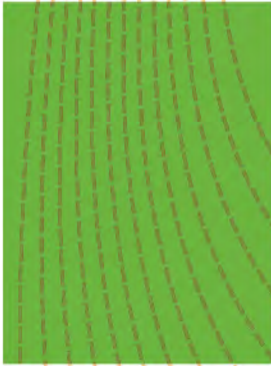

Family Trusts

in Manitoba

Canada

Growing Forward 2
A federal-provincial-territorial initiative

Manitoba

Family Trusts in Manitoba

The surest way to reach a business goal is to plan on it. Successful Manitoba farmers are focused business people. They have clear, flexible, short and long term business plans – and they monitor their plans regularly.

Whether you're starting, growing or passing along your business, you need a solid business plan. And Manitoba Agriculture, Food and Rural Development (MAFRD) can help you build a plan for success.

Farm businesses are rapidly growing in size and complexity. The need for careful assessment of a farm operation and determination of which business structure best meets the needs of a farm is essential. Understanding how a family trust is created, how it functions and the advantages and disadvantages of using them in structuring your farm operation will provide assistance in making these decisions. Use this as a resource to help you be informed about Family Trusts.

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This publication was completed with the valuable contribution of Mona G. Brown, Harley Shepherd and Andrew Winkless.

Available in alternate formats upon request.

Table of Contents

What is a trust? **4**

What is a discretionary trust? **4**

Definitions associated with trusts **4**

Why create a trust? **7**

Benefits of a trust 7

How is a discretionary trust formed? **8**

The settlor and trust document 8

The trustees 8

Subscription for shares of farm corporations 8

Estate freeze 9

Common uses of discretionary farm trusts **10**

Wealth preservation fundamentals and use of discretionary family trusts **11**

Deemed disposition on death 11

Exceptions to the deemed disposition on death 11

Tax planning strategies 12

Issues to be aware of when considering using a family trust **13**

The 21 year deemed disposition 13

Association 14

The capital gains exemption (CGE) **15**

Conclusion **18**

What is a trust?

A trust is a legal entity through which a person, called the “settlor” gives assets to persons call the “trustees” to hold and administer those assets for the benefit of others, known as the “beneficiaries.”

What is a discretionary trust?

A discretionary trust is a trust where the settlor gives the trustees broad discretion and powers to decide when, and to whom, income or capital owned and earned by the trust are distributed to one or more of the beneficiaries of the trust. It is important to have an “outside trustee” (not the settlor or one of the beneficiaries) if the farmer(s) and their spouse(s) are to be named as beneficiaries of the trust, as there must be a separation between the legal owners (the trustees), and the beneficial owners (the beneficiaries) to establish a valid trust.

Historically, trusts were used in England to avoid estate taxation when the land owner died. Therefore, most trust law is based upon the common law Canadians inherited from England. Manitoba has *The Trustee Act*, but where the act does not specifically deal with an issue, the common law will apply. Trusts first started to be taxed in Canada in 1927.

The *Income Tax Act* has a number of special rules relating to trusts and their taxation, thus, the advice of professionals who are knowledgeable in this area is essential.

Definitions associated with trusts

Trust

A trust is a gift of assets to an individual or group of people known as the trustees to administer for the benefit of the trust’s beneficiaries.

Settled Property

A coin, coin set, or other symbolic object purchased by the settlor and given to the trustees of the trust as the initial “settled property.” The “settled property” must not earn income and must remain in its initial form throughout the life of the trust. The trustees borrow money (from a financial institution or a private person) to buy the common shares of the family farm corporation (Farmco) or other farm assets.

Settlor

The person who creates the trust by directing the lawyer on the terms of the trust (with the lawyer's guidance and advice), signing the trust deed, and by gifting the "settled property" to the trustees to use on behalf of the beneficiaries.

Trustee

The trustees are the people chosen by the settlor to administer the trust assets on behalf of the beneficiaries. The trustees make all decisions in relation to the trust property and have broad discretion. On an annual basis, the trustee must determine how much of the trust's income, if any, or capital, if any, is to be distributed to one, some, or all of the beneficiaries and determine the amount of income to be retained and added to the capital of the trust.

