Do trusts still make sense in light of the new tax rules?

Tax alert

Recent changes in tax legislation have affected the way that trusts can be used, as well as the information they are required to report. Many have speculated that these changes have limited the usefulness of trusts as a tool for holding assets, but there are still many advantages to setting up a trust.

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What has changed?

Limits on income splitting

The extension of the income splitting rules that came into effect on January 1, 2018 has made certain business owners question their current corporate structure. This is because the manner in which shares are held (i.e. through a holding company or through a trust) will affect whether the income received will be subject to tax on split income (TOSI), which imposes tax at the highest marginal rate on certain types of income.

For example, where shares of a private corporation (meeting the definition of a “related business” for the purposes of TOSI) are held by a family trust, and an inactive spouse and inactive adult children are beneficiaries of the trust, none of the family members will be able to exempt themselves from TOSI through the use of the “excluded shares” exemption (which may be available to taxpayers owning shares with at least 10 percent of the votes and value of a corporation). That’s because this exemption requires that the shares be held by the individual directly. As a result, taxpayers who own shares of a private corporation through a family trust will need to look to the other TOSI exclusions to alleviate the potential tax burden.

For some taxpayers this is an undesirable result, as the remaining exclusions typically require a certain level of involvement within the business, either through labour or capital contribution, while the “excluded shares” exemption allows individuals to receive income from a corporation simply on the basis of share ownership.

New reporting requirements

Another way that the advantages of using a trust may be limited in the future is through the new reporting requirements that will come into effect in 2021. These new rules will require that certain types of trusts file a T3 return more frequently and provide more personal identification information relating to beneficiaries, settlors and protectors of the trust.

The impact here is that by increasing these reporting requirements, the government will now have more information at its disposal regarding Canadian property and those who are entitled to it.

For example, where residential property is owned by a bare trust, the trust will now be required to file an annual T3 return that will notify the government when beneficiaries of the trust—in other words, those who are entitled to the property—change. This increased information is likely to form the basis for future tax changes. At the very least, it is sure to lead to additional scrutiny of taxpayers.

Advantages to using a trust

While these changes mean that some of the advantages to using a trust may be limited, there are still multiple tax and non-tax advantages to using a trust.

Tax advantages

Multiplication of the Lifetime Capital Gains Exemption (LCGE)

From a tax perspective, one of the major remaining benefits of using a trust—when it comes to holding shares of a private corporation in particular—is that by having multiple beneficiaries to the trust, it is possible to effectively multiply the LCGE on the disposition of shares of a qualified small business corporation (QSBC).

Multiplying the LCGE will allow each family member that is a beneficiary to the trust to shelter from tax $848,252 (in 2018) of any gain that has been allocated to them on the sale. A family of four would therefore be able to jointly shelter $3.39 million in gains from tax through the use of a trust, which provides a significant tax advantage.

Maintaining QSBC status of shares

In light of the new income splitting rules, it is helpful to ensure that your private corporation meets the criteria for being considered a QSBC. This is due to the fact that taxable capital gains on the disposition of QSBC shares are exempt from TOSI. Where a private corporation is not considered a QSBC (as a result of holding a large value of passive assets), a trust can be a helpful tool for purifying the corporation to meet the definition.

For example, a trust with a corporate beneficiary could be introduced (through a reorganization) as a shareholder of an operating company (Opco). Opco could then pay dividends to the trust, which would then allocate the income to the corporate beneficiary, thus allowing for constant purification of Opco using inter-corporate dividends.

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Prescribed rate loan strategies

While direct income splitting through a trust may no longer be possible due to the extension of the income splitting rules, it is still possible to make use of prescribed rate loan strategies to facilitate income splitting with family members who are inactive in the business—including minor children.

This strategy is especially beneficial while interest rates are still low as the prescribed rate of interest in effect at the time the loan is entered into will remain in effect for the duration of the loan, regardless of whether the prescribed rate changes during that time.

A typical prescribed rate loan strategy involving a trust would see a higher income spouse loaning funds to a discretionary family trust set up for the benefit of the lower income spouse and any adult or minor children. The trust would then use the funds to invest in a portfolio of publicly traded securities (additional issues may result if the trust invests in other Canadian controlled private corporations), and will distribute any net income earned above the annual interest payment to the beneficiaries. Interest must be paid annually from the trust to the higher income spouse by January 30 of the following year.

