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Monitor, manage, maximize:

Preserve family trust benefits with effective management

You've spent years building a successful professional practice, and you've worked with your advisers to create a corporate structure that includes a family trust. You may have decided on a family trust for a number of reasons, such as business succession and estate planning, creditor proofing and/or multiplying access to the capital gains exemption.

In many cases, a family trust also includes the ability to split income, potentially unlocking enormous benefits for you and your family members throughout the trust's life. Income splitting can be an excellent option, but all too frequently, people assume—incorrectly—that once a trust is set up, its benefits will be ensured simply by maintaining the status quo. Instead, you should be asking: "How can I make sure those benefits are preserved and protected over time?"

It all comes down to effective management

To maximize income splitting benefits, a family trust must be managed with care and diligence, especially given its associated complexities. Additionally, there are a number of scenarios that can impact the trust and its beneficiaries in ways you may not have anticipated. However, if you've been, and continue to be, attentive, you should be able to consistently maximize the income splitting benefits your trust affords.

Ensure lasting value by getting income splitting right

The CRA is focusing more time, attention and audit activity on family trusts, making it more important than ever to ensure your trust is managed with diligence and care. This is particularly critical when it comes to the income splitting process.

First of all, remember that your trust is a separate entity that operates under a fixed sequential process. A well-managed trust flows one way. For example, your company makes the dividend payment into the trust, and the trustees allocate the dividend to the beneficiaries.

> If you have yet to set up a trust, consider whether it should include mechanisms for income splitting, estate planning, business succession planning, creditor proofing, multiplying your capital gains exemption—or all the above.

By doing this, you effectively split the trust's income so that it can be taxed in the hands of lower income beneficiaries, at lower rates. To do this properly, however, a two-step process MUST happen before the end of the trust's taxation year (e.g., 12-31-XX):

1. Trustees must decide how income/capital gains will be allocated to beneficiaries and ensure the process is documented in the Trustee's Resolution.
2. Income must be paid to beneficiaries (by cheque) or payable to beneficiaries (through issuance of a promissory note) prior to the end of the trust's taxation year.

If this process is not accurately followed AND documented, income will be subject to tax in the trust at the trust's tax rates, which are equal to the highest personal marginal rates.

Stay in touch with the family—and their financial situation

To optimize income splitting opportunities associated with your family trust, you must annually assess the trust's beneficiaries' financial situations. As their lives change, it may impact the income you allocate to them. Keeping a vigilant eye on the ever-changing lives of your beneficiaries—whether they're entering adulthood, starting university, marrying or even moving to a different province—is not only recommended, it's necessary if you want to ensure you're getting the benefits you intended when you first established the trust.

Your beneficiaries' financial situations are bound to change as they age. Consider, for example, a dependent who has just turned 18 (if they're younger than 18, you become subject to the "kiddie tax,"[1] which creates another set of issues) or a spouse who recently stopped earning income. Such changes in financial situation are likely to affect an individual's personal tax credits, and you may be able to take advantage of those credits, and the individual's lower marginal tax rate, to generate tax savings.

On the flip side, however, sometimes a dependent or spouse enters the workforce, and you are no longer able to utilize their personal tax credits and/or marginal tax rates to their fullest extent. In situations where beneficiaries' income increases, you may want to re-examine your trust's income allocations to ensure they continue to minimize taxes overall.

Finally, consider an adult child who has just started university and is entitled to tuition and education tax credits. The receipt of dividend income by the child may negate the tax benefits associated with the tuition and education tax credits. The amount and type of income allocated to the child should be re-evaluated. Regardless of the scenario, it's simply a matter of making sure you are up-to-date on the income situation of your trust's beneficiaries. Doing so will help ensure you're minimizing any tax implications, which will almost certainly change year over year. And isn't that the point of the trust in the first place?

Moves, marriages and other matters

Changes to the income level of a beneficiary aside, other factors can affect your family trust and how you use it to split income. But again, with care and attention, their impact can be kept to a minimum or avoided entirely.

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1 Grant Thornton Tax Planning Guide: 2013-2014, http://www.taxplanningguide.ca/tax-planning-guide/section-2-individuals/income-splitting-using-family-trusts/. Accessed July 28, 2014

> "The implications of the 21-year rule may seem distant, but planning well in advance of this deadline will be critical."

A move to another province, for example, can trigger significant tax implications or impact allocations to the beneficiary. Knowing the income tax rate in your—or your beneficiary's—new province is important as it varies by province. And, of course, you should have an understanding of what tax credits are available, whether they're being maximized and whether you have the documents to support them.

Consequences can also occur when a beneficiary moves to another country, such as the United States. Consequences could include: (1) extensive information reporting to the IRS; (2) the beneficiary having to include a share of the company's income in their US tax return, even if the income has not been distributed from the company; (3) distributions from the trust to the US beneficiary resulting in double tax; and/or (4) Canadian withholding requirements. If your beneficiary has moved to the US or is contemplating such a move, you should contact your adviser as soon as possible.

Marriage is another life event that should trigger a fresh look at income allocations, whether personal tax credits and marginal rates are being maximized, and an overall look at your corporate structure. If a beneficiary gets married, it can have unforeseen consequences—for example, a decrease in the small business deduction—if not properly dealt with.

Transacting with the trust—a cautionary tale

While this discussion focuses on getting the most out of your family trust from an income splitting perspective, you should also consider the potential negative impacts should certain rules not be followed. Treat your trust with caution. Be particularly careful when you or a family member transacts with the trust (e.g., lending to the trust, transferring assets to the trust).

If not done properly, what seem like simple transactions can inadvertently "taint" the trust so you can't use it to split income. This is difficult to fix, and you could lose all income splitting privileges permanently. To avoid unseen issues, always contact your trust administrator before transacting with your trust.

Despite the challenges associated with managing a family trust, it's more than possible to consistently achieve the objectives you started with. To that end, follow a few tried, tested and true "Dos" to help ensure you're reaping your trust's full benefits.

Do:

- Treat your trust as a real and separate entity, complete with its own bank account.
- Be up-to-date with the income levels of all beneficiaries.
- Maximize use of your beneficiaries' marginal tax rates.
- Be mindful to not waste available tax credits, such as dividend and tuition tax credits.
- Know and understand beneficiaries' income tax rates in their province of residence, as they will vary.
- Ensure that the paperwork for the trust is in proper order—Trustee Resolutions.
- Ensure cash is flowing and/or promissory notes are in place.
- Monitor the age of your trust to take into account the 21-year rule.[2]
- Monitor rules and repercussions related to non-resident beneficiaries.

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2 The big freeze, Grant Thornton LLP. 2009. http://www.grantthornton.ca/resources/insights/TLs/PHBs/The_big_freeze.pdf. Accessed October 18, 2014. Page 3.

Even if you're sure the above measures are currently in place, remember that your life and your beneficiaries' lives will change, perhaps greatly, over the course of your trust's lifespan. Children will grow up, beneficiaries will leave and enter university or the workforce, marriages are likely to occur and grandchildren may soon follow. Reacting accordingly—and in a timely manner—to these inevitable changes will help ensure your trust remains optimized, both in the short and long terms, for all parties involved.

If you've taken the time to set up a family trust, you know it's a critical part of your and your family's future. Don't let mistakes, lapses and oversights jeopardize your ability to maximize trust value for as long as your professional and personal goals require.

To learn more about managing your family trust and effectively splitting income to minimize your tax burden, contact

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