Trust Reporting Rules - Draft Legislation Released

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As part of draft legislation released on July 27, 2018, the Department of Finance moved forward with new trust reporting rules that were announced in the 2018 Federal budget. The draft legislation did not contain many surprises. Having said that, the new trust reporting rules will be a big change for many trustees, beneficiaries and protectors of trusts who will now be required to adhere to additional reporting requirements. Accordingly, here are some quick observations that advisors, trustees, beneficiaries and protectors of Canadian trusts should be aware of:

1. The new reporting requirements will be applicable for taxation years that end after December 30, 2021. In other words, trusts that have calendar taxation year-ends (all trusts have calendar year-ends, other than graduated rate estates) will need to comply with these new requirements for the 2021 taxation year and forward;
2. The new reporting requirements will include additional disclosures as part of an expanded T3 trust income tax and information return;
3. Existing subsection 150(1.1) of the Income Tax Act (the “Act”) permits a taxpayer, including a trust, to not have to file annual income tax returns under various circumstances, such as where no income tax is payable for the year. Proposed subsection 150(1.2) contained in the draft legislation makes subsection 150(1.1) inapplicable for certain trusts. In other words, if the conditions of new subsection 150(1.2) apply, then the trust must annually file a T3 return. New subsection 150(1.2) applies to a trust that is resident in Canada and is an *express trust*. The phrase express *trust* is not explicitly defined in the draft legislation nor is that phrase currently used in the Act;
4. So, what is an *express trust*? A leading English textbook on trusts describes two types of trusts: “*trusts created deliberately (“express trusts”); and trusts created by the court to prevent unconscionable behavior (“trusts implied by law”).*[1] Accordingly, the concept seems quite simple. But what about “bare trusts”?[2] Are they “*express trusts*”? It would appear so. Bare trusts are commonly used to hold property in many business and other situations. However, subsection 104(1) of the Act excepts bare trusts from certain applications of the Act and it appears that the new trust reporting rules are part of those exceptions enunciated. Thankfully, then, bare trusts do not appear to be caught by the new trust reporting rules;
5. Proposed subsection 150(1.2) contains a long list of certain trusts that will be exempt from the new reporting rules. The list includes:
    - trusts that have been in existence for less than three months at the end of the year;
    - trusts that hold assets with a total fair market value that does not exceed $50,000 throughout the year if the only assets held by the trust throughout the year are one or more of cash, certain debt obligations, publicly traded shares or debt, mutual fund corporation shares or trust units or an interest in a related segregated fund. Notably absent from this list are private corporation shares and real estate. Accordingly, if a trust holds private corporation shares or real estate, it will be required to file a T3 return.
    - certain lawyers’ trust accounts;
    - registered trust accounts like TFSAs, RRSPs, RRIFs, etc.

- graduated rate estates;
    - registered charities;
    - mutual fund trusts; and
    - certain other exceptions
6. If a trust fails to make the necessary disclosures on time, then the normal failure to file penalties will apply under subsection 162(7) of the Act ($25/day to a maximum of $2,500);
7. However, if the failure to disclose the required trust information is done knowingly or under circumstances amounting to gross negligence or as a result of a failure to comply with a demand made by the Canada Revenue Agency ("CRA"), the subsection 162(7) penalties will not apply and instead proposed subsections 163(5) and (6) will impose a penalty equal to the greater of: a) $2,500 or b) 5% of the highest amount of the fair market value of the trust assets. **Ouch!** To our knowledge, this is the first penalty introduced into Canadian tax law that imposes a penalty on the fair market value of the assets held by a taxpayer (failure to file prescribed forms T1141 and T1142 also lead to a 5% penalty on fair market value, but only with respect to the property contributed/distributed). This appears draconian to us;
8. The new penalties under subsections 163(5) and (6) will be imposed on any person or partnership that is subject to the new regime. It appears to us that more than one person may be subject to the 5% penalty regime with respect to the same trust, e.g. trust with multiple trustees. **Ouch!**
9. The new trust reporting rules will apply to deemed resident trusts[3]. Any tax practitioner who has worked through the Canadian deemed resident trust rules will know that these rules are horrifically complex. With the stakes now being very high to ensure that all disclosures are made to avoid penalties, one wonders how the CRA will administer the new penalties under proposed subsections 163(5) and (6) with respect to deemed resident trusts (since it may be very easy to make a mistake when determining if an otherwise non-resident trust may, in fact, be a deemed resident trust);
10. Proposed subsection 204.2(1) of the Regulations to the Act sets out the required information that will need to be disclosed and includes the name, address, date of birth (if applicable), the jurisdiction of residence of and the Tax Identification Number[4] of:
    - trustee(s), beneficiary(ies), settlor
    - persons who have the ability to exert influence over trustee decisions (commonly this person is often referred to as a "protector")
11. Currently, a T3 return does not require disclosure of anyone involved with the trust, except for the trustees. This expanded disclosure requirement is in line with the global trend of enhanced transparency and has been predicted by many tax practitioners, including us.
12. What about certain trusts who may have contingent beneficiaries? For example, often times a beneficiary is referred to in the trust instrument as the "children of Mr. and Mrs. X". Accordingly, when a child of Mr. and Mrs. X is born they are automatically added as a beneficiary. Subsection 204.2(2) of the Regulations addresses these types of situations and states that the requirement to disclose will be met if the required information is provided in respect of each beneficiary of the trust whose identity is known or ascertained with reasonable effort by the person making the return at the time of filing. The Explanatory Notes add additional color to this by stating:

    For example, the beneficiary of a trust may not be known where the trust provides for a class of beneficiaries that includes the settlor's current children and grandchildren and any children or grandchildren that the settlor may have in the future. In these circumstances, the reporting requirement will be met if the relevant information in respect of all of the settlor's current children and grandchildren are included as well as the details of the terms of the trust that extend the class of beneficiaries to any of the settlor's future children or grandchildren.

Overall, trusts are a great tool to consider when holding property. However, the new trust reporting rules will change the game and require trustees, beneficiaries and protectors of trusts to very carefully consider required disclosures in 2021 forward in order to avoid penalties. The good news is that there are three filing seasons – 2018, 2019 and 2020 – before these new reporting requirements come into effect, giving time for taxpayers and their advisors to get ready.

[1] "Equity & Trusts" by Alistair Hudson, LLB, LLM, PhD; 2003 Cavendish Publishing Limited, The Glass House, Wharton Street, London, UK; p.31.

[2] Bare trusts are usually defined as "…*a trust where the trustee or trustees hold property without any duty to perform except to convey it to the beneficiary or beneficiaries upon demand.*" See "Waters' Law of Trusts in Canada" Fourth Edition; Waters, Donavan WM, Gilles, Mark R and Smith, Lionel Editors, 2012 Thomson Reuters Canada Limited; p.33.

[3] Section 94 of the Act will deem an otherwise non-resident trust to be a resident Canadian trust if certain rules are met. The application of section 94 is horrifically complex and beyond the scope of this blog. The Explanatory Notes to the draft legislation confirms that deemed resident trusts under section 94 of the Act will need to comply with the new trust reporting rules.

[4] As defined as TIN under subsection 270(1) of the Act. Generally, this will be the social insurance number for an individual, the business number for a corporation and an account number issued to a trust.