Why Family Trusts Are Still Useful

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Agenda

- Tax on split income
- Multiplication of Lifetime Capital Gains Exemption
- Purifying company of passive assets
- “Golden Share” strategy
- Prescribed rate loan
- Non-tax considerations

Tax on Split Income

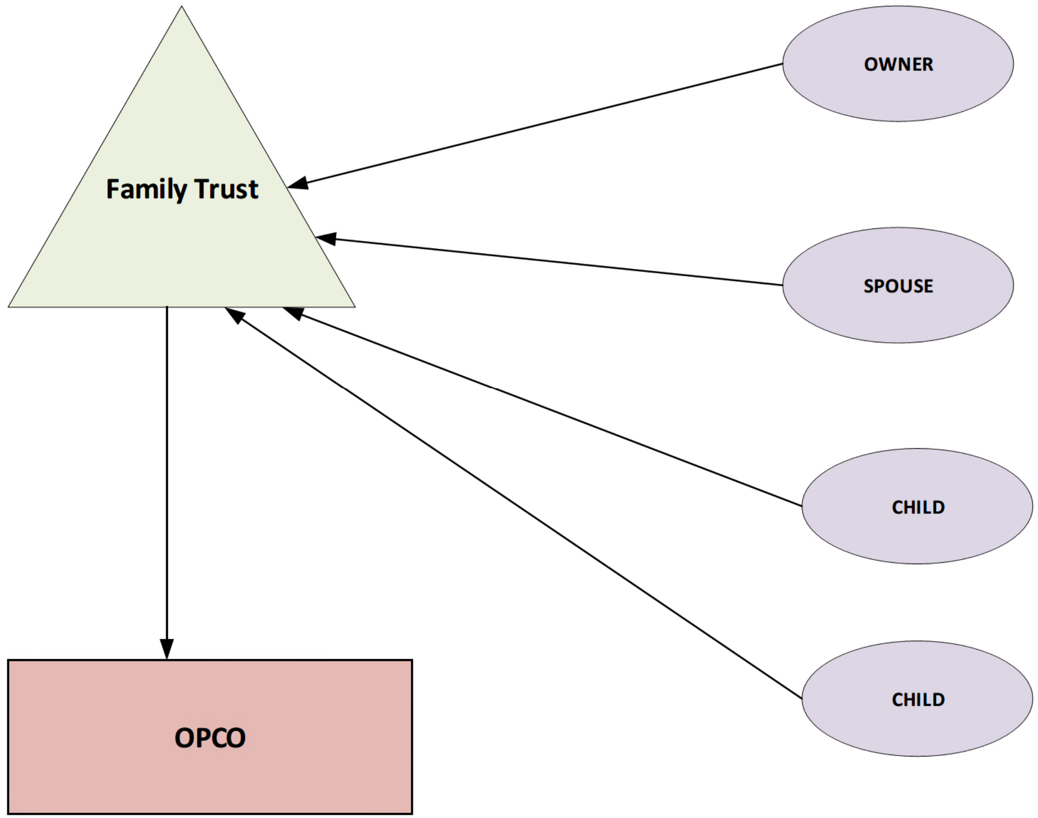
Income Splitting
What is it?

- Strategy to shift income from high income taxpayer to low income taxpayer – Reduce overall tax burden

- Historically, could be achieved in a several ways:
  - Dividend payments to spouse and adult children who were shareholders of professional corporation (“Income Sprinkling”)
  - Pension income splitting
  - Spousal RRSPs
  - Salaries for work done in the business
  - RESPs
  - TFSAs

- Significant tax savings could be realized. For example:
  - Family member with no other income could receive the following tax free:
    - Eligible dividends – approximately $50,000
    - Non-eligible dividends – approximately $30,000

