, for example, if you live in Ontario and only the final $1,000 of your taxable income falls into the 43.41% tax

bracket, a RRSP contribution of $1,000 will remove this amount of income at that tax rate, saving you tax of $434. The highest rate of tax you will then pay will then be reduced to 37.91% as the last of your taxable income will fall into a lower tax bracket.

RRSP contributions do not have to be deducted in the year the contributions are made. Therefore, by getting a sense of what your tax liability is for the year, you can use contributions to your advantage, by claiming higher deductions for higher tax years, and holding off on claiming deductions for lower tax years.

One note of caution – if you also contribute to certain pension plans provided by your employer, this will normally reduce your RRSP contributions room, although CRA's record of available contribution room should already factor this in. Check your CRA My Account for the exact amount that you can contribute.

There is a buffer of $2,000 available for over-contributions before penalties are charged, but you cannot deduct any over-contributed amounts.

Also be careful if you also contribute to a First Home Savings Account (FHSA). These have similar tax deduction benefits to RRSPs, but the contribution deadline for a FHSA tax deduction in 2023 was December 31, 2023. Therefore, any contributions made to your FHSA now, in February 2024, will be deductible only on your 2024 tax return.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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