

INCOME TRUSTS VS FAMILY TRUSTS

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Much has been written about the announcement made by the Minister of Finance, Mr. Jim Flaherty, and, in that regard, many commentators have failed to distinguish between income trusts and family trusts. It is therefore important to note that the amendments proposed by the Minister of Finance relate only to income trusts and will have no impact whatsoever on family trusts.

Income trusts are essentially business corporations that are listed on a stock exchange and generate substantial income, while family trusts are usually trusts created to hold a principal residence or shares of a private company. Family trusts are not intended as an investment vehicle for the public.

Consequently, it is worth noting that the types of trusts suggested to owners of family businesses are not targeted by the amendments proposed by the Minister of Finance and that it is still wise and timely for business owners to consider restructuring their business operations so as to incorporate a family trust. If you need convincing arguments on this point, the following brief overview of the advantages of a family trust should suffice.

A Trust is a Separate Patrimony

The Civil Code clearly states that a trust is a patrimony distinct from that of the settlor or the beneficiaries. This means that a trust's only creditors are those with whom the trust has contracted. The trust's patrimony cannot be held liable for the debts of the settlor or of the beneficiaries. Of course, no transfer of assets to the trust can take place to the detriment of the creditors of the transferor. Since a trust has a separate patrimony, it may be worthwhile for business owners to consider transferring their principal residence and other significant assets to a discretionary trust whose beneficiaries are their spouse and children. In this manner, the assets held by the trust can be shielded from their creditors. The trust's patrimony can ensure that the lifestyle of the family members is maintained, while protecting family assets from any financial setbacks the business owner may suffer.

The Trust as an Income Splitting Vehicle

Where children are 18 years of age or older, it is advantageous to consider creating a family trust in which the business owner, his children (including any grandchildren) and his spouse, where the company is a small business, can be the discretionary beneficiaries of the family trust. In this way, it is possible to make an annual allocation, among the beneficiaries, of the dividends declared by the operating company to the trust. Taxes can then be minimized by allocating the dividend income among the various members of the family. Of

course, the dividends must be paid to the beneficiaries in order to be able to avail oneself of this income splitting rule.

Trusts and the Capital Gains Exemption

Given that, for taxation purposes, a trust is a flow-through entity making it possible to attribute the income earned by the trust directly to its beneficiaries, provided the distribution is made before the trust's year-end, each beneficiary is entitled to claim his or her \$500,000 capital gains exemption on the capital gain attributed to him or her as regards qualifying shares. Consequently, the trust may, at its discretion, distribute a part of the capital gains realized upon the sale of the shares held by the trust so as to maximize the capital gains exemption each beneficiary is entitled to claim. Of course, certain mechanisms must be implemented so that the business owner can continue to manage the family patrimony. For example, one might consider creating a family investment corporation controlled by the business owner and in which each beneficiary could subscribe for common shares and/or preferred shares.

The Trust as a Means of Deferring Taxes Upon Death Unto the Next Generation

Given that the business owner is only a discretionary beneficiary of the trust, there is no deemed tax disposition of his interest in the trust, at the time of his death, because his right as a beneficiary of the trust terminates upon his death. The assets of the trust will be allocated on a tax free rollover basis, among the surviving beneficiaries who usually represent the next generation. The deferred tax liability will become due the day these beneficiaries dispose of the assets of the trust allocated to them or upon their death.

Conclusion

The Legislature allows a trust to act as the mandatary of the beneficiaries who, while clearly identifiable, merely hold an indeterminate interest in the trust. This flexibility makes it possible to designate the business owner as one of the beneficiaries, thereby ensuring that he can draw income and capital from the trust when necessary. Each year, the trustees may also modify the share attributable to each beneficiary. This flexibility also allows the trustees to defer, for a maximum period of 21 years (deemed disposition), the determination of each beneficiary's ultimate share. Again, it is this flexibility which, by far, makes the use of a trust more advantageous than the traditional estate freeze in which the share of each family member must be precisely determined and cannot be modified without a subsequent reorganization; moreover, in a traditional estate freeze, the business owner is deprived of control over the portion of his business which he has transferred to the members of his family, contrary to the trust situation which allows him to defer such a decision for a period of 21 years.