How a trust can safeguard your family's wealth

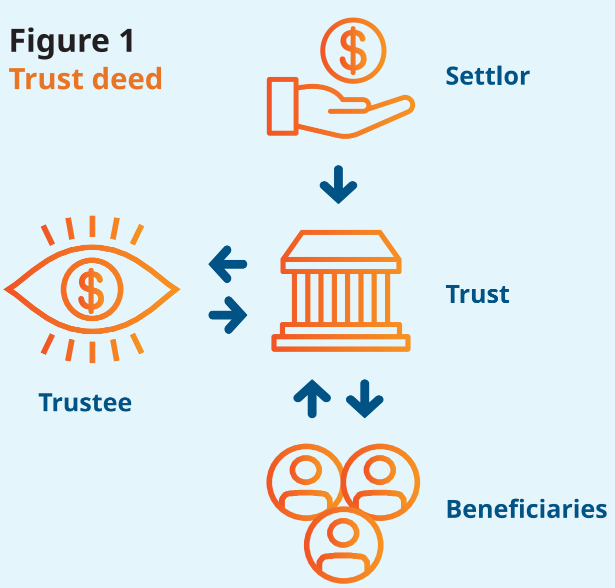
The benefits of family trusts

As family wealth increases, so do thoughts about tax reduction, wealth preservation and wealth transition.

Families can address all three concerns through a family trust. Family trusts can be testamentary (arising on death) or inter vivos (used while alive). The case studies outlined below focus on the uses of inter vivos family trusts.

A family trust, like any other trust, requires three main parties: a settlor, trustee(s) and beneficiary(ies). The settlor establishes the trust and contributes the first asset. The trustee manages and administers the assets on behalf of the beneficiary. The beneficiary benefits from the income and capital of the trust. These roles and the terms of the trust are found in the trust deed (Figure 1).

Figure 1
Trust deed



Case study: Li family business

The Li family owns a successful auctioneer business. Melanie and her husband, Daniel, would like to include their four adult children as shareholders in the company as part of their succession plan. Three of the four children (Daniel Jr., Edward and Isabel) are married, while Tanya is single. All children are active in the business and as a result, the parents would like to include all children as shareholders. Melanie and Daniel have the following concerns:

- Distributing the value of the business fairly among their children in the event of their deaths;
- Income splitting by paying dividends to each of their children, as well as to themselves;
- Maintaining control over the business until the children are ready to run it;
- Protecting each child's interest in the business from potential future spousal and creditor claims; and
- Locking in the tax liability on the growth of the business to date and splitting the future growth with their children.

Melanie and Daniel decide to proceed with an estate freeze that includes the operating company, Li Auctioneers, that is now wholly owned by the holding company (a numbered company). All common shares of the holding company are owned by the Li Family Trust. Melanie and Daniel own 100% of the holding company's voting preferred shares, which allows them to retain control of the business, caps the growth of the business in their hands, and transfers the future growth to their children.

The children will be the beneficiaries of the family trust, with Melanie and Daniel acting as trustees. If the trust is fully discretionary, Melanie and Daniel can control when the income of the trust (in this case, dividends, but other types of income are possible) is retained by the trust or allocated to the trust's beneficiaries (Figure 2).

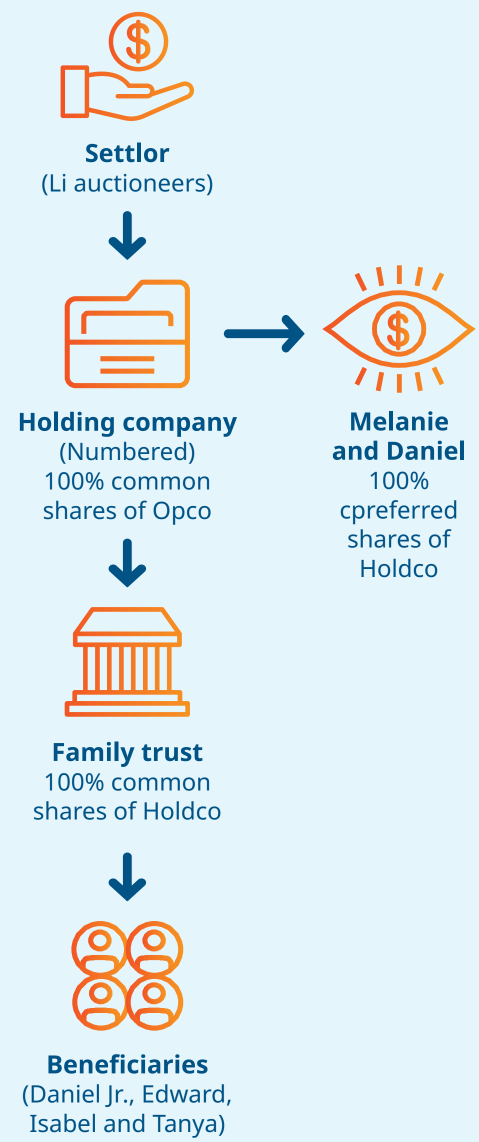
Role of the family trust

While a family trust isn't a mandatory component of an estate freeze, its presence helps the Li family meet their objectives. Through the trust structure, they can ensure a fair distribution of the business, take advantage of a certain amount of income splitting with the children (subject to the Tax On Split Income rules), and protect the children's interest from future spousal or creditor claims. If the trust is fully discretionary, protection from such claims is further improved.