Income Splitting
Traditional Use of Family Trust



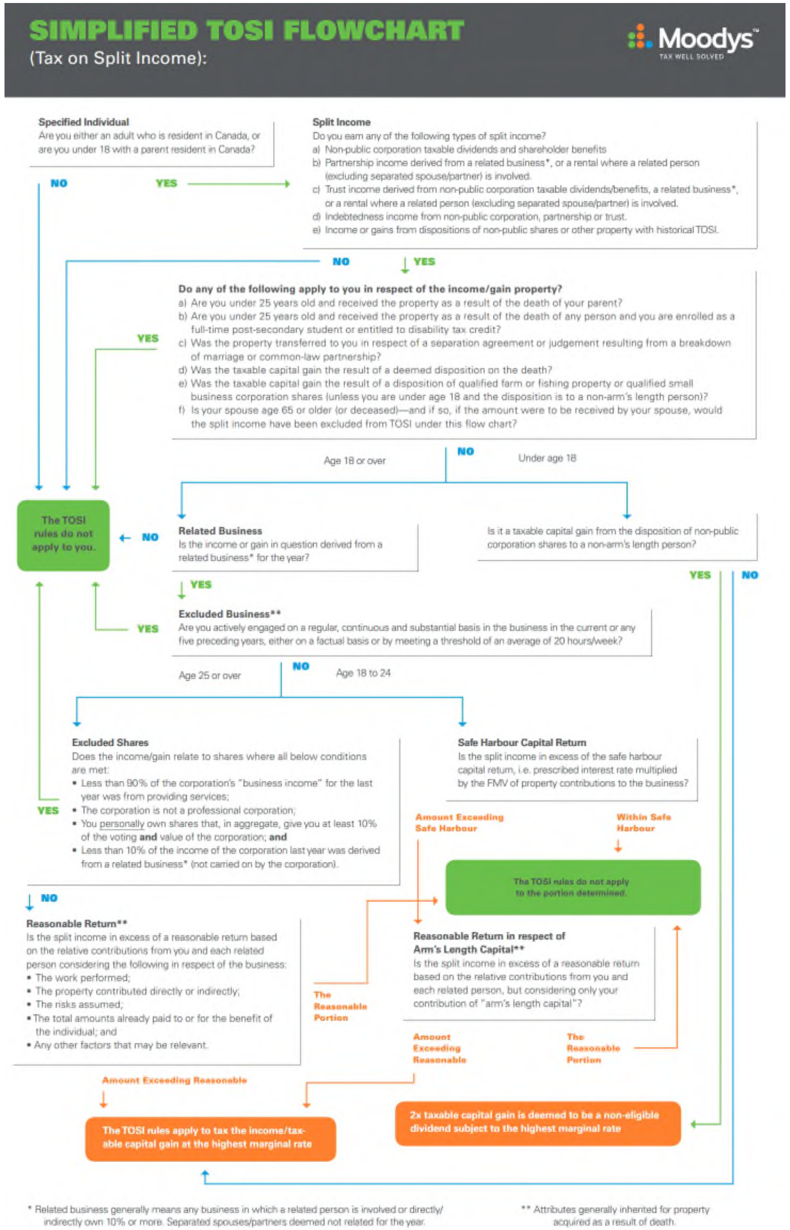
Income Splitting

Why Income Split?

Tax Efficiency

	Eligible Dividends		Ineligible Dividends	
	$205K at Marginal Rates	$205K at High Rates	$205K at Marginal Rates	$205K at High Rates
BC	26,914.66	51,295.09	62,428.89	90,018.07
AB	25,989.89	63,868.98	50,256.34	84,519.74
SK	28,354.59	61,011.57	51,936.82	81,500.33
MB	44,181.89	77,771.22	64,813.45	94,517.78
ON	36,404.73	80,687.83	55,511.51	96,161.92
QC	47,826.52	82,070.75	61,555.86	91,854.60
NS	45,777.50	85,589.10	62,487.72	97,432.50