For example: The trustees are usually the farmer and the spouse of the farmer and one "outside" unrelated trustee. The "outside" trustee is usually a professional advisor, close family friend, or a business associate. The trust document usually names replacement trustees, often family members or the children of the farmers upon them attaining a certain age. The replacement for the outside trustee should be another unrelated person.

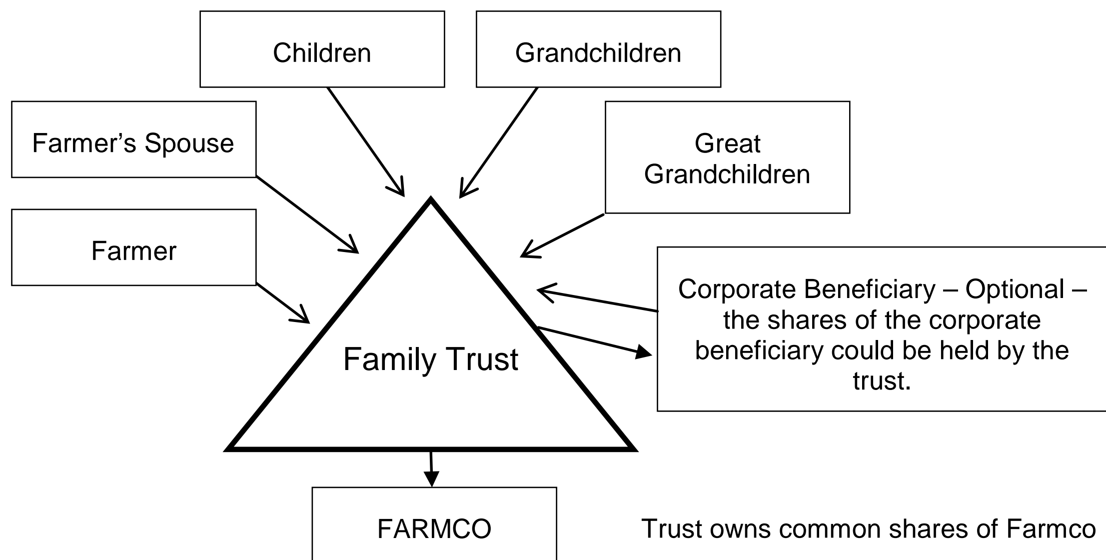
Beneficiaries

The beneficiaries of a trust are the people entitled to the income or capital of the trust property. In discretionary family trusts, the beneficiaries have no right to any of the trust assets until the trustees meet and agree to distribute the assets to that beneficiary.

For example: in a discretionary family trust for a farming family, the beneficiaries would normally be:

- The farmer and spouse
- Their children, grandchildren and great grandchildren
- A corporate beneficiary (optional, the trust agreement could allow one to be added at a later date)

The schematic looks like this:



A corporate beneficiary can be named at the start of the discretionary family trust, or added later. Its shares are usually owned by the family trust, creating a circle.

Trust Roll Out

A tax free transaction which allows the trustees to give its assets (shares of Farmco) to any beneficiaries, including minors, without creating any tax liability under section 107 of the *Income Tax Act*.

Deemed Disposition

Discretionary family trusts have a birthday every 21 years from their initial creation. The trust's assets can be gifted by the trustees to any or all of the capital beneficiaries any time prior to the trust's 21st birthday on a tax free basis.

Farmco

Family farm corporation.

Why create a trust?

A discretionary family trust allows the farmer and spouse to make the decisions and control the trust while amassing capital in the trust that can be allocated in the future to the trust's beneficiaries (family members including the farming couple or an optional corporation). The formation of a discretionary family trust allows the trustees to control the spread of farm-acquired income to several adult family members (beneficiaries), instead of being claimed by one individual. It also allows the trust's capital assets to be allocated to capital beneficiaries, who can be minor children, who can use their capital gains exemption on any later sale of the trust's farming assets or on the trust's 21st anniversary by allocating capital gain.

