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It's a matter of trust – Part II

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This discussion is a continuation of our earlier Tax Alert and will focus on selected traps that taxpayers should be aware of when undertaking tax planning involving trusts. Although there are many different types of trusts, the focus of this discussion will be on discretionary family business trusts with Canadian resident trustee(s) and beneficiaries.

Over the last several years, the Department of Finance has enacted changes to income tax legislation to close perceived tax loopholes while attempting to maintain relatively low corporate tax rates. As part of these sweeping changes, there has been a trend to increase the personal tax cost on distributions of corporate surplus. This trend may result in business owners reviewing income-splitting opportunities to extract corporate surplus in a tax-efficient manner. Although there are a number of income-splitting strategies, using a family business trust to hold a company's shares is particularly beneficial.

The following issues may be encountered by taxpayers who introduce trusts to their corporate structure.

Association

In a discretionary trust where a trustee has discretionary power over a beneficiary's entitlement to income or capital of the trust, each beneficiary is deemed to own all of the corporate shares owned by the trust. If beneficiaries are minors, both parents are deemed to own 100% of the shares held in the trust for those children. Both of these deeming rules can cause two corporations that would otherwise not be associated to become associated. Associated corporations must share their annual small business deduction limit. These association issues often present themselves in multi-generational businesses or when children of business owners start to operate their own businesses.

Change in trustees – acquisition of control considerations

Many discretionary family trusts survive for 21 years or longer. During this time, the trustee(s) may change. Where the trust is discretionary and holds the majority of voting shares of a particular corporation, a change in trustees can result in an acquisition of control of that particular corporation. An acquisition of control will result in a deemed year-end of the particular corporation, among other tax consequences. For example, if a trust has one trustee (Mr. A.) who resigns in favour of an unrelated trustee (Mr. B), an acquisition of control will generally occur. This would occur even if Mr. B was appointed as a result of Mr. A's death. If Mr. A and Mr. B are related, however, it is likely that there is no acquisition of control. If the trust has multiple trustees and there is a change in one of these trustees, this will likely give rise to an acquisition of control. (In the case of non-discretionary trusts, limited relief from this rule may be available for non-discretionary trusts for changes in trustees that occur after September 12, 2013.)

U.S. persons and trusts

If U.S. citizens are serving as trustees or beneficiaries, care needs to be taken as outlined in a previous Tax Alert.

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Corporate beneficiaries

The use of a corporation as a discretionary beneficiary ("BenCo") has increased over the last several years. This type of structure allows for redundant assets of an operating company ("Opco") to be distributed on a tax-deferred basis to BenCo. The remaining assets of Opco would be active assets used in the business. This type of planning – commonly referred to as a "purifying" Opco – improves the likelihood that the shares of Opco will be eligible for a taxpayer's lifetime capital gains exemption.

If Opco generates income from an active business, Opco pays taxable dividends to the trust to distribute redundant assets to the trust. The trustee(s) would then allocate this dividend to BenCo. Assuming that BenCo is "connected" to Opco for income tax purposes and certain anti-avoidance rules found in Section 55 of the Act are not applicable, the dividend would be received tax-free by BenCo. Determining whether or not BenCo is connected with Opco can be quite complicated, particularly in businesses with multiple unrelated shareholders.

Introducing corporate beneficiaries to a business group can yield significant advantages, but this also adds complexity to the tax environment. Couple this with the proposed changes to the anti-avoidance rules found in Section 55 (discussed in an earlier Tax Alert) and taxpayers will be faced with significant complexity in analyzing whether or not their structure can achieve their objectives without encountering adverse income tax consequences.

A discretionary family trust can offer significant tax planning opportunities to many businesses. In times with increasing personal income tax rates on corporate distributions, business owners should consider establishing a trust to facilitate income and capital splitting strategies. However, the structure is only as good as the execution of the plan. Please contact your trusted Collins Barrow advisor to determine if a trust would be beneficial to you or if you would like to ensure you are administering and operating your trust appropriately.

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