$40,000 **$35,000**



SIMPLIFIED TOSI FLOWCHART
(Tax on Split Income):
Moodys
TAX WELL SOLVED
Specified Individual
Are you either an adult who is resident in Canada, or are you under 18 with a parent resident in Canada?
NO
YES
Split Income
Do you earn any of the following types of split income?
a) Non-public corporation taxable dividends and shareholder benefits
b) Partnership income derived from a related business*, or a rental where a related person (excluding separated spouse/partner) is involved.
c) Trust income derived from non-public corporation taxable dividends/benefits, a related business*, or a rental where a related person (excluding separated spouse/partner) is involved.
d) Indebtedness income from non-public corporation, partnership or trust.
e) Income or gains from dispositions of non-public shares or other property with historical TOSI.
NO
YES
Do any of the following apply to you in respect of the income/gain property?
a) Are you under 25 years old and received the property as a result of the death of your parent?
b) Are you under 25 years old and received the property as a result of the death of any person and you are enrolled as a full-time post-secondary student or entitled to disability tax credit?
c) Was the property transferred to you in respect of a separation agreement or judgement resulting from a breakdown of marriage or common-law partnership?
d) Was the taxable capital gain the result of a deemed disposition on the death?
e) Was the taxable capital gain the result of a disposition of qualified farm or fishing property or qualified small business corporation shares (unless you are under age 18 and the disposition is to a non-arm's length person)?
f) Is your spouse age 65 or older (or deceased)—and if so, if the amount were to be received by your spouse, would the split income have been excluded from TOSI under this flow chart?
YES
Age 18 or over
NO
Under age 18
The TOSI rules do not apply to you.
NO
Related Business
Is the income or gain in question derived from a related business* for the year?
Is it a taxable capital gain from the disposition of non-public corporation shares to a non-arm's length person?
YES
NO
YES
Excluded Business**
Are you actively engaged on a regular, continuous and substantial basis in the business in the current or any five preceding years, either on a factual basis or by meeting a threshold of an average of 20 hours/week?
YES
Age 25 or over
NO
Age 18 to 24
Excluded Shares
Does the income/gain relate to shares where all below conditions are met:
• Less than 90% of the corporation's "business income" for the last year was from providing services;
• The corporation is not a professional corporation;
• You personally own shares that, in aggregate, give you at least 10% of the voting and value of the corporation; and
• Less than 10% of the income of the corporation last year was derived from a related business* (not carried on by the corporation).
YES
Safe Harbour Capital Return
Is the split income in excess of the safe harbour capital return, i.e. prescribed interest rate multiplied by the FMV of property contributions to the business?
Amount Exceeding Safe Harbour
Within Safe Harbour
The TOSI rules do not apply to the portion determined.
NO
Reasonable Return**
Is the split income in excess of a reasonable return based on the relative contributions from you and each related person considering the following in respect of the business:
• The work performed;
• The property contributed directly or indirectly;
• The risks assumed;
• The total amounts already paid to or for the benefit of the individual; and
• Any other factors that may be relevant.
The Reasonable Portion
Reasonable Return in respect of Arm's Length Capital**
Is the split income in excess of a reasonable return based on the relative contributions from you and each related person, but considering only your contribution of "arm's length capital"?
Amount Exceeding Reasonable
The Reasonable Portion
Amount Exceeding Reasonable
The TOSI rules apply to tax the income/taxable capital gain at the highest marginal rate
2x taxable capital gain is deemed to be a non-eligible dividend subject to the highest marginal rate
* Related business generally means any business in which a related person is involved or directly/indirectly own 10% or more. Separated spouses/partners deemed not related for the year.
** Attributes generally inherited for property acquired as a result of death.

Income Splitting

- **Split income of a specified individual includes:**
  - Taxable dividends or shareholder benefits in respect of shares of a private corporation
  - Partnership income, derived directly or indirectly from a Related Business or from rental property in certain instances
  - Income from (a) and (b) above earned through a trust
  - Debt obligation of a private corporation, partnership or trust
  - Gains from disposition of property described above

Excluded Amounts

- Income not derived directly or indirectly from a “related business”
- Income from “excluded business”
- Income from “excluded shares”
- Safe harbor capital return
- Arm’s-length capital and reasonable return
- QSBC/QFP – Taxable Capital Gain
- Special rules over age 65 or older
- Income or property acquired as part of divorce

Related Business

- A related business to the specified individual is:
  - A business carried on by a related person
  - The business of a partnership, corporation or trust if a related person is actively engaged in the income earning activities (no ownership required)
  - The business of a partnership if a related person has an interest in it (ownership, but no activity required); or
  - The business of a corporation if a related person owns shares or property that are equal to 10% or more of the total FMV of the shares of the corporation [FMV only; % votes is not a consideration here]

Derived Directly or Indirectly

- How will CRA interpret this phrase? We suspect very broadly
- Look for any linkage between related businesses
- Includes amounts derived from providing property or services to, or in support of, a business
- “Derived” also catches income earned on amounts derived from a related business

Exclusion 1: Safe Harbour

- Income / taxable capital gain from the disposition of property under the following circumstances:
  - If less than 25 years old, the property was acquired as a result of:
    - A parent's death
    - Any person's death, if the individual is enrolled in full-time post-secondary studies, or entitled to the disability tax credit
  - Certain matrimonial divisions (ITA 160(4))
  - Taxable capital gain arising on death
  - Taxable capital gain on disposition of QFP or QSBC