Benefits of a trust

When you create and administer a discretionary family trust, there are both tax and non-tax benefits. Some of these benefits include:

- avoidance of capital gains tax by use of multiple capital gains exemptions
- saving on probate fees and taxes
- holding assets for minors
- tax savings by income splitting with adult children and a spouse or common-law partner
- protection of assets from claims by creditors or under family law
- organization of family affairs
- holding family assets after death and avoiding the deemed disposition and tax on death for farm property that does not qualify for the farm rollover or capital gains exemption
- increases in the confidentiality of financial affairs
- preservation of the family farm by giving the younger generation some rights, while keeping control in the trustees until they gain business experience
- keeping the family Farmco "pure." Ninety per cent of the assets of the Farmco must be in active business, so that its shares qualify for the farm rollover and/or the capital gains exemption. If Farmco has too much cash or non-active farm assets, these can be allocated to the beneficiaries, including the optional corporate beneficiary so that Farmco stays on side for the capital gains exemption.

How is a discretionary trust formed?

The settlor and trust document

The settlor (for example, the parent of farmer A), arranges the establishment of the discretionary family trust by buying a coin with the settlor's own money and giving instruction to a lawyer (who is experienced in trust and tax law) to draft the trust document. The lawyer hired to draft the discretionary family trust must ensure it qualifies as a trust. To qualify as a trust, it must contain the following three (3) certainties of a trust:

1. certainty of objects
2. certainty of subject matter
3. certainty of intention

As the *Income Tax Act* has many complicated rules relating to trusts and their taxation, the lawyer must draft the trust for the family and advise them of these rules.

The trustees

The trustees are farmer A, spouse or adult child, and an unrelated third party, often their lawyer or accountant or a close friend with business acumen. Replacement trustees, or a mechanism to name replacement trustees, are also established. The beneficiaries are divided into "income" and "capital" beneficiaries. Usually, these beneficiaries are identical: farmer, spouse, children, grandchildren, great grandchildren, and corporation (optional).

Subscription for shares of farm corporations

The trust is now formed and the trustees can go to a financial institution and borrow a small amount of funds ($300 by overdraft or line of credit) to purchase the common shares of the Farmco and the common shares of the family farm land corporation (hereinafter "Landco"), if one is established. The coin ("settled property") is **never used** or all the income and capital will be taxed to the settlor.

Estate freeze

In order for the trust to subscribe for common shares of the Farmco or Landco, an "estate freeze" of the Farmco is required. An "estate freeze" is a corporate and tax transaction where the Farmco's assets are valued and debts subtracted by Farmco's qualified accountant and the common shares are exchanged for preferred shares that are worth exactly what the common shares were worth on the freeze date. All the value is now in the preferred shares and the family trust can subscribe for common shares at a nominal price (usually $1 per share) and all the future growth of the Farmco and/or Landco goes to the trust.

For example: Mr. and Mrs. Farmer Brown each own 50 common shares in Farmco. Their accountant values the assets of Farmco, subtracts the debt and establishes that the 100 common shares are worth $2 million. Mr. Brown exchanges his 50 common shares for 1000 preferred shares worth $1 million in total, and Mrs. Brown does the same. There are no more common shares and all the value of the Farmco is in the preferred shares. Preferred shares are always issued for a set dollar amount and rank ahead of the common shares on a windup. Preferred shares do not grow in value although they may be entitled to a preferential dividend (interest). They can be voting or non-voting, your lawyer will advise you what is best or required for your farm family. Common shares are the growth shares that reflect the accumulated value of the Farmco after debt is paid and the issued preferred shares are paid out.

Common uses of discretionary farm trusts

Often, farmers will choose to incorporate their business in order to limit their personal liability for debts of the Farmco and to take advantage of the low small business tax rate (currently 11 per cent) in order to grow the farm by paying less tax.

The farmer(s) and spouse(s) can pay themselves by a salary or by receiving dividends in the discretionary farm trust. In Canada, our graduated rate system of taxation taxes a single person more compared to the same income shared between two or more people.

A child turns 18 and wants to go to university out of province to study a specialized course. Rather than have the parent earn a higher salary or receive more dividends, which would result in the parent paying tax at a high rate, the family trust would receive a dividend which it would allocate to the child. The money is taxed in the child's hands as if the child had received the dividend directly. If the child has no other source of income, the income is taxed at his or her low marginal tax rates. The fact that the child resides out of province makes it difficult to justify salary for that child. If the child has no other income, a $30,000 dividend would attract approximately $3,300 in tax at current rates. Tax on the same $30,000 dividend paid to the parent could be as much as $12,000 if the parent is at the highest marginal tax rate.

