



## **The Discretionary Family Trust**

This edition of Landry McGillivray "Advisor" is intended as general information only, with respect to a discretionary family trust. A lawyer in our firm should be consulted prior to proceeding with a discretionary family trust.

### **1. GENERAL ASPECTS**

A trust is a relationship in which one person (known as the settlor) transfers property to another person or persons (the trustees) for the benefit of certain other persons (the beneficiaries).

Discretionary family trusts are used in corporate reorganizations and estate freezing to transfer future income and wealth to a taxpayer's family. Those family members then use their lower marginal tax rates to effect overall savings and the potential for making multiple use of the super capital gains exemption is enhanced.

Interests in trust include income and capital interests. An income interest entitles a beneficiary to a share of the income earned by the trust property. A capital interest entitles a beneficiary to a share in the trust property, the capital, when it is distributed. A trust is flexible. A settlor can name any persons as beneficiaries of the trust. In the discretionary trust, the income and the capital interests of a beneficiary are contingent on the discretion of the trustees to allocate income or capital to the beneficiary. Thus, the principal can maintain control over the underlying shares held by the trust and the income attributable to it.

The income beneficiaries of a discretionary family trust are usually the principal and the spouse, children, children's spouses, grandchildren and their spouses. The capital beneficiaries are usually the same persons.

### **2. BENEFITS OF A TRUST AS A SHAREHOLDER**

There are additional advantageous aspects of having shares owned by a trust:

- A principal can undo the arrangement easily by distributing the assets to himself or in any proportion to the capital beneficiaries;
- The trust does not pay tax if it allocates and pays its income to beneficiaries;
- With a discretionary trust, the allocation of income can change from year to year;
- Dividends maintain their character as they flow through a trust. Therefore, individuals without income from other sources can earn about \$30,000 of dividends without any tax costs; and
- Capital gains retain their identity as they flow through the trust, and may be eligible for the enhanced capital gains exemption.

### 3. ANCILLARY BENEFITS OF DISCRETIONARY FAMILY TRUSTS

#### a) Estate Planning

A discretionary family trust survives the death of an individual. Therefore, the shares in the trust are not subject to estate proceedings nor probate fees. The deceased would be replaced as a trustee and the trust would continue.

#### b) Creditor Protection

Each principal controls the underlying assets, those assets are subject to the rights of the other beneficiaries. Therefore, the underlying assets should be safe from the principal's creditors.

#### c) Estate Freezing

There is merit in being able to pass future appreciation in the value of the shares to family members. The most important reason is to provide an opportunity to "tax" future capital gains in their hands. Those beneficiaries could use their capital gains exemption to reduce or eliminate future income tax.

In the past, the potential disadvantage of estate freezing has been loss of control. A freeze in favour of a discretionary family trust does not suffer from this disadvantage.

### 4. INSTITUTING A DISCRETIONARY FAMILY TRUST

The principal will arrange for a friendly settlor to establish the trust. The settlor is someone who has reason to benefit the principal and his family. The settlor will give the principal an amount of money in trust.

The principal trustee will coincidentally appoint two co-trustee or additional trustees. The principal trustee can remove the co-trustees or additional trustees. Any trustee's decision will be by way of a majority decision of those trustees.

The beneficiaries of the trust will typically be the principal, his wife, his children, his children's spouses, and the children's children or any desired combination thereof.

## 5. THE PARTIES

(a) settlor - the person who establishes the trust by transferring property to other persons to hold in accordance with his instructions for the benefit of certain other persons.

(b) trustees - persons who receive property to hold on behalf of certain other persons and to deal with in accordance with the instructions of the settlor.

(c) beneficiaries - those persons entitled to benefit from the property.

## 6. TYPES OF TRUSTS

To fully understand the use and operation of a trust, it will be necessary for you to become familiar with the differences between certain types of trusts:

### (a) Testamentary Trust v. Inter Vivos Trust

A testamentary trust arises upon the death of an individual; all other trusts are inter vivos (or living) trusts.

### (b) Discretionary vs. Non-Discretionary Trust

Where the terms of the trust Indenture require the trustees to decide which beneficiaries will receive income of the trust and how much of the income each will receive, the trust is a discretionary trust. A non-discretionary trust is one

under which a beneficiary's entitlement to income does not depend on the exercise of any discretion by the trustees.

#### (c) Revocable Trust v. Irrevocable Trust

Where the property of the trust is to revert to the settlor or someone appointed by the settlor (subsequent to the creation of the trust), the trust is a revocable trust. Where the property of the trust is divested of unconditionally by the settlor (that is, the settlor can never reacquire the property), the trust is an irrevocable trust. A trust must be irrevocable to avoid attribution of income or loss from trust property or taxable capital gains or allowable capital losses from the disposition of trust property to the settlor.

