

Trusts, an essential business component

The 1994 reform of the Civil Code had a significant impact on the civil law concept of trusts. Trusts, as they now exist under the new Civil Code of Québec, are an improved version of the common law trust, with all its benefits and flexibility and none of the disadvantages of the former concept of trusts found in the Civil Code of Lower Canada.

The following is a brief outline of the major benefits of trusts and the potential they offer for favourable tax planning.

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 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.

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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 UNTIL THE NEXT GENERATION

Given that the business owner is but a discretionary beneficiary of the trust, there is no disposition 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 shared among the surviving beneficiaries who usually represent the next generation.

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.



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