The exact amount saved, and whether it would be better for the parent to receive dividends or salary, will vary based on what the parent's income actually is, but there is often a large advantage to getting money out to the child rather than getting the money out to the parent to then give to the child. You can only start doing this when a child turns 18, but children are at their most expensive when they begin post-secondary education. Dividends to minors are subject to a punitive provision in the *Income Tax Act* commonly referred to as "kiddie tax," which results in the income being taxed at the highest marginal rate.

When the farmer has a family, he or she can save tax by causing the corporation to dividend to the discretionary family trust. A discretionary trust is taxed at the high rate of 50 per cent if the income is left in the trust. Normally, only small amounts of money are left in the trust to pay administrative costs and the balance of money is dividended from Farmco to the trust and then allocated by the trustees to one or more of the adult income beneficiaries of the trust. The tax is paid in the beneficiary's tax return at the beneficiary's marginal rate. An adult beneficiary who is a student and has no other taxable income can receive substantial dividends and pay little tax. Farmers often use this mechanism to assist their children and grandchildren while they are in post-secondary education, particularly if they are studying out of province or it is otherwise difficult to justify a salary.

Wealth preservation fundamentals and use of discretionary family trusts

Deemed disposition on death

- The *Income Tax Act* deems everyone to sell at fair market value on death
- Capital gain or recapture may be generated
- Capital gain is a tax on capital assets based upon their fair market value, minus their original cost, plus capital improvement. Currently, 50 per cent of capital gains are included in a taxpayer's income.
- Recapture is a tax on depreciable assets (i.e. buildings, equipment, and quota), and is based upon the difference between the fair market value (assuming it is below the original cost) and the value to which the asset was depreciated. Recapture is fully taxed as regular income, versus 50 per cent taxable, like capital gains.

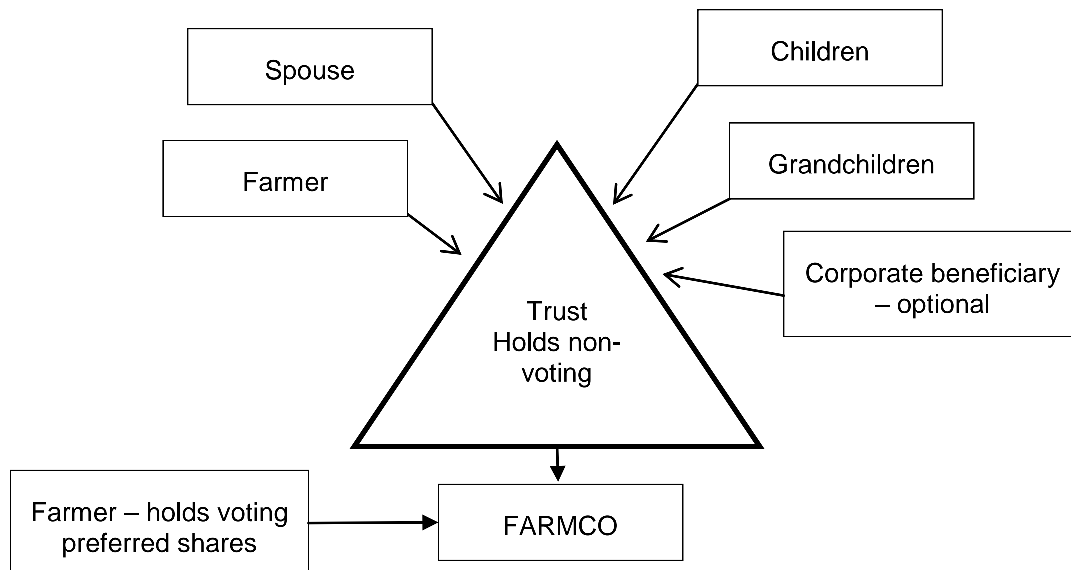
Exceptions to the deemed disposition on death

There are exceptions to the deemed disposition on death:

