Enhanced Tax Reporting for Trusts Starting 2022

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On August 9, 2022, the Department of Finance released the latest draft legislation with respect to Enhanced Reporting Requirements for Trusts first introduced in the 2018 Federal Budget. The government first announced its intention to amend the *Income Tax Act* (the "**Act**") to impose these new requirements and this latest set of draft legislation will likely be the final version of the legislation.[1] The new filing and reporting obligations would require the identity of all trustees, beneficiaries, settlors, and "protectors" who had the ability to exert control over the trustee's decisions to be disclosed. We have previously recorded a podcast on this topic and this blog dives deeper into these new filing obligations.

The draft legislation requires express trusts, **including bare trusts**, with taxation years ending after December 30, 2022 to annually file T3 trust income tax return and disclose the following:

- name, address;
- date of birth (in the case of an individual other than a trust);
- jurisdiction of residence; and
- taxpayer identification number,

of any person who is a trustee, beneficiary, or settlor of the trust, or has the ability to exert influence over trustee decisions.

Once enacted, the new rules will require enhanced reporting for trusts with a December 31, 2022 taxation year-end. Paragraph 249(1)(c) defines, for purposes the Act, a taxation year of a trust, other than a graduated rate estate, to be a calendar year, except as expressly provided otherwise. For example, any family trusts in existence in 2022 (for greater than 3 months), including trusts wound up in 2022, would have a December 31, 2022 taxation year-end and be subject to the enhanced reporting rules.

There are several narrow exemptions to these new requirements. Here are some common ones (only one of these need to be met):

- the trust have been in existence for less than three months;
- the trust hold certain assets with fair market value not exceeding $50,000 throughout the year (the assets consisting sole of money, and generally speaking, publicly listed securities; note that this exception *cannot* be met if the trust holds any interest in real estate or in private corporations);
- the trust is a graduated rate estate, a qualified disability trust, a registered charity, a mutual fund trust or an employee life and health trust;
- the trust is a registered plan, e.g. RRSP, RRIF, TFSA, etc.

Given the uncertainty surrounding the exclusion for solicitor-client privilege, practical challenges in obtaining certain information from trust beneficiaries, ubiquity of bare trust arrangements, and hefty

penalties (being up to 5% of the FMV of all the property held by the trust), the new required information disclosure requirements for trusts will be burdensome for trustees and their advisors.

Below are some of the issues created by this new legislation.

Beneficiaries

Proposed subsection 204.2(1) of the *Income Tax Regulations* (the "**Regulations**") requires the name, address, date of birth, jurisdiction of resident of every person who is a beneficiary of the trust. However, the draft proposals do not confirm whether disclosure of such beneficiaries include contingent beneficiaries. While proposed subsection 204.2(2) of the Regulations requires disclosure if the identity of a beneficiary of the trust is known or ascertainable with reasonable effort by the person making the return at the time of filing, it does not make explicit whether this reasonable effort includes identifying contingent beneficiaries. Given that a contingent beneficiary is arguably ascertainable, it appears so. In fact, the Department of Finance's explanatory notes refer to situations where the trust provides for a class of beneficiaries that include future children and grandchildren, and such cases, the explanatory notes say that the details of the terms of the trust and relevant information to allow the Canada Revenue Agency ("**CRA**") to determine with certainty what future persons will fall under the class will need to be disclosed.

Therefore, trust indentures must be carefully reviewed to ensure any beneficiaries, contingent or otherwise, that can be ascertained are properly disclosed with the required information going forward. The new reporting requirements for each beneficiary of the trust is further problematic in the cases of arrangements between the testator and trustee without written agreement.

The practical challenges of obtaining accurate reporting information for each beneficiary of the trust is highlighted with the required disclosure of jurisdiction of residence. Residency for tax purposes would be implicated in such disclosure, and for beneficiaries of trusts that are remote or unclear as to tax residency, accurate disclosure may be problematic without a fulsome analysis as to tax residency as required by the "reasonable effort" requirement in proposed subsection 204.2(2) of the Regulations.