#### (d) Spousal Trust

A spousal trust contained in a will is a trust under which all the income is for the benefit of the taxpayer's spouse and no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust. The spouse need not be a capital beneficiary. Tax-free rollover of property may be made by a taxpayer to a testamentary or inter vivos spousal trust although in an inter vivos transfer, income or loss and gain or loss are attributed back to the taxpayer.

#### (e) Bare Trust

A bare trust is often used in situations where there are many investors and it is expedient to have the property registered in the same name of one person as nominee or, in the case of real property, to have a corporation as registered owner of the property and liable under the mortgage in order to limit the exposure of the investors.

#### (f) Others

There are many other types of trusts, such as units trusts and mutual trusts, etc.

7. A trust can arise in one of two different ways:

(1) by intention of the parties evidenced by the transfer of property by one person to another for the benefit of certain other persons;

(2) by one person declaring that he holds the property for and on behalf of another (declaration of trust).

There are three requirements in establishing a valid trust. These are:

(1) certainty of intention: the intention of the settlor to transfer the property to the trustee for the beneficiaries and not the trustees themselves;

(2) certainty of subject matter: the subject matter of the trust must be certain (it must be clear what property the trustee is holding for the beneficiaries). Legal ownership of the property must vest in the trustees;

(3) certainty of objects: the objects of the trust must be clear; that is, who is the benefit from the trust.

If any of these certainties is not fully complied with, then the trust will not be properly constituted and the desired purposes of establishing the trust, including tax and estate planning, will also fail. The courts have required strict compliance to trust law in the establishment of trusts and Canada Revenue Agency has successfully attacked family trusts simply on the basis of poor and sloppy documentation (or the lack thereof).

## 8. APPOINTMENT OF INDIVIDUALS

(a) Who Should be the Settlor?

Any individual over the age of 18 years can be the settlor of the trust. The trust can be created by the individual (the settlor) gifting an appropriate amount of cash to the trustee to benefit certain persons on the terms and conditions set forth in the Trust Indenture. However, because it may be desirable to take advantage of the preferred beneficiary election and because the taxpayer and his spouse normally wish to be income beneficiaries of the trust, it is recommended that a parent of the taxpayer (grandparent of the children) be the settlor of the trust. In the event that there are no surviving grandparents, the settlor should be a relative or friend. This will result in loss of the preferred beneficiary election but will allow the taxpayer and his spouse to remain income beneficiaries of the trust

without affecting the income-splitting advantages of the discretionary family trust.

Under the Income Tax Act, a reference to a trust is read as a reference to the trustees having ownership or control of the trust property.

Therefore, for many situations, it is recommended that a trust have three trustees. One may be the taxpayer and the remaining trustees may be persons knowledgeable about taxpayer's affairs and kindly to his way of thinking. However, the trustees must be advised that they are in a fiduciary capacity (position of trust) and must exercise their discretion with regards to the interest of the beneficiaries and not of the taxpayers.

The Trust Indenture should contain additional or substitute trustees in the event of the death or withdrawal of any of the trustees. Trustees should automatically be withdrawn in the event that they are no longer residents in Canada. This is to avoid the possibility of the trust becoming non-resident (the residence of a trust for tax purposes is considered to be residence of the majority of its trustees) and being deemed to dispose of its property at that time.

#### (b) Who Should be the Beneficiaries?

In a discretionary family trust, the income and capital interests of a beneficiary are contingent interests only. An income interest is contingent on the discretion of the trustees to allocate income to that beneficiary; a capital interest is contingent on a beneficiary meeting the conditions of the trust.

Trust income may be allocated to beneficiaries with lower marginal tax rates and as a result the total amount of taxes paid will likely be less than if the income were taxed in the trust itself.

The income beneficiaries of a discretionary family trust will usually be the taxpayer and his spouse, children, children's spouses, grandchildren and their spouses and any registered charity; the capital beneficiaries are often the same persons.

The preferred beneficiary election may be neither appropriate nor available in all situations. However, where income of a trust was not payable in the year but was held in trust for an infant or minor whose right to such income had vested and the only reason that it was not payable was that the beneficiary was an infant or a

minor, the income allocated to that beneficiary is considered to have been payable.

Therefore, the trust will be entitled to deduct the amount of such income and it will be taxed in the hands of the infant beneficiary (or, more accurately, his/her legal guardian) to be used in paying such child's share of the family vacation, his/her clothes and his/her share of family expenses.