- Every Canadian has a tax free roll to their spouse or common-law partner (defined as living together for one year under the *Income Tax Act)*
- Roll of farm property to children/grandchildren – must be land or depreciable property "used principally" (i.e. for more than 50 per cent of the time it's been owned) for farming.
- Roll of shares of a family farm corporation or an interest in a family farm partnership to children/grandchildren – 90 per cent of the value of the partnership or corporation must be attributable to property "used principally" for farming.
- Capital gains exemption on qualified small business corporation shares. Manitoba Agriculture, Food and Rural Development supports many small business corporations who supply to the agricultural industry, including seed, chemical, equipment, technology, export and processing businesses. While shares of a qualified small business corporation do not qualify for a rollover to children or for the $1 million capital gains exemption available to shares of a family farm corporation, they are eligible for a capital gains exemption of $813,600 (as of 2015, indexed to inflation). Ninety per cent of the value of the corporation must be attributable to assets used in the active business.

Tax planning strategies

For a Farmco, a farmer should consider tax planning strategies to optimize tax savings. An example of a tax planning strategy, a freeze, is illustrated below with a further description to follow:



- A family trust is created for the family members.
- The capital of the company or business is reorganized (the freeze).
  - The trustees will want to maintain control and possibly hold sufficient voting power in preferred shares, so he or she will be able to continue to control the farm operations and dividends to the trust.
  - Preferred shares with a value equal to the value of the farmer's common shares are issued to the farmer in exchange for common shares. To ensure that the preferred shares have the same value as the common shares so that there is no transfer of value from the existing shareholder to the family trust, the preferred shares must have special rights.
  - The common shares are the growth shares of a corporation, while preferred shares in a corporation have a special right or privilege attached to them and they do not grow in value.
  - The family trust borrows money to subscribe for new common shares. As there is no value in the common shares after the freeze, these are for nominal value. All future growth accrues in the common shares held by the family trust.
  - To ensure control and participation in future profits, voting and non-voting common shares can be issued.

- The shares held by the family trust can receive dividends when Farmco makes a profit.
- The discretionary family trust borrowed funds from a financial institution to pay for shares; the trust will repay the borrowed funds with a dividend from Farmco.
- The family trust makes payments for the benefit of the various beneficiaries. This income is taxed in the tax return of the beneficiaries.
  - Beneficiaries will pay tax on the benefits they receive from the family trust; however, if the farmer has a higher tax rate, there will be considerable tax savings. The family will have more after-tax dollars to save or spend or grow the farm.
- At the end of each taxation year, dividends can be allocated to beneficiaries who are 18 years of age or older, or to a spouse to maximize lower marginal rates of tax.

Issues to be aware of when considering using a family trust

Discretionary family trusts are powerful and useful, but have side effects that need to be considered when using them.

The 21 year deemed disposition

An important note about trusts is that every 21 years a trust is "deemed to dispose" all of its assets at fair market value. This "deemed disposition", could trigger an unplanned tax issue. There are many ways to plan around this, however, including a tax-free rollout to one or more beneficiaries, so you can never be worse off by having a family trust, unless it is not properly set up. For example: farmer A and farmer B – (spouses) own the common shares in Farmco and one of their parents establishes a discretionary family trust. Farmers A and B exchange their common shares for preferred shares of the same value. The trust subscribes for common shares at nominal value, and names as capital beneficiaries farmer A and farmer B, their children and grandchildren.

Ten years later farmer A and B's two children have been working on the farm. The trustees of the discretionary family trust meet and allocate 20 per cent of the common shares to each child on a tax free basis in year 10. The two children become 20 per cent owners of all the future growth in Farmco. In year 20, just before the trust's 21st birthday, the trustees meet and allocate, under section 107, a tax free "trust roll out" of the balance of the discretionary family trust's shares. No tax is payable. The growth for 20 years goes to the next generation.

If no allocation is made, the trust is deemed to dispose of all its assets (the common shares of Farmco) on its 21st birthday. The trustees might purposefully allow this deemed disposition. The trust that now holds 60 per cent of the common shares of Farmco will have a capital gain on the increase in value of its common shares. Assume that capital gain on the trust's 60 shares is $2 million, due to the large increase in the value of the land Farmco owns. The trustees can allocate that gain to any or all of the beneficiaries. Farmers A and B have two non-farming children. The trustees meet and allocate that gain equally to the two non-farming children. Each child claims the gain on their tax return and uses their $1 million capital gains exemption to offset the capital gains tax. There are steps required to do this. Your lawyer or accountant can assist you. The end result is the trust still owns the 60 common shares of Farmco, with a stepped-up cost base of $2 million.

