

Investor Insight

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Using a Family Trust to Split Income

These days, it seems that the cost of raising children continues to rise. If you are a parent or grandparent who has expenses associated with a child, you may want to consider a family trust as a way to split income and save taxes.

A family trust can be used for income splitting when it comes to expenses such as a child's education, athletics or other lessons. When properly structured, it may allow you to provide income, which would have otherwise been taxed at a higher tax rate in your hands, to minor children "beneficiaries" at their lower marginal tax rate.

Depending on your objectives, two of the main ways to contribute capital to the family trust are gifting and lending funds. To lend funds to the family trust, a demand loan must be made using the Canada Revenue Agency's (CRA) prescribed rate. The prescribed rate in effect at the time the loan is established will prevail for the duration of the loan.

Each method of contributing capital has its own tax implications:

Gifting funds – Capital gains realized in the trust can be taxed in the hands of the beneficiaries. However, interest and dividend income are attributed back to the contributor for tax purposes and the contributor cannot reclaim the gifted capital.

Lending funds – Here, all income earned in the trust, not just capital gains, can be taxed in the hands of the beneficiaries, less the interest paid on the loan. The lender must pay tax on the interest paid on the loan. However, unlike gifted funds, the capital can be reclaimed by the lender by calling back the loan.

If you plan on establishing a family trust with loaned funds, the CRA prescribed rate is one percent as of September 2015.

Tax savings can be substantial, but depend on the way in which you fund the trust as well as the marginal tax rates of the contributor and beneficiary(ies). We recommend consulting with a professional legal or tax advisor prior to establishing a family trust to ensure that it is structured properly to avoid potential tax or legal consequences.

Dekker Hewett Group
Canaccord Genuity Wealth Management
609 Granville St., Vancouver, BC, V7Y1H2
T: 604.699.0852
E: dhginfo@canaccord.com
www.dekkerhewettgroup.com

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