## 9. TAXATION OF THE TRUST

For purposes of income tax, a trust is considered to be an individual but is not entitled to personal exemptions. The taxation year of the trust is the calendar year. Inter vivos trusts are subject to income tax at the highest marginal rate. The effective minimum rate of tax applicable to inter vivos trust is approximately 50 %. Therefore, there is no tax advantage where income is left and taxed in a trust rather than in the hands of the taxpayer.

A trust is entitled to deduct amounts paid or payable to a beneficiary. Any remaining income not otherwise payable to beneficiaries will be taxed in the trust itself. Therefore, trustees should allocate and pay all income of the trust prior to the year-end of the trust.

A trust is generally considered to be a conduit for tax purpose; that is, the income of the trust distributed to beneficiaries and certain deductions made by the trust retain their character in the hands of the beneficiaries. Categories of income that retain their characters when flowed through are dividends, taxable capital gains, foreign source income, eligible interest from Canadian sources, superannuation or pension benefits and amounts received upon or after death of an employee in recognition of services..

It is important that trustees monitor the sources of the trust income so that they can pay or allocate the particular type of income to a beneficiary.

In cases where property is transferred to a trust, there is a possibility that such property may never be disposed of and , consequently, capital gains tax may be deferred indefinitely. To overcome this result, the Act deems the property of a trust to be disposed of every 21 years (the so-called rule against perpetuities). The tax ramifications of this 21-year rule must be carefully considered, particularly in cases where trust property is held until the death of the survivor of the settlor and his spouse or in cases where trust property is to be held until the death of the survivor of the settlor and his spouse or in cases where trust

property is not to vest in infant beneficiaries until they reach 25 or 30 years of age.

In order to avoid the 21- year deemed disposition rule, the Trust Indenture should include a provision to eliminate the trust prior to the 21st anniversary date of the creation of the trust. Capital property of a trust can generally be rolled out at its adjusted cost base or undepreciated capital cost and, as a result, would be a tax-free distribution to the capital beneficiaries.

## 10. PLANNING WITH TRUSTS

Discretionary family trusts are extremely useful vehicles in many estate planning circumstances. They can be used to provide income to maintain children or handicapped members of one's family. Discretionary family trusts are often used on corporate reorganizations and estate freezing arrangements as a means to transfer income and wealth to a taxpayer's family (and thereby use the lower marginal tax rates of family members) without losing control of the assets benefitting the trust.

The discretionary aspect of the family trust allows trustees to pay trust income based on the individual needs of each beneficiary.

A taxpayer must thoroughly consider the tax and financial implications of using a discretionary family trust as part of a corporate reorganization or estate freeze. To be of any tax advantage, discretionary family trusts must be irrevocable and once constituted, it may be difficult to vary the trust. However, in many cases a trust can be dissolved by simply distributing all the assets to the capital beneficiaries on a tax-free basis.

## 11. PUTTING IT TOGETHER

A trust is not a legal entity. It is not capable of being registered in a government office like a corporation or partnership, so there is no third-party evidence of its existence. As a result, it is important to properly constitute and document the creation of the trust to withstand the scrutiny of Revenue Canada or the courts.

The following steps serve as a guideline to the creation of a trust, but no action should be taken without prior consultation with your professional advisor:

(a) Intention to create trust - the settlor must evidence his intentions to create the trust by gifting an amount (\$500 to \$1000) to the trustees to be used in accordance with his instructions for the benefits of the beneficiaries. This is normally done by the settlor issuing a cheque to the trustees (payable to "The Family Trust").

(b) Trust Indenture - the Trust Indenture should grant sufficiently broad and flexible powers to the trustee in order to enable them carry out their functions. Unless specifically otherwise provided, a trustee's power will be governed and limited by the particular provincial legislation or the common law. For instance, a trustee is restricted by statute to certain qualified investments, which do not include shares in private corporations. Therefore, if the intention of trust is to hold shares in a private corporation, this must be specifically set out.

The Trust Indenture then should be dated and signed by the settlor and each of the trustees.

(c) The settled funds - might be deposited in a non-interest-bearing chequing account from which no transaction would take place. A second bank account could be opened from which the trustees could transact the business of the trust.

(d) Borrowed funds - the trust now duly constituted can borrow the funds necessary to purchase investments. This loan should only be repaid from income earned by investment of borrowed funds to avoid attributions of income to the settlor.

(e) Affairs of the Trust - the organization of the trust (the Trust Indenture and banking documentation) and the day to day affairs should be recorded in a manner similar to that of a corporation. Minutes and Resolutions should be kept of trustee's meetings and decisions, and should be dated and signed by the trustees.