

Marmer Penner Newsletter

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KEEPING THE TAX SAVINGS ALL IN THE FAMILY: USING FAMILY TRUSTS IN FAMILY LAW

From an income tax standpoint, “income splitting” refers to the legitimate shifting of income from a high rate to a low rate taxpayer. One of the most common examples of income splitting is the parent who Larry the lawyer is a sole practitioner. He earns about \$200,000 a year based on revenues of \$500,000 and expenses of \$300,000 per year. A family trust established for the benefit of his two children incorporates a company to provide administrative services to Larry’s practice. The

pays a reasonable salary to a spouse and/or children for services provided.

Family trusts owning management companies have become popular methods of income splitting with children, management company administers Larry’s practice by paying all of its bills and is permitted by Revenue Canada administrative policy to charge Larry’s practice a fee of up to 15% of the expenses paid. Accordingly, the management company bills Larry a fee of

even ones who are minors and are incapable of providing service to any business.

Consider the following example:

\$45,000 (15% of \$300,000). The corporation, which is a Canadian controlled private corporation, must pay income tax on this income, albeit at the low tax rate of 23%. This results in \$34,650 of after-tax income to the corporation (\$45,000 less 23%). This amount may

be declared as a dividend by the corporation to its shareholder, the family trust. The family trust, if it retained the dividend, would be required to pay income tax on the dividend at the highest marginal personal tax rates, or about 35%.

However, the trustees may designate the dividend to be paid to each of the beneficiaries, which are Larry's children. Accordingly, the trust designates \$17,325 (one-half of \$34,650) to each of Larry's children. As the after-tax income was paid for the benefit of Larry's children, it may be spent only for the benefit of these children. Larry cannot use the money for his personal needs. However, he may use the money on behalf of the children to pay for their clothing, private school tuition, daycare, summer camp, nanny costs,

Larry's children have no other income, these dividends are received free of personal income tax. It should be noted that as a result of the dividend tax credit available to individuals on dividends received from taxable Canadian corporations, an individual with no other income can receive almost \$24,000 of dividends annually without paying any personal income tax.

The \$45,000 management fee charged by the corporation is a deductible expense to Larry. children's vacation costs, sports or music lessons and equipment, computer and furniture for the children, and gifts. It may be possible to charge the trust a pro rata amount of rent or mortgage interest based on the children's proportionate use of the family home. With respect to items such as groceries, it is questionable whether

Accordingly, at a 50% tax rate, Larry has saved \$22,500 in personal income tax. Conversely, the \$45,000 of income generated \$10,350 (23% of \$45,000) of corporate income tax to the management company, and no additional personal income tax on the payment of the dividends to the children. Accordingly, this income splitting manoeuvre saved Larry's family \$12,150 (\$22,500 less \$10,350) of income tax.

the family trust can be charged with these amounts. Revenue Canada's view in the past has been that parents have a legal obligation to provide for their children's needs until they are sixteen years of age or later if they are enrolled in school full time. Accordingly, such a basic necessity of life is the parents' responsibility.

It should also be noted that where one parent may deduct child care expenses such as daycare and nanny costs, these amounts must be paid by the parent and not by the family trust in order to maintain their deductibility to the parent.

Given the high cost of raising a family and the tax advantages noted above, it is not surprising that family trusts owning management corporations have grown in popularity.

Now let's assume Larry does not have such a management company and family trust in place and that he and his wife Lois separate. Based on the Child Support Guidelines for a resident of Ontario, Larry must pay child support of \$2,281 per month, or \$27,372

annually. As this child support is non-deductible to Larry, the full amount of the support represents his after-tax cost. If instead of support, a family trust with a management corporation as described above was established, Larry's practice would pay a fee of \$45,000 which, as described above, only costs Larry \$22,500 in after-tax money. As also indicated above, the after-tax proceeds to the children amounts to \$34,650. As a result, the children benefit by \$7,278 (\$34,650 in tax-free dividends versus \$27,372 in support) and Larry benefits by \$4,872 (\$22,500 in after-tax management fee costs as opposed to non-deductible support of \$27,372).

As can be seen, this is a win-win situation for the entire family with Revenue Canada picking up the cost. Such a child support agreement requires that the custodial parent waive any right to formal child support in order to receive the enhanced income by way of the family trust for as long as the management company is able to support the children.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner will be pleased to assist you with any matters that arise.