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TAXSTRATEGY

A Family Trust

Rise of the Prescribed Rate

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Inflation is here and with it, increased interest rates. And for the first time in many years, the prescribed interest rate as set by the CRA is going up. We have been somewhat spoiled with a low 1 per cent prescribed rate for over a decade(with a few brief periods of 2 per cent). The first half of 2022 started off at 1 per cent but we saw an increase for Q3 to 2 per cent, which was not unexpected. However, the Department of Finance confirmed at the beginning of August that this rate will increase to 3 per cent for Q4 of 2022. Which means that those of you looking to do some income splitting with your low-tax-rate family members should move quickly if you are looking to do the prescribed rate loan strategy.

This tax strategy involves high tax-rate family members lending after tax-money to low-tax rate family members at the prescribed rate so that any income earned by the latter will be taxed at their low rates (otherwise, the personal attribution rules will attribute any income earned on funds gifted or lent for less than the prescribed rates back to the high tax earner). This can be done quite easily when lending directly to adult family members (a simple promissory note reflecting the prescribed interest rate can be put in place with terms that require the borrower to pay (and not accrue) interest every year by no later than January 30 of the following year).

But what if the only low tax rate family members are minors? As you know, minors can't enter into legal documents so they can't actually borrow funds from you.

The solution is to establish a discretionary family trust, of which your minor family members (and even adult children and spouses or common-law partners) are beneficiaries. Some clients balk when I tell them this is the route to go, as many have no idea how a family trust works. So if you also would like a primer on such trusts, then read on.

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, 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 also 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 bene-

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ficiary becomes a non-resident of Canada (see discussion below).

If you want to set up a family trust and you also want to contribute (i.e. gift) property to the family trust, then you cannot be a beneficiary of the trust. There is a second attribution rule (not just the one I mentioned above) under the Tax Act which would be triggered if a property that is transferred without consideration 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). In addition, this attribution rule will also kick in if such an 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) – and in this instance, it does not matter if that individual is a beneficiary or not. So the general rules 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 ability to distribute 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 example, caselaw has held that if you were to lend money or sell property to the Trust at fair market value, then 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. In this case, 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 the trustees 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, known 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.

When to distribute from the Trust

The Trustees would also have the discretion to determine when to wind up the trust and distribute the assets to the beneficiaries. However, there is an important tax rule to remember with discretionary family trusts: they only have a tax shelf life of 21 years. That's because under 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 at that time 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.

As I mentioned at the top of this article, a family trust can allow for income splitting with minors by way of the prescribed rate loan strategy, such that income earned by the trust can be allocated out to your minor children and taxed in their hands at low rates.

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.

So, remember that the clock is ticking with the 2 per cent prescribed rate – you only have until September 30 of this year to form a family trust and lend funds to it before the rate jumps to 3 per cent. And if you meet this deadline, don't worry about what happens on October 1 as you can lock into the 2 per cent rate for the lifetime of the loan. My parting note is that it is important to speak to your tax advisor before you finalize the trust agreement and transfers to it to ensure it is drafted properly, keeping in mind some of the issues I have highlighted above. And in some instances, simply fixing the problem after the fact won't save you from a tax problem. ❑