Association

In Manitoba, a corporation is taxed at a low rate for the first $425,000 of its active business income (increasing to $450,000 in 2016) due to the operation of the "small business deduction". The $425,000 is called the "small business limit." When corporations are controlled by the same person, group of people, or certain combinations of related people, the corporations are considered "associated" and must share one small business limit. For example, farmer A is the sole shareholder of two corporations, Xco and Yco. Xco and Yco do not each enjoy the small business deduction on their first $425,000 of income; a single $425,000 small business limit is divided between them.

All beneficiaries of a discretionary family trust are deemed to own all shares owned by the trust. Further, the parents of a minor who owns shares are deemed to own the shares the minor owns. If a beneficiary is involved with another corporation (perhaps they have their own business) or is married to a person who is involved with another corporation and have children who are beneficiaries of the trust, Farmco could become "associated" with the other corporation, which would result in both corporations paying more tax. Make sure your lawyer and accountant understand your family situation in full so they can properly craft a trust that benefits you and doesn't have unwanted side-effects. Also, make sure that your lawyer and accountant are kept up to date with major changes (such as marriage, common-law unions, grandchildren, businesses of children, grandchildren or spouses of each) in your family's situation.

The capital gains exemption (CGE)

- Currently, our capital gains exemption for farmers is $1,000,000 per individual resident Canadian for qualified farm property and $813,600 for qualified small business corporation (QSBC) shares.
- The capital gains exemption was first created in 1985 and has been increased and modified numerous times. It was a huge gift to Canadian taxpayers, especially farmers. Smart planning suggests you should plan your estate to use your and your farm family's capital gains exemption as soon as possible as these rules could change at any time.
- One method tax advisors recommend to multiply the number of exemptions available to your farm family is to establish a discretionary family trust.
- To qualify for the farm rollover or capital gains exemption, each asset of the corporation or partnership must have been principally used (more than 50 per cent) in the business of "farming".
    - The key to qualifying as "farming" is "risk."
    - Renting is not "farming."
    - Sharecropping is not "farming"; but "farming" can be done by hiring others to do all the farm labor and activities by a custom farm agreement provided the owner/farmer takes <u>all</u> the risk.
- The test applied to each asset is quantitative. Cash, other than an amount sufficient for the next years' operating, is considered passive income and therefore does not qualify as active business income. A family trust, with a corporate beneficiary, can be used to move money to that corporate beneficiary so the shares of the Farmco remain qualified for the farm rollover or capital gains exemption.
- The test looks at each asset (i.e. each parcel of land) to see how many years that parcel has been farmed versus rented. For example: farmer A and spouse own Farmco. Farmco owns two sections of farmland, equipment, and buildings. One section (bought 20 years ago) has been actively farmed for 15 years and rented for five years, so it is qualified. Its value is $2 million.
- Half of the second section was bought five years ago and has been share crop rented for three years and farmed for two years. It is a non-qualifying asset, as it has not been actively farmed more years than rented. Its value is $600,000. The balance of that section (worth $800,000) was farmed by the farmer's father for 10 years, grandfather for five years, and by Farmco for two years, then cash rented for 16 years. The total years farmed is 17 (you can count grandpa and dad), and total years rented is 16, so it is qualified as an active business asset. Note: if it is rented for one more year, it will not be qualified.
- Cash for one year's operations is usually considered an active business asset, but anything above that is not.

