Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Please contact us for more information about the topics discussed in this article.

RBC DS Declaration of Trust accounts (for common law provinces)

RBC DS Trust Agreement accounts (for Quebec)

Prepare now for new enhanced trust reporting requirements beginning in 2021

As part of your financial arrangements with RBC Wealth Management, you may have opened an account using the RBC Dominion Securities (DS) Declaration of Trust (DOT) in common law provinces, or RBC DS Trust Agreement in Quebec. For the purpose of this article, we will refer to both agreements as the DOT. This account is referred to as the “DS Formal Trust Account”. It’s important to note that by signing the DOT, you created an irrevocable formal trust and you should be aware of the tax reporting and legal obligations associated with a formal trust.

The trust and all transfers made to it are irrevocable. This means that any gifts or transfers of assets to the trust cannot be recovered by you, the settlor, or any other contributor/donor (if different than you). There are a number of versions of the DOT. Most versions of the DOT provide the trustee with absolute discretion to pay out any or all of the income or capital of the trust to any one of the named beneficiaries, to the exclusion of all others. Information on what is a trust, how it’s created, and the parties to a trust can be found in the Appendix to this article.

This article highlights key information regarding new reporting and compliance requirements for trusts that may apply to your trust. Due to the government’s move toward increased

disclosure for trusts, as trustee you should prepare now to meet these new obligations. It’s important you understand the terms in the signed DOT, a copy of which is available from your RBC advisor. You should consult with a qualified tax and/or legal advisor to discuss your particular circumstances and how best to prepare for the new reporting obligations.

The Canadian government and many governments around the world have been stepping up disclosure requirements in order to determine taxpayers’ tax liabilities and to effectively counter aggressive tax avoidance.

Trust reporting requirements

Current trust reporting requirements

For Canadian income tax purposes, a trust is treated as a separate taxpayer, distinct from the settlor and beneficiary. Under the Income Tax Act (ITA), as well as the Canada Revenue Agency’s (CRA’s) current administrative position, a trust needs to file a T3 return if the trust has tax payable, has a taxable capital gain, is requested to file, or holds property that’s subject to subsection 75(2) of the ITA (the “super attribution” rules, discussed later). A trust will also be required to file a T3 return in a year if it receives income or capital gains from the trust property that’s allocated to one or more beneficiaries, and the trust has:

- Total income from all sources of more than $500;
- Income of more than $100 allocated to any single beneficiary;
- Made a distribution of capital to one or more beneficiaries; or
- Allocated any portion of the income to a non-resident beneficiary.

Note that this is not an exhaustive list.

The super attribution rules generally apply where the person who transfers property to the trust (e.g. the settlor or contributor to the trust) retains control over the property or where the property can revert back to the settlor or contributor. An example of a situation where this may occur is where the settlor is the sole trustee or the controlling trustee of the trust (e.g. one of two trustees).

Generally speaking, under current CRA filing requirements, many trusts established using the DOT have an annual T3 return filing obligation.

Canadian government enhancing trust reporting requirements beginning in 2021

The Canadian government and many governments around the world have been stepping up disclosure requirements in order to determine taxpayers’ tax liabilities and to effectively counter aggressive tax avoidance. As part of these efforts, the Canadian government has proposed enhanced income tax reporting requirements for certain trusts for taxation years that end after December 30, 2021. All inter vivos trusts, including a trust created with the DOT, have a December 31 year-end and therefore these rules will apply for the 2021 taxation year.

The new reporting requirements will have the following effect:

– Trusts that have a T3 return filing requirement under current rules will be required to disclose significant additional information on the T3 return; and

– The number of trusts required to file a T3 return will be expanded to include many trusts that otherwise would not have previously been required to file.

Under the proposed rules, an “express trust” that is resident in Canada, for a taxation year that ends after December 30, 2021, will be required to file a tax return, unless it meets certain exceptions. An express trust is generally understood to be a trust that’s deliberately created by a settlor. A non-express trust is a trust that’s imposed or created by courts, such as a resulting trust or a constructive trust.

An exception to these rules is for a trust that holds assets with a total fair market value (FMV) that doesn’t exceed $50,000 throughout the year, if the only assets held by the trust throughout the year are one or more of cash; certain government debt obligations; a share, debt obligation or right listed on a designated stock exchange; mutual fund corporation shares or trust units; or an interest in a related segregated fund. Note that this list doesn’t include private company shares or real estate.

Even if a trust is exempt from the reporting obligations under the proposed rules, a T3 return will still need to be filed if it is required to do so under the current rules.