Exclusion 1: Safe Harbour

- Income received by an individual with a spouse aged 65+ where that income would be an excluded amount to the spouse
- Income / gain on shares inherited via a will if the amount would not be TOSI to the deceased

Exclusion 2: Excluded Business

- A business, if the specified individual (18+ only) is actively engaged on a regular, continuous and substantial basis in the activities of the business in either:
  - The current year (except in respect of taxable capital gains); or
  - Any five prior taxation years (need not be continuous or recent)

Exclusion 2: Excluded Business

- Actively Engaged
  - What exactly does actively engaged on a regular, continuous and substantial basis mean?
    - Bright-line test: average of 20 hours per week
  - Finance’s Explanatory Notes appear to support this interpretation a simple mathematical formula:
    - Total hours worked in year / No. of Weeks in the year the business was operational
  - Other cases: Consider the individuals relative contributions to the business
    - Can be regular, continuous and substantial <u>even if you do not work 20 hours per week average</u>

Exclusion 3: Excluded Shares

- Excluded Shares: All the Following Criteria is Required to be Met:
  - Individual has attained the age of 24 years before the year
  - Shares must be directly held (i.e., not through a trust)
  - Less than 90% of the corporation’s business income for the last taxation year was from the provision of services
  - The corporation is not a professional corporation
  - Immediately before the time, the specified individual owns shares that represent 10% or more of the votes AND value of the corporation; and
  - All or substantially all (i.e., 90% of the corporation’s business income for the taxation year referred to above is not derived directly or indirectly from a Related Business in respect of the individual, other than a business of the corporation

Exclusion 4: Reasonable Return

- 18-24 Years Old – Two Methods
  - Safe Harbour Capital Return:
    - Prescribed rate of return on value of contributions (currently 2%)
    - Requires tracing of the origin of funds invested in the business
  - Reasonable return on arm's-length capital:
    - Generally capital not received from a related person or through a loan

Exclusion 4: Reasonable Return

- 25 Years Old and Older
  - Considers the following factors relating to the relative contributions of the specified individual and each source individual in respect of the related business:
    - Labour contributed
    - Property contributed
    - Risks assumed
    - Total all amounts paid or payable to the individual in respect of the business
    - Such other factors as may be relevant

Income Splitting
Post 2017

- Income splitting post TOSI changes:
  - ~~Dividend payments to spouse and adult children who were shareholders of corp ("Income Sprinkling")~~
  - Pension income splitting
  - Spousal RRSPs
  - Salaries for work done in the business
  - RESPs
  - TFSAs

- Many options still exist in the right circumstances!