As trustees, Melanie and Daniel enhance their control of the children's interests. This complements their control as the voting preferred shareholders. Not only can they make decisions about the operations of the business and declare dividends, they can control the allocation and distribution of income from the trust to their children. If any of the children have no other income sources, non-eligible dividends could be paid to them tax-free. These tax-free dividends could range from $14,300 (Manitoba) to $28,900 (Ontario), assuming no additional income or deductions other than the basic personal amount and dividend tax credit are claimed.

Finally, with future growth of the business being attributed to the common shares held by the family trust, the lifetime capital gains exemption of each beneficiary can be used to shelter future capital gains from taxation.

Figure 2 | Li family trust



Case study: Sharing the wealth in the Gerard family

Peter Gerard is an executive vice-president with a large Canadian conglomerate. His wife, Mary, is raising their four minor children (Alex, Michael, Justin and Elizabeth). Peter has accumulated significant cash outside his registered investment accounts. He wants to:

- Invest the cash in a diversified portfolio and split the income with Mary and the children;
- Continue to contribute to the assets over time and use them to pay for expenses related to the children, such as sporting activities and private school; and
- Use the assets to fund the children's post-secondary education, home purchases, weddings and so on.

The family establishes the Gerard Family Trust. Charlene Gerard, Peter's mother, settles the trust with an initial $100 cash contribution. Peter is the trustee and his wife and children are equal beneficiaries. Next, Peter lends $1 million to the trust through a prescribed-rate loan. The trust takes the cash proceeds and invests in a diversified portfolio.

The trust must pay the annual interest on the loan to Peter no later than January 30 of the year following the year the interest accrued. Peter must claim the prescribed-rate loan interest as taxable income on his tax return. The interest payment can be deducted from the trust's income, with the net income being allocated or paid to the beneficiaries. This allows the income to be taxed in the beneficiaries' hands with presumably little or no taxes payable (Figure 3).

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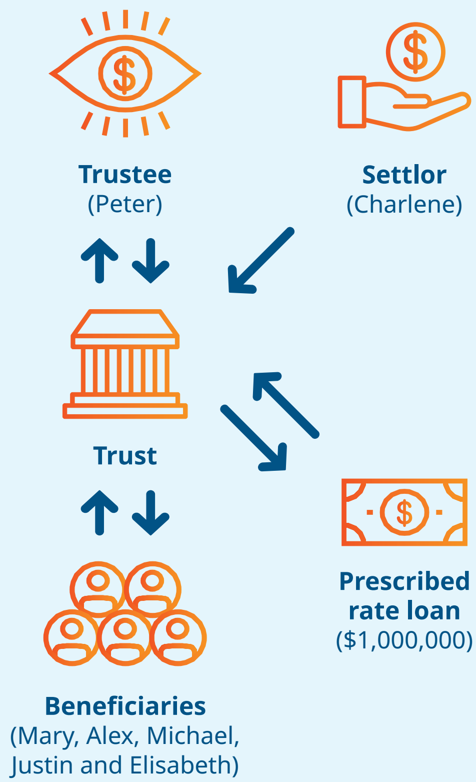
Investments

Figure 3 | **Gerard family beneficiaries**



Role of the family trust

Since most of the beneficiaries are minors, the trust structure allows Peter to execute the prescribed-rate loan strategy and lend the money necessary for investment directly to the trust. Income and capital gains earned on the invested funds are not attributed back to him. This could provide significant tax savings for the family.

While Peter will have interest income of $10,000 (1% of $1,000,000) and pay tax of $5,000 (assuming a 50% tax rate), the beneficiaries of the trust will likely have tax liabilities near zero on the taxable income of the portfolio.

Peter's taxes would likely be higher on the portfolio's earnings if he earned them directly, given his tax bracket and the probability that the portfolio would generate taxable earnings greater than 1%. Further, as trustee, he maintains control over the asset, including investment decisions, allocations and distributions to beneficiaries.

Conclusion

A family trust can be an invaluable tool for high-net-worth families to pool their wealth, to lower income taxes across the family unit and to meet estate planning objectives. Whether planning for business succession or investment wealth transfer, a family trust is a viable solution to keep more wealth in the family.

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