The advantage of using a trust in this scenario is that it provides more control with regards to the allocation of the income earned by the investment portfolio. This is especially advantageous when income or gains are being allocated to minor children, as the trust allows for the parent to exercise a certain level of control as to when any amount is paid out to the child.

Estate planning

While the recent expansion of the income splitting rules may have impacted your ability to reduce your tax bill, a trust can still be used as a tool to estimate the amount and, to a certain extent, control the timing of it.

Where parents have accumulated the wealth they require, and wish to begin passing additional growth on to future generations, an estate freeze can be used to lock in the current value of any passive investments or active business assets to the parents, and allow all future growth to occur in the trust. An estate freeze also has the added benefit of allowing for flexible distribution of that wealth to any selected beneficiaries.

By freezing at a determined value, any accrued gains on the assets will be locked in, making it relatively simple to estimate the amount of tax owing once the assets are disposed of, typically on death. This allows individuals to plan for their tax bill ahead of time and ensure that adequate cash is available when the time comes.

A freeze transaction also provides flexibility to the beneficiaries on the trust side as they will not be taxed on any future asset growth until the asset is sold or 21 years have passed (at which point a deemed disposition will occur). While this does not avoid or minimize taxes payable, it does provide flexibility in terms of when the payment is required.

Non-tax advantages

While trusts, when structured correctly, have the added benefit of providing tax savings, the primary motivation for setting up a trust is typically non-tax related and these advantages remain despite changing tax rules.

Flexibility

One major benefit to using a trust is the flexibility it provides. For example, in the context of a family business, using a family trust to subscribe for shares of the corporation will allow future generations to benefit from the growth of the corporation without those children or grandchildren having to purchase the shares of the corporation directly. Bringing a family trust in as a shareholder of a private corporation could be completed through a simple estate freeze transaction. The family trust would subscribe for non-voting shares at a nominal amount (non-voting shares would allow the family member who is active in the business to retain control) and any future children, grandchildren or great grandchildren could be named as future beneficiaries through the terms of the trust deed.

In addition to providing for a wide range of beneficiaries, trusts also allow for flexibility in terms of allocating assets, and income earned from those assets, to the beneficiaries. A family trust imposes no obligation to allocate income equally between beneficiaries, as would be required if the children or grandchildren owned the same class of common shares of a corporation. This provides added flexibility and control in the case that certain beneficiaries have different financial needs, as the trustee can consider the specific needs and circumstances of each beneficiary when making distributions.

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Asset protection

From a legal standpoint, because a trust holds assets on behalf of a beneficiary, it provides an added level of protection against creditors, as the asset is not owned directly by the beneficiary. A beneficiary of a trust does not own an asset held by the trust, but instead owns the ability to benefit from the asset.

Removing this line of immediate ownership is also beneficial in a situation where there is a marriage breakdown, as any property held by the trust would generally not be under the control of the beneficiary and therefore could not be transferred to their spouse as part of the marriage settlement. This provides an additional level of security for the family as a whole on a long-term basis.

Control

Another benefit of using a trust is that it can provide family members with a benefit, while restricting their ability to control the asset. This, again, becomes valuable in the context of a family business whereby a founder might want his or her children to benefit from the wealth provided by the business, but to not exert any control over the management decisions of the business—as might occur if the children were to hold shares directly in the corporation. The trust also continues to provide control to the founder or parent in that the trustee and trust deed will carry out their wishes throughout the lifetime of the trust, which may extend long past the lifetime of the founders themselves.

Minimizing probate

Depending on a taxpayer's province of residence, assets that are held by a taxpayer on death, which subsequently form part of the taxpayer's estate, will be subject to probate fees, often calculated as a percentage of the total assets held by the estate. Assets that are held in a trust though are not subject to probate, as they fall outside of the estate. Depending on the province and the total value of the assets held in the estate, the savings here can be substantial.

The priority for your Grant Thornton tax advisor is to help you reach your long-term financial goals, at every step of the corporate journey. When done in advance, tax planning can both support and guide your decisions in a way that will maximize returns and help you avoid unexpected pitfalls.

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