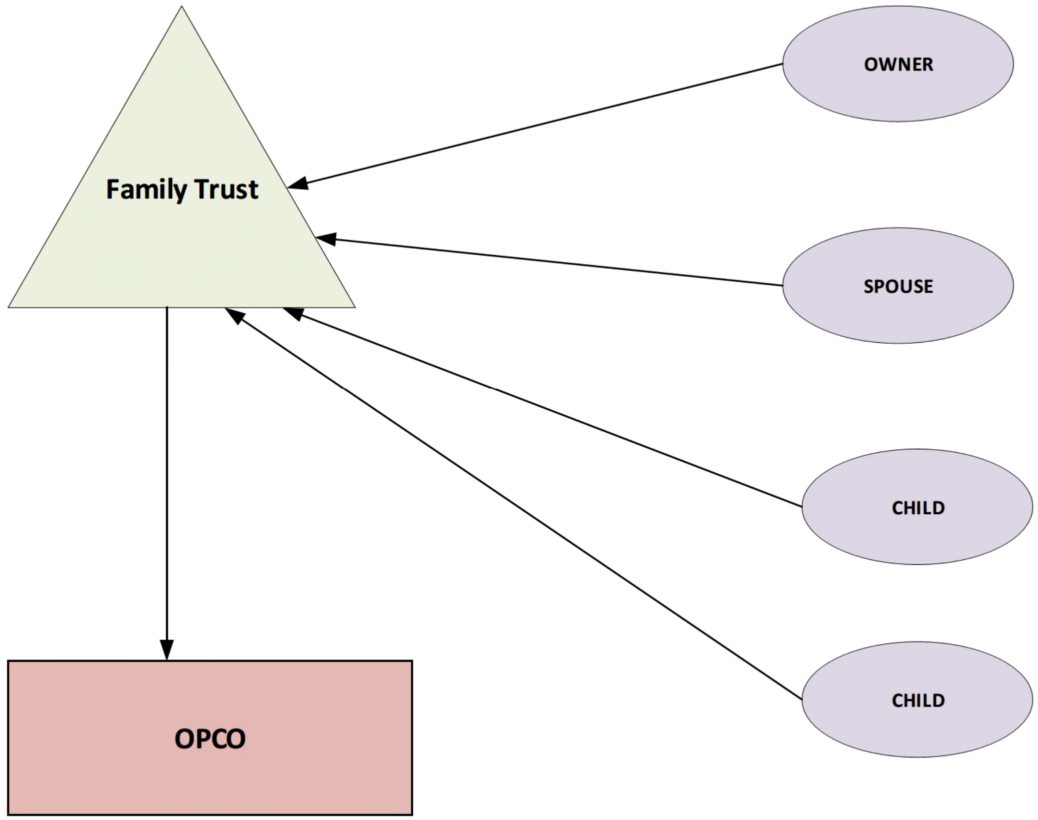
Multiplying Capital Gains Exemption

- Exclusion exists for QSBC shares
- Must meet criteria:
- A Canadian-controlled private corporation in which all or most (90% or more) of the fair market value of its assets:
  - are used mainly in an active business carried on primarily in Canada by the corporation or by a related corporation
  - are shares or debts of connected corporations that were small business corporations
  - are a combination of these 2 types of assets
- Shares have been held for 24 months
  - Not applicable to new treasury shares
  - Look through rule for trusts
- Over 50% of the assets were used in active business over the prior 24 months

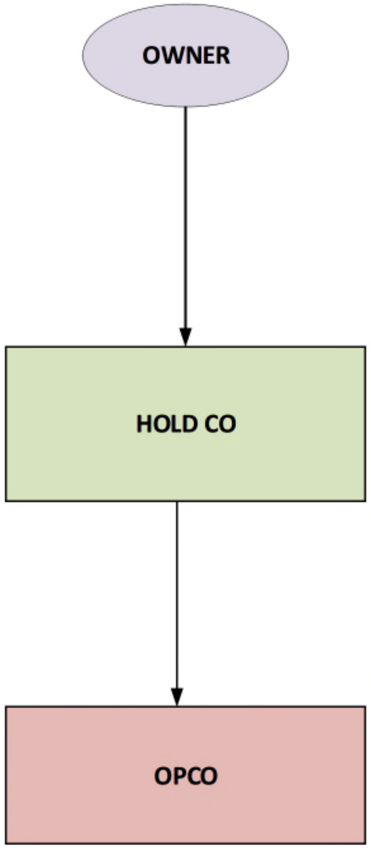
Multiplying Capital Gains Exemption (cont)

- With trust in place, the gain on any sale can split between spouse and adult children
- Lifetime Capital Gains Exemption for 2020 - $883,384
- Indexed for inflation
- Minimum tax may apply
  - Can be recovered as income is earned by the taxpayer

