What is a Family Trust and Why Would I Want One as a Business Owner?

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There are potential income tax benefits of having a family trust as a part of your corporate structure, as it could mean tens — if not hundreds — of thousands of extra dollars in your pocket… legally. Generally, family trusts are useful to have when there is a desire to income split and save on taxes, or in preparation of the sale of your business since you can multiply your eligible capital gains exemption.

If you are interested in having a family trust in your corporate structure, you will need to consult with a specialist in tax planning to reorganize your corporation's share structure. Don't worry, while this may sound daunting, it's something we do regularly here at Fuller Landau and we are happy to do the "heavy lifting" for you.

What is a Family Trust?

A family trust is a legal relationship between trustees, who control the family trust's assets, and the beneficiaries who benefit from the family trust's assets. Trustees are most commonly Dad, Mom, (or the specific form of your family's parental make-up; for this article we will use Mom and Dad) and another family member or trusted business advisor. Examples of typical beneficiaries are Dad, Mom, children, grandchildren, grandparents, other people as desired, and corporations wholly owned by one or more beneficiaries. Effectively, Mom and Dad could be both trustees (the decision-makers of the trust) and beneficiaries (reaping the benefits of the trust).

A settlor, who is usually a family member or close friend who will not be a trustee or beneficiary, sets up the family trust. The settlor establishes a family trust with a gift (e.g. $5 bill). Once the trust has been set up, the settlor generally does not have any further involvement with the trust.

Tax Benefits of a Family Trust

A family trust is considered a taxpayer for Canadian income tax purposes and pays income tax at the top marginal tax rates. However, any income or capital gains earned by the family trust can be allocated to a beneficiary who would pay income tax on the allocated income at their respective marginal tax rates rather than the top tax rate that the family trust would pay. The trustees would determine which beneficiaries receive the income allocations from the trust each year. It is important to note that any allocation/money that is received by a beneficiary is legally theirs.
The main tax benefits of a family trust are:

1. Accessing other family members' Capital Gains Exemptions ("CGE"): every individual gets one CGE during their lifetime. Currently, a CGE can shelter up to $813,000 (2015 amount) of capital gains relating to the sale of qualified small business corporation shares. Each CGE shelters approximately $200,000 of income tax. This is particularly beneficial when a corporation is anticipating significant growth in the future. If a family trust became a shareholder of the corporation, the growth in the value of the corporation would accrue in the value of the shares owned by the trust. If the shares were sold in the future, the capital gain relating to the shares owned by the trust could be allocated to the beneficiaries. Each beneficiary could then potentially use their CGE to shelter up to $813,000 of the capital gains from capital gains tax.
2. Income splitting with spouse, adult children and other adult beneficiaries: dividends can be paid out to the family trust and allocated to beneficiaries in lower income tax brackets. Beneficiaries with no other income could receive approximately $40,000 of dividends in a year and pay little to no income tax. As compared to a taxpayer earning over $140,000 of income, they pay approximately $14,500 in tax on the $40,000 dividend.
3. Having a corporate beneficiary allows dividends that are not required for personal use to flow to the corporate beneficiary on a tax-deferred basis. This is beneficial for corporations that generate excess cash that is not required for business purposes and that is not currently required for personal use.

Steps Required for a Family Trust to become a Shareholder of your Corporation

If you decide to you want to set up a family trust, what happens next? Let's say you own Company X.

1. Your common shares of Company X would be exchanged for special shares of Company X that have a fair market value ("FMV") equal to the current FMV of the common shares. The special shares would reflect the current value of the company and would not participate in the future growth of the company. A formal valuation of the corporation would be required to determine the FMV of the common shares.
2. A family trust would be established. The trust subscribes for new common shares from the treasury of Company X for a nominal amount (e.g. a $5 bill). Any future growth in the value of Company X would accrue in the value of the common shares owned by the family trust.

Have more questions about family trusts? Call me, Derek Wagar, at (416) 645-6518 or email me at dwagar@fullerllp.com. You can also contact a member of our Tax department and we would be happy to family trusts with you.