Moreover, as intended, the new reporting rules will allow the CRA to easily confirm which corporations have been failing to report associated corporations and accordingly share the $500,000 small business deduction ("**SBD**"). The SBD is limited where taxable capital of all associated corporations exceeds $10 million or adjusted aggregate investment income ("**AAII**") exceeds $50,000. The SBD will be reduced to nil where the total capital employed in Canada by associated corporations exceeds $15MM (proposed to be increased to $50MM) or the AAII of all associated corporations reaches $150,000. Paragraph 256(1.2)(f) of the Act provides for a "look-through" rule which deems shares held by a discretionary trust to be owned entirely by a beneficiary of a trust – a corporation held by a family trust could be easily associated with the other corporations owned by the trust's beneficiaries. This is a good time to review a family's overall corporate structure and historical tax filings to determine if there were incorrect reporting in this regard.

Furthermore, there are certainly cases where a settlor does not wish a beneficiary to know of their potential interest in the trust property, particularly in situations where far-flung relatives are included as beneficiaries of the trust simply for adding flexibility to future planning. With the new rules, there will surely be a few awkward conversations surrounding the gathering of beneficiary information – including advising the beneficiary that they are a beneficiary of the trust and that their corporation may be associated with corporations held by the trust.

Solicitor-Client Privilege

Proposed subsection 150(1.4) of the Act provides that the reporting and disclosure required under proposed subsections (1.1) to (1.3) do not require the disclosure of information that is subject to solicitor-client privilege. While the definition of "solicitor-client privilege" in subsection 232(1) of the Act is more limited than solicitor-client privilege under the common-law, such that it does not apply to all documents that might be privileged (eg. a lawyer's accounting records), the Supreme Court of Canada ("**SCC**") has held that solicitor-client privilege has quasi-constitutional status such that this statutory limitation is unconstitutional. In *Chambre des notaires*, 2016 SCC 20 [*Chambre des notaires*], the SCC determined that the exception for a lawyer's accounting records set out in the definition of "solicitor-client privilege" in subsection 232(1) of the Act is unconstitutional and invalid.

Solicitor-client privilege belongs to the client and can be waived only by the client. It requires that the client be seeking legal advice of counsel in confidence and in their professional capacity, as distinguished from business advice. Communications between the client and members of a law firm, or between agents of the client and a solicitor are privileged if the communication is made for the purposes of facilitating the obtaining of legal advice for the client (see *Copthorne Holdings Ltd. v. R.*, 2005 TCC 491). This is distinguished from operational outcomes or end products of legal advice, such as certain computations that would not disclose the legal advice provided (*Canada (National Revenue) v. BMO Nesbitt Burns Inc.*, 2022 FC 157). Where the information falls on the continuum of solicitor-client communications, the privilege extends to client names.

Accordingly, the exclusion for information that is subject to solicitor-client privilege in proposed subsection 150(1.4) gives rise to several uncertainties, especially considering that proposed subsection 204.2(1)(b) of the Regulations requires the disclosure of information regarding a person who "has the ability (through the terms of the trust or a related agreement) to exert influence over trustee decisions regarding the appointment of income or capital of the trust". The uncertainty gives rise to certain questions such as: (a) could information related to the new trust reporting rules be subject to solicitor-client privilege? If client names contained in a lawyer's accounting records are subject to solicitor-client privilege, then do the names of beneficiaries need to be disclosed if the trust was settled pursuant to the provision of legal advice? (b) do bare trust arrangements or nominee companies created pursuant to the provision of legal advice require filing of a T3 return? (c) what part of the trust arrangement set-up recommended by a lawyer is subject to solicitor-client privilege? (d) could the very existence of a trust relationship be subject to solicitor-client privilege?

However, unlike written or oral communications between a solicitor and a client, which should be protected from disclosure as confirmed in *Chambre des notaires*, the contents of an enforceable agreement or executed document such as a trust deed, do not disclose the very legal advice provided. Not all end products of legal advice fall on the continuum of solicitor-client communications, as they must communicate the very legal advice given by counsel (*Canada (Public Safety and Emergency Preparedness) v Canada (Information Commissioner)*, 2013 FCA 104 at para 31). Therefore, it is likely that the contents of a trust deed prepared by a lawyer based on instructions received from the client and executed by the settlor and trustee, would not be protected from disclosure to the CRA on the grounds of solicitor-client privilege because such contents represent the end product of the legal advice provided and do not disclose the actual legal advice provided. As such, it is unlikely that proposed subsection 150(1.4) would exempt the disclosure of information pertaining to beneficiaries, trustees, settlor, and persons with the ability to exert influence over trustee decisions regarding the appointment of income or capital of the trust where such information was contained in a trust deed or bare trust agreement

executed by the parties.