The proposed measures will increase the amount of information that needs to be included when a trust tax return is filed. Currently, if a trust is required to file a T3 return for a year, there is no requirement for the trust to disclose the identity of anyone involved in the trust other than the trustee (unless income has been paid or made payable to a beneficiary). Under the proposed measures, when a trustee files a T3 return, they will be required to provide the identity and specific information for each

person who is settlor, trustee, beneficiary or protector of a trust. The new reporting requirements will place a heavier burden on a trustee to gather and report this information.

Under the proposed measures, a trustee who fails to file a T3 return or who makes a false statement or omission on the trust tax return knowingly, or in circumstances that amount to gross negligence, will be subject to a penalty. This penalty will also apply where a trustee fails to comply with a demand by the CRA to file a trust tax return. The penalty will be equal to the greater of $2,500 or 5% of the highest total FMV of all the property held by the trust for the year. With this in mind, this penalty may be quite substantial if the trust holds assets of significant value. Although the rules are currently proposed, they are expected to be enacted into law in 2021. With the potential penalties in mind, you should review your DOT with a qualified tax and/or legal advisor and discuss next steps to prepare for the new reporting obligations.

Taxation of income and capital gains earned in your trust, where the super attribution rules apply

If the super attribution rules apply, all income/losses and capital gains/losses earned in the trust are attributed back to the settlor or contributor and taxed in their hands at their marginal tax rate. It's the CRA's administrative position, however, that a T3 return still must be filed. All income and capital gains earned on the trust's capital for the year must be declared on its T3 return. The trust would claim a deduction for any income or capital gains that are attributed back to the settlor or contributor under the super attribution rules. If the intention of setting up the trust is to achieve income splitting, the application of the super attribution rules has the result of defeating any income splitting opportunity.

Taxation of income and capital gains earned in your trust, where the super attribution rules do not apply

Income and capital gains earned but not paid or made payable to the beneficiaries

In general, where a T3 return must be filed, all income and capital gains earned on the trust's capital for the year must be declared on its tax return. A trust can claim a deduction for any income or capital gains that have been paid or made payable to a beneficiary of the trust during the year. Any income or capital gains earned in the trust and not paid or made payable to a beneficiary is taxed in the trust at the top individual marginal tax rate for the trust's province or territory of residence. The trust is not entitled to claim a personal tax credit.

Under the proposed measures, a trustee who fails to file a T3 return or who makes a false statement or omission on the trust tax return knowingly, or in circumstances that amount to gross negligence, will be subject to a penalty.

As trustee, you should seek advice from a qualified tax and legal advisor as to your ability to make income and capital gains paid or payable to a beneficiary of the trust, as well as the steps you need to take to do so, in accordance with the trust terms.

Income or capital gains paid or made payable to an adult beneficiary

Income or capital gains paid or made payable to a Canadian resident adult beneficiary (not including the settlor's or contributor's spouse or common-law partner) are included in the beneficiary's tax return and subject to tax at the beneficiary's marginal tax rate in their province or territory of residence. It's important to note this does not mean the T3 return reporting obligation step can be skipped. Any income earned in the trust should still be reported on the T3 return and a deduction claimed for income that is taxable to the beneficiaries.

Income or capital gains paid or made payable to a minor beneficiary

Where the trust is properly structured (i.e. the super attribution rules do not apply), other attribution rules may apply where the settlor or a contributor makes a gift to the trust, and income (e.g., interest or dividends) earned on that property is allocated to a non-arm's length minor beneficiary, such as a child, grandchild, niece or nephew. In these cases, the income is attributed back to the settlor or contributor and taxed in their hands at their marginal tax rate. Capital gains paid or made payable to a minor beneficiary are generally not attributed back to the settlor or contributor. Again, the trust will be required to file a T3 return to report any income earned in the trust and can claim a deduction for income that is paid or made payable to the beneficiaries, even where the attribution rules apply.

Winding up your trust

In light of the upcoming tax changes, you may be interested in winding up your trust established using the DOT. It's important to note that if your named beneficiary is a minor, distributions from the account cannot be made directly to them (as a minor beneficiary cannot provide a valid discharge to the trustee to relieve them

of personal liability). You should review the DOT with a qualified legal advisor to determine when and how the trust can be wound up.

