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Discretionary Family Trusts

The Basics

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Discretionary family trusts can sometimes trigger thoughts of trust fund babies, insane amounts of funds held offshore, or shielding trust assets from creditors or the taxman, all of which are available to the ultra rich. However, family trusts are becoming very common and the norm for many families, even those without yachts! All kidding aside, a family trust is a standard estate and tax planning tool for every family. So, I thought it would be worthwhile to go through the "ABCs" of a discretionary family trust, as well as some of the tax-planning tips and traps to be aware of when forming a family trust.

Beneficiaries – who are they?

A typical family trust is drafted as a discretionary trust for the benefit of a class of beneficiaries. Beneficiaries could include yourself, your spouse and your issue (children, grandchildren, great-grandchildren etc.), and in fact, can include as many family or friends that you would like (subject of course to certain tax issues to consider). People often include a class of secondary beneficiaries, such as further-removed family members or registered charities. These secondary beneficiaries would typically kick in if none of the primary beneficiaries were alive at the time the trust is wound up and the trust assets are distributed.

One tax-planning tool I use is to allow for a corporate beneficiary. This could include a corporation to be incorporated (even at a later date), of which the shares are owned by any one or more of the primary beneficiaries. The use of a corporate beneficiary allows for some tax planning on the eventual distribution out of the trust, for example, if a beneficiary becomes a non-resident of Canada (see discussion below).

If you want to set up a family trust and you also want to contribute property to the family trust, then you cannot be a beneficiary of the trust. There is an attribution rule under the Tax Act which would be triggered if property that is transferred to the trust by an individual could potentially revert back to such individual (i.e. by virtue of you being a beneficiary of the trust). This attribution rule will also kick in if such individual who contributes property to the trust is able to determine how the trust property is to be distributed (i.e., if he or she is the sole trustee or have a veto power as a trustee). In this instance, it does not matter if that individual is a beneficiary or not.

So, the general rule is that if you or someone else contributes or gifts funds or property to a trust, you or that particular person is not allowed to be a beneficiary, or cannot be able to make decisions on their own as to how the trust distributes out the property. And to make matters worse, if this attribution rule is triggered for any moment in time (even if the situation is cured after the rule has applied), a second tax rule jumps in to prevent the distribution of the capital of the trust to a Canadian resident beneficiary without triggering capital gains tax.

There are, of course, certain ways to get around this rule. For

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example, case law has held that if you were to lend money (even without interest) or sell property to the Trust at fair market value, this attribution rule will not apply. So, if you are gifting funds or property to a trust, be very careful about whether you are included as a beneficiary (or even as a contingent beneficiary) or if you have too much control in determining who gets what out of the trust.

A second event that could trigger capital gains tax on a distribution of capital out of a family trust is if the beneficiary is no longer a Canadian resident. The general rule is that distributions of capital out of a family trust will not trigger any capital gains tax on the increase in value of any trust assets provided that the beneficiary receiving the distribution is a resident of Canada at that time. These days, this problem can arise more often than not, what with kids going to school in the U.S. and staying south of the border. Hence, the use of a corporate beneficiary would allow you to get around this problem: simply incorporate a Canadian resident company of which the non-resident child is a shareholder, and distribute the trust capital to the company. I would mention that it would be important for the non-resident child to get proper tax advice in the country where they live just in case there are other rules triggered under their jurisdiction.

Trustees – Who should they be?

The choice of trustees is usually a personal decision. This is due to the fact that the trustees, who hold the trust property on behalf of the beneficiaries, will have a fairly active role in managing the trust property and determining distributions. A discretionary trust typically gives the trustees "absolute discretion" in respect of distributions to the beneficiaries. They can determine when distributions are to be made, and to whom (and can distribute to any one beneficiary to the exclusion of the others). So, choose your trustees wisely.

I would also typically recommend that three trustees be appointed. It may be that you want to transfer property to the trust; if so, then in order to avoid that attribution rule discussed above, you should be one of three trustees in making any decisions regarding the distribution of that transferred property. If you are one of two trustees, then arguably you have a negative veto (since majority rule is required). Although CanRev has provided some administrative largess where you are one of two trustees, it's better to be prudent and ensure you are one of three trustees so there is no uncertainty.

