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Penalty!

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Kim G C Moody looks at Canada's draft legislation to implement new trust reporting rules

Key points

What is the issue? On 27 July 2018, Canada's Department of Finance released draft legislation[1] to implement new trust reporting rules that were announced in the 2018 Federal Budget.[2]

What does it mean for me? The draft legislation did not contain many surprises from the previously released Budget announcement. However, the new trust reporting rules will be a big change for many trustees, beneficiaries and protectors, who will now be required to complete additional reporting requirements.

What can I take away? This article outlines some key observations that advisors, trustees, beneficiaries and protectors of Canadian trusts should be aware of.

The new Canadian trust reporting requirements will be applicable for the 2021 taxation year and forward, and will be made by

submitting additional disclosures as part of an expanded T3 trust income tax and information return form.

Proposed subsection 150(1.2) of the *Income Tax Act* (1985) (the Act) provides an exception to the general rule under existing subsection 150(1.1) (which is the existing provision that sets out when filing obligations of a taxpayer do not apply) for certain trusts. In other words, if the conditions of new subsection 150(1.2) apply, then the trust must 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 used in the Act. So what is an express trust?

A leading English textbook describes two types of trust: 'trusts created deliberately ("express trusts"); and trusts created by the court to prevent unconscionable behavior ("trusts implied by law")'.[3] Accordingly, the concept seems quite simple. But what about 'bare trusts' – defined as those 'where the trustee or trustees hold property without any duty to perform except to convey it to the beneficiary or beneficiaries upon demand'?[4] 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) 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.

Proposed subsection 150(1.2) contains a long list of certain trusts that will be exempt from the new reporting rules. Such a list includes:

- trusts that have been in existence for fewer than three months at the end of the year;
- trusts that hold assets with a total fair market value (FMV) that does not exceed CAD50,000 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. Accordingly, if a trust holds private corporation shares, it will be required to file a T3 return;
- certain lawyers' trust accounts;
- registered trust accounts like TFSAs, RRSPs, RRIFs;[5]

- ‘graduated rate estates’, which are estates that elect, if eligible, to have any income subject to graduated tax rates;
- registered charities;
- mutual fund trusts; and
- certain other exceptions.

Penalties

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 (CAD25/day to a maximum of CAD2,500). 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 either CAD2,500 or 5 per cent of the highest amount of the FMV of the trust assets. To my knowledge, this is the first penalty introduced into Canadian tax law that imposes a penalty on the FMV of the assets held by a taxpayer.[6] This appears draconian to me.

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 that more than one person may be subject to the penalty regime with respect to the same trust.

The new trust reporting rules will apply to deemed resident trusts.[7] Any tax practitioner who has worked through the Canadian deemed resident trust rules will know that these rules are highly 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 determining whether an otherwise non-resident trust may in fact be a deemed resident trust will be a challenge).

Disclosure

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), jurisdiction of residence and Tax Identification Number[8] of:

- trustee(s), beneficiary (or beneficiaries), settlor; and
- persons who have the ability to exert influence over trustee decisions (this person is often referred to as a ‘protector’).

What about certain trusts that may have contingent beneficiaries? For example, often a beneficiary is referred to in the trust instrument as the 'child 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 this type of situation, and states that the requirement to disclose will be met if the required information is provided in respect of each beneficiary whose identity is known or ascertained with reasonable effort by the person making the return at the time of filing. The *Explanatory Notes* also add additional colour 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.'

Conclusion

Overall, trusts remain 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 and forward in order to avoid penalties. The good news is that there are three filing seasons (2018, 2019 and 2020) in which taxpayers and their advisors will be able to live without the new reporting requirements, giving them time to get ready.

1. bit.ly/2DB9bUG
2. bit.ly/2DIkvP4
3. Alistair Hudson, *Equity & Trusts* (London: Cavendish Publishing, 2003), p.31
4. D. W. M. Waters, M. Gillen and L. Smith, *Waters' Law of Trusts in Canada*, 4th edn (Thomson Reuters Canada, 2012), p.33
5. Tax-Free Savings Accounts, Registered Retirement Savings Plans, Registered Retirement Income Funds
6. Failure to file prescribed forms T1141 and T1142 also lead to a 5 per cent penalty on FMV, but only with respect to the property contributed/distributed.
7. 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 s.94 is highly complex and beyond the scope of this article. The *Explanatory Notes* to the draft

legislation confirm that deemed resident trusts under s.94 of the Act will need to comply with the new trust reporting rules.

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

The views expressed in the STEP Journal and Trust Quarterly Review are not necessarily those of STEP. Read more.

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