From an income tax perspective, distributions of income will be taxable in the beneficiary's hands, subject to the attribution and super attribution rules. If capital assets are distributed to a beneficiary, the assets can be received by the beneficiary tax-free. As trustee, you can choose to make the capital distribution in cash or in-kind. From an income tax perspective, if you make the distribution in-kind to a Canadian resident beneficiary, this can generally be done on a tax-deferred basis unless the super attribution rules apply to the trust at the time of wind-up. If the super attribution rules apply, the capital will generally need to be distributed to a beneficiary at FMV. Capital distributions to a non-resident beneficiary must also be done at FMV, triggering a taxable disposition in the trust.

Obtaining a CRA trust account number

In addition to the enhanced reporting rules for trusts in 2021, the CRA requires financial institutions to collect additional information for trusts and other entity accounts. Financial institutions are required by the CRA to request trust account numbers for existing DOT accounts. The CRA may apply a penalty to the trustee of $100 if the trustee fails to provide a valid trust account number to the financial institution. This penalty may not be imposed where an application for a number is made to CRA within 15 days after receiving the financial institution's request and the number is provided to the financial institution within 15 days after its receipt by the trustee.

The CRA will issue a trust account number, if the trust does not already have one, when the first T3 trust return is filed. A copy of the DOT should be attached along with the first T3 return. The CRA will show the trust account number assigned on the T3 Notice of Assessment for the trust.

Given the upcoming increased trust reporting and compliance requirements, you may wish to review your DOT with a qualified tax and/or legal advisor and discuss next steps to prepare for the new reporting obligations.

The trustee may choose to apply for a trust account number before filing the first tax return by submitting CRA Form T3 APP, *T3 Application for Trust Number*, along with a copy of the trust document. It's important to seek advice from a qualified tax and/or legal advisor before filing a T3 trust return or applying for a trust account number, especially in the case where previous filing requirements have not been met.

Next steps

Given the upcoming increased trust reporting and compliance requirements, you may wish to review your DOT with a qualified tax and/or legal advisor and discuss next steps to prepare for the new reporting obligations.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Appendix

What is a trust?

A trust is not a separate legal entity like a corporation, although it is treated as a separate taxpayer for tax purposes. A trust is a legal arrangement or relationship. An individual, known as the "settlor" creates a trust by entrusting some or all of their property to a trustee of their choosing. The trustee holds legal title to the trust property for the benefit of one or more individuals (the beneficiary), specified by the settlor. The trustee owes a fiduciary duty to the beneficiary. This means that they are required to act in the best interest of the beneficiary, who is the beneficial owner of the trust property. The trustee must administer the trust in accordance with the terms of the trust agreement and the laws that govern the trust.

A trust can be created during the lifetime of the settlor (known as an inter-vivos or living trust) or on their death (known as a testamentary trust). In general, a trust will come into existence with the transfer of at least one asset to the trustee.

For a trust to be valid, three certainties must be met:

1. Certainty of Intention – there should be a clear intention to create a trust by the settlor;
2. Certainty of Property – there must be certainty as to what property is being held upon trust and the amount or share of the trust property that each beneficiary is to receive; and
3. Certainty of Beneficiary – the beneficiary of the trust must be clearly identifiable by name or class.

Although a trust can be created informally, as demonstrated by the actions of the parties to the trust, it is generally preferable to formally establish a trust by signing a legal document referred to as a trust agreement. Increasing "Know Your Client" regulatory requirements means financial institutions are moving away from informal trusts, and a trust agreement helps ensure that the parties to and terms of the trust are known. The trust agreement indicates the settlor, trustee, beneficiary or beneficiaries, the powers and restrictions placed on the trustee, and how and when income and capital are to be distributed to a beneficiary and to which beneficiary. By formally documenting the parties to and terms of the trust, the potential for mismanagement of the trust assets or misinterpretation of the trust terms is reduced.

Parties to a trust

Settlor

A settlor is the person who creates the trust by transferring property to a trustee to be held and administered for the benefit of the beneficiary.

Contributor

A contributor is a person who transfers property to a trust for the benefit of the beneficiary. Often, the settlor is a contributor to the trust; however, a third party can also be a contributor.

Trustee

A person or trust company that is appointed to administer property entrusted to them for the benefit of the beneficiary. A trustee's responsibilities are governed by the terms of the trust agreement and laws of the jurisdiction that govern the trust. Typical obligations include:

- Carrying out the express terms of the trust arrangement;
- Prudently investing the trust assets;
- Remaining impartial among beneficiaries;
- Accounting for their actions and keeping the beneficiaries informed about the trust; and
- Administering the trust in the best interest of the beneficiaries.

Beneficiary

A beneficiary is a person entitled to the use and enjoyment of the trust property. A beneficiary might be entitled to the income of the trust, capital of the trust or both.

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