To the extent that the trustees make any decisions regarding the trust property, or distributions, it is important that they document their decisions in writing. In addition, if any income / funds are distributed out of the trust to the beneficiaries, the trustees must ensure that the funds are actually paid out to the appropriate beneficiaries, and not scooped by the parents. This is an issue that has apparently been targeted by the CRA on audits, so it's important to ensure that the flow of funds matches the trustees' decisions.

Is the Trust Properly Formed?

The "Settlor" plays an important role in establishing the family trust. He or she formally establishes the trust by "settling" the trust with property (i.e. cash or a gold coin has been typically used). It is important that this property, knows as the "settlement instrument" be properly held on to by the trustees as CanRev has also been known to ask for proof of the initial instrument's existence – one tip might be to tape or attach the settlement instrument to the original trust agreement so it doesn't get lost.

But the settlor's role is not as simple as handing over a gold coin. He or she must actually intend to form the trust and should understand the terms of the trust agreement. The settlor cannot be a beneficiary of the trust, or else the attribution rule discussed above will kick in. However, he or she should be the person who instructs the advisor preparing the trust deed, or at the very least (as that may not always be practical), review and confirm the terms of the trust prior to its finalization and execution. The settlor's role also includes the confirmation of the trustees. So, the Settlor should not always be a choice of convenience.

Once the Settlor has formally formed the trust deed, his or her role is generally done, as the Settlor has no ongoing duties in respect of the Trust. That is the Trustees' duty.

Tax Considerations

The various roles discussed above are not the only considerations when establishing a family trust. Tax planning is very important when drafting the trust agreement. In addition to the attribution rule discussed above, there are some additional attribution rules which may apply in certain circumstances. If you transfer / gift property to the trust for no consideration, and that property throws off income, any such income that is to be allocated to your spouse or your minor kids through the trust could be attributed back to you. There are exceptions to the application of these attribution rules, such as the prescribed loan strategy that I have written about before, or ensuring that the trust agreement contains the appropriate anti-attribution clause, which would prevent distributions of income to your spouse or minor child. It is important to speak to your tax advisor to ensure that the proper steps are taken or included in the trust agreement at the time that the trust is formed. I would highly stress that you speak to your advisor before you finalize the trust agreement as it is very difficult to amend a trust agreement. And in some instances, simply fixing the problem after the fact won't save you from a tax problem.

Lastly, an important tax rule to remember with a discretionary family trust is that they only have a tax shelf life of 21 years. That's because under the Tax Act, a discretionary family trust is deemed to have sold all of its assets on its 21st anniversary (and every 21st anniversary thereafter). So, if the discretionary trust owns assets with a large pregnant gain, it could be stuck with a huge tax bill if nothing is done. So, the rule of thumb with discretionary family trusts is to ensure that the trustees distribute the trust capital to the beneficiaries just prior to the trust's 21st birthday.

Why a Discretionary Family Trust?

There are many potential answers to this question. But I thought I would provide a few of them that tend to tie to estate & tax planning.

For tax purposes, a family trust can allow for income splitting with minors. If you were to simply gift funds to your minor children, any interest income would be taxed in your hands. However, if you were to lend the funds at the prescribed rate (currently 2 per cent as of April 1, 2018), then such income can be taxed in your minor children's hands at low rates. However, legally, a minor child cannot borrow funds. Hence, a family trust can provide the vehicle by which a loan at the prescribed rate can be made for the benefit of your minor children.

Another benefit of a trust is that if you are not yet sure how certain property is to be held among your family members, then having a family trust hold such property in the meantime gives you the ability to control how the property is managed, and at least 21 years before you need to decide how the assets get hold by your family members.

Again, as noted above, there are many more reasons why a family trust can provide some benefit to you and your family. So, I would suggest that the next time you speak to your financial, estate or tax advisor. You just might be interested in one of the answers that might be relevant to your particular situation. ❑