Bare Trusts

Bare trusts are commonplace. A bare trust agreement facilitates the separation of legal and beneficial ownership of property. They are commonly used to facilitate cost-efficient transfers of property. An elderly parent adding an adult child to a joint bank account for their benefit, may have retained beneficial ownership of the account but has conveyed legal title to their child, for example. Could this be considered a bare trust for the purposes of trust reporting?

There are three certainties which must exist for a trust relationship to be valid and recognized (***Knight v Knight*** (1840) 49 ER 58) in trust law and for income tax purposes: (a) Certainty of intention – it must be clear that the settlor intends to create a trust (b) certainty of property – the assets constituting the trust must be ascertainable, and (c) Certainty of objects: the beneficiaries must be ascertainable. At common law, a trust is a relationship between the trustee and beneficiary, whereby there is an equitable and fiduciary obligation binding on the trustee to deal with the trust property that the trustee controls, for the benefit of the beneficiary.

In a bare trust, the trustee holds property without any further duty to perform, and only conveys the trust property upon the demand of the beneficiaries. In the real estate development context, bare trusts are commonly utilized to hold legal title of real property, such as through nominee corporations. In provinces such as British Columbia where land transfer taxes apply, bare trusts are sometimes used to circumvent land transfer taxes on the sale of property. Moreover, bare trusts may facilitate the mitigation of probate fees, such as in the above example of joint bank accounts.

It would seem these relationships could now be caught in the new rules where the three certainties are met. Previously, bare trusts were exempt from T3 filings, but it now appears they will need to file complete T3 returns and provide the new disclosure information. As bare trusts are an often-used tool, advisors should review their client portfolio to identify any transactions where a bare trust has, or may have, been created.

Settlor

A “settlor” is defined in subsection 17(15) to mean any person (who at any time) that has made a loan or transfer of property, either directly or indirectly, in any manner whatever, to or for the benefit of the trust at or before that time (with an exception for a transferor who dealt at arm’s length with the trust at arm’s length terms).

To illustrate how broad this is, in the course of a reorganization involving a Trust purchasing corporate shares from a non-arm’s length seller (such as on a freeze transaction), the seller appears to fall into the 17(15) definition of a “settlor” since the seller is transferring property “in any manner whatever” to the trust. The Trust now needs disclose the required information relating to this historical seller as a settlor of the Trust.

This broad and inclusive definition of settlor may result in the information disclosure of many individuals who would not be commonly thought of as settlors or otherwise would not be expected to be included in the reporting requirements.

Penalty 5% of FMV

A false statement or omission on a T3 would result in a penalty equal to the greater of $2,500 and 5% of the highest amount at any time in the year that is equal to the total fair market value of all the property held by the trust. This is notable for bare trusts holding real estate or assets with significant value as the agency relationship will need to be disclosed, despite the bare trustee only holding legal title to the property. Trustees and their advisors will need to make a reasonable attempt to determine the identities of each beneficiary, settlor and of the trust, as well as persons who have the ability to exert influence over the trustee to avoid the penalty, however onerous.

Conclusion

Once enacted, the new enhanced reporting rules will apply to 2022 reporting for almost all express trusts currently in existence.

Trustees and their advisors will be required to gather and report information before the March 31, 2023 filing deadline. Given the additional compliance requirements for trusts including bare trust, it may be beneficial in some cases to wind up existing trusts, especially those that no longer serve a purpose in the family overall long term objective or that are close to their 21-year anniversary date. (But again, note that trusts wind up during 2022 are still subject to the enhanced reporting rules for 2022.)

Drafting of trust indentures should pay particular attention to encompassing beneficiaries which may be too remote or otherwise unintended in being caught in the web of the enhanced reporting rules.

Enhanced transparency legislation has been increasing worldwide and this new legislation is Canada's latest attempt to keep up with, or out pace, the rest of the world. While the reporting disclosures will provide the government with increased ability to better enforce the Act, the cost of the compliance burden placed on taxpayers and their advisors does not go unnoticed.

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[1] The author wishes to thank Kenneth Keung, Evan Crocker and Douglas Ewens for their significant contributions to this blog.

[2] Following consultations with respect to draft legislation released on July 27, 2018, a revised draft of the 2018 legislation was released on February 4, 2022. The new draft legislation released August 9, 2022 remains substantially unchanged from the February 4, 2022 draft legislation.