Multiplication of Capital Gains Exemption



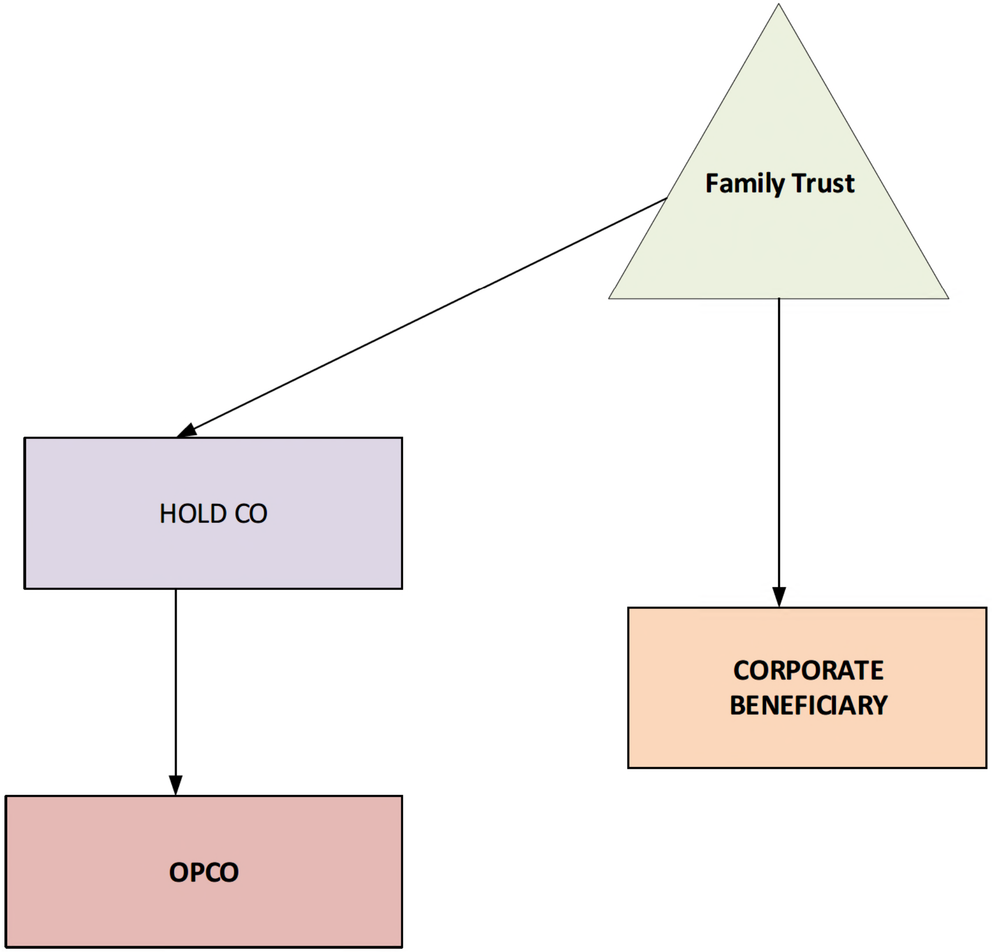
Purifying a Company Using a Trust



Purifying a Company Using a Trust

- Passive assets can build up in holding company of traditional structure
- This can push company offside for LCGE in event of sale
- Trust can be set up to allow for corporate beneficiary
- Allows for dividends to flow to second company for investing, creditor protection, etc

Purifying a Company Using a Trust



“Golden Share” Strategy

- If shares meet definition of “excluded business”; ie the shareholder was active in business, they will still meet exclusion after being bequeathed on death
- Only if shares are inherited directly from individual, not received from trust
- This could be a problem with having a trust
- There is a solution!

“Golden Share” Strategy

- Have family trust hold common shares
- Active business owner hold some class of preferred shares personally
- When owner passes away, he bequeaths preferred shares to spouse and children
- Common shares come out of the trust
- Preferred share means that the “excluded business” test is still met
- Pay dividends on common shares

Prescribed Rate Loan Strategy

- Current prescribed interest rate is 2%
- Higher income spouse lends money to trust
- Trust buys portfolio of publicly traded securities
- Trust pays annual interest on the loan before January 30th
- Income is distributed to non-active spouse and children

MNP LLP

Non-Tax Considerations

- Business owner is contemplating retirement in 5-10 years
- Has children working in business that want to succeed him in ownership
- Has enough built up equity in the company for retirement
- Wants future growth to go to children
- Wants to retain some control over business for the foreseeable future

Non-Tax Considerations

- Estate freeze to lock in the value of the company in redeemable preferred shares by exchanging his common shares on a tax deferred basis
- Trust subscribes for new common shares
- Future growth attributes to common shares held in trust
- Accomplishes goals; retains control and passes growth to next generation
- What happens if value of company decreases?
- What happens if preferred shares don’t fully fund retirement?
- Allows for flexibility

Non-Tax Considerations

- Provides asset protection
- Assets of the trust are not owned directly by trust beneficiary
- Harder for creditors to attack trust assets
- This can be limited by bank and creditor guarantees
- Can also protect assets in marriage breakdown as beneficiaries don’t own assets

Non-Tax Considerations

- Minimizing probate
- Assets held in trust are not subject to probate
- Avoids probate fees which can be substantial for larger estates

Wrap Up

- LCGE multiplication
- Purifying company of passive assets
- Flexibility
- Maintain Control


THANK
YOU!

Disclaimer