- The farm equipment and buildings are worth $1.5 million and have always been actively farming. Your lawyer and accountant would chart the "farm history" as follows:

Asset	Value Qualified	Value Non-Qualified
1 section	$2,000,000	
½ section		$600,000
½ section	$800,000	
Equipment & Buildings	$1,500,000	
Cash for Operating	$400,000	
Cash in Excess of Operating		$700,000
Totals:	$4,700,000	$1,300,000
Total Farm Assets		**$6,000,000**

- Currently the shares of Farmco are not qualified for the farm rollover or capital gains exemption because more than 10 per cent of the assets are non-qualifying. If the farmer died, he or she could still roll to a spouse or common-law partner, but, if farmer has no spouse or they died in a common accident, there would be tax to pay on $6 million. This potential tax could force the sale of the Farmco.
- This risk can be eliminated by moving the cash from the Farmco to a family trust that has a corporate beneficiary. In our example, if we eliminate the excess cash of $700,000, the shares would qualify. The shares of the corporate beneficiary can also be owned by the family trust, or the farmer and spouse, in most circumstances, but not always. Your expert advisor will determine this. The cash in the corporate beneficiary can be lent back to the Farmco with or without interest.
- Another option would be to farm the non-qualifying half section (including custom farming), instead of renting, but there would still be too much cash in the Farmco by $100,000. A lawyer experienced in tax planning can draft a custom farming agreement.
- Assume the farmer and spouse follow this advice such that the half section which was non-qualifying has now become qualifying (i.e. custom farmed for two more years and a $100,000 dividend is paid to farmers A and B). Now the shares of Farmco are qualifying. Assume farmer now wants to sell. To use the capital gains exemption, farmer must sell shares, not assets, as only individuals are entitled to the capital gains exemption.
- Farmer Dyck, an unrelated party, agrees to buy the shares of Farmco for $6 million. Farmer and spouse own preferred shares issued on the freeze, worth $2.5 million. They can use $1 million each of capital gains exemption to reduce their tax. The discretionary family farm trust owns shares worth $3.5

million. There are three adult children who have not used any of their capital gains exemption and two infant grandchildren.

- The discretionary trust sells its shares and the trustees meet and decide to allocate the $3 million of capital gain to the three adult capital beneficiaries and $250,000 of capital gain to each of the two infant grandchildren capital beneficiaries. All capital beneficiaries elect to use their capital gains exemption and no capital gains tax is payable on the sale of the shares of Farmco. Note: Other tax implications may occur. Expert advice is always required to ensure all the potential implications are considered and addressed.

Conclusion

In conclusion, some of the advantages of a discretionary family farm trust are:

1. Income splitting: The trustees have full discretion to allocate the income of the trust to any adult beneficiary or a combination of beneficiaries who may pay tax at a lower marginal rate than the farmer.
2. Accessing multiple capital gains exemptions: If the trust realizes a capital gain (either because it sold its shares in the Farmco or Landco or on the 21st year deemed disposition) it can allocate the capital gains to any or all beneficiaries, including minors, who can claim their capital gains exemptions.
3. Income allocated to minors is taxed at the high rate due to a tax commonly referred to as "kiddie tax." This tax does not apply to capital gains unless the capital gain is the result of a sale to a related party. Expert advice is needed.
4. By having a corporate beneficiary, you can keep the shares your Farmco "on side" for the farm roll and capital gains exemption.
5. No need to decide who gets the assets of the trust for 21 years or more.
6. Family Law Protection: the beneficiaries don't have a right to anything unless and until the trustees, in their total discretion, meet and allocate to them, so the trust property is protected from sharing in family law proceedings.
7. A trust does not die, so you avoid probate fees on the death of the farmer and/or spouse and have time to plan if the farmer(s) and/or spouse die suddenly. The trustees can help by acting as a transition from one generation to another if a death occurs before the next generation is ready for the responsibility of the farm.
8. Ability to utilize the capital gains exemption on the trust's 21st anniversary without transfer of the trust's assets out of the trust, thus increasing the cost base without being required to dispose of the trust's assets.

Note: The authors have only used some examples and there are many other issues that must be considered in establishing a discretionary family farm trust. Consult advisors who have significant experience in farm tax and trust law. Do not be afraid to question your professional(s) on their prior experience in this area.

Discretionary family farm trusts are contemplated under the *Income Tax Act* and are a legal way to structure the farm's affairs to accommodate the farm's succession plan while saving considerable tax.

For more information

- Contact your local Manitoba Agriculture, Food and Rural Development (MAFRD) GO Office.
- To find your nearest GO Office, call Manitoba Government Inquiry, toll free at **1-866-626-4862**.
- To find out more about the federal-provincial *Growing Forward 2* initiative and provincial programs and services, go to **manitoba.ca/agriculture**.

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