2024 Issue No. 44
22 August 2024

Tax Alert – Canada

Proposed modifications to the enhanced trust reporting requirements and post-mortem tax planning by a trust

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

The proposed income tax technical legislative amendments released on 12 August 2024 by the Department of Finance provided some welcome news with respect to the enhanced trust reporting requirements and existing limitations in post-mortem tax planning strategies commonly undertaken by certain trusts. Careful reading of the proposals is recommended, as certain categories of bare trusts will still be required to file starting again in 2025 after the proposed one-year legislative repeal.

In this Tax Alert, we provide a brief overview of the proposed amendments. Interested parties are invited to provide comments to the Department of Finance on the proposed legislative amendments by 11 September 2024.

For more information on the other draft legislative proposals released on 12 August 2024, refer to EY Tax Alert 2024 Issue No. 42, *Finance releases draft legislation for 2024 budget and other measures*.

Building a better working world

Enhanced trust reporting requirements

Legislative amendments enacted in 2022 impose additional reporting requirements on many express trusts (i.e., trusts that are created with the settlor's express written or verbal intent, as opposed to other trusts arising by operation of law), including many agency and other commercial relationships, for taxation years ending after 30 December 2023. The broad and comprehensive requirements also apply to bare trusts and other informal trust and agency relationships.[1] While administrative relief was given to the 2023 tax return filing for bare trusts only a few days before the 2 April 2024 filing deadline, the 2022 legislative amendments had otherwise remained in force.

The enhanced reporting requirements mandate the filing of a T3 *Trust Income Tax and Information Return* and additional disclosure on an annual basis. Under the enhanced rules, express trusts subject to the additional reporting requirements must disclose detailed information for each trustee, beneficiary and settlor of the trust, as well as any person who has the ability to exert influence over trustee decisions regarding the allocation of trust income or capital in a year.

With limited exception under the additional reporting requirements, the enhanced requirements prove to be cumbersome for many trusts and trustees. The proposed legislative amendments released on 12 August 2024 aim to expand and clarify the relieving exceptions to the requirements.

Exempted express trusts

Under the proposed amendments, the list of express trusts that are exempt from the enhanced reporting requirements in subsection 150(1.2) of the *Income Tax Act* (the Act) is expanded and includes trusts that meet the following conditions:

- Each trustee of the trust is an individual;
- Each beneficiary is an individual who is related to the trustee; and
- The total fair market value of the trust's property does not exceed $250,000 throughout the year, and the trust's only assets held throughout the year are one or more of the following:
    - Money;
    - A guaranteed investment certificate (GIC) issued by a Canadian bank or trust company;

[1] For more information, see EY Tax Alert 2024 Issue No. 4, *New trust reporting requirements are broader than you think*. For information on the application of the rules to nonresident trusts, see EY Tax Alert 2024 Issue No. 2, *New Canadian trust reporting requirements to impact many foreign trusts*.

- A debt such as a bond or debenture issued by a government agency where the interest is fully exempt interest;
- A debt obligation, such as a bond issued by:
    - A Canadian publicly traded corporation, mutual fund trust or partnership;
    - A foreign publicly traded corporation; or
    - A Canadian branch of a foreign bank.
- A share or debt listed on a designated stock exchange;
- A share of a mutual fund corporation;
- A unit of a mutual fund trust;
- An interest in a related segregated fund trust;
- An interest as a beneficiary under a publicly traded trust;
- Personal-use property of the trust; or
- A right to receive income on property described above.

As a result, smaller trusts without any corporate trustee, corporate beneficiary and assets that meet the above criteria with a total fair market value of $250,000 or less would be exempt from the enhanced reporting requirements.

Moreover, amendments have been proposed for smaller trusts that hold assets with a total fair market value of $50,000 or less to also be exempt from the enhanced reporting requirements even if those trusts have corporate trustees or whose beneficiaries may not be an individual who is related to each trustee. Under the existing legislation, the "small trust" exception only applied where the trust held certain types of property; the proposed amendments have removed any exclusions based on the types of property held for the "smaller" trusts.

In addition, the exception for trust accounts used by professionals, such as lawyers, which are required to hold funds for the purposes of regulated activities, is extended to include certain client accounts. Specifically, a specific trust account will be exempt from the enhanced reporting requirements if the only assets held by the trust throughout the year are money with a value of no more than $250,000. This proposed enhancement may prove to be of limited value to lawyers who hold specific segregated funds or trust accounts in GICs or other comparable investments, as the exclusion only applies to "money" and does not extend to investment contracts such as a GIC. It is unclear whether this limitation was or was not intentional given the extension and specific reference to GICs for the related family ownership enhancement.

An exemption is also added, for greater certainty, to exclude statutorily created trust relationships, such as those of bankruptcy trustees or provincial guardians.

The above proposed relief applies to taxation years ending after 30 December 2024.

Bare trusts

Certain welcome changes are also found in the proposed amendments with respect to bare trusts. Despite enhanced relief, the proposed amendments would still result in large categories of bare trust filings required for certain sectors, such as the investment real estate sector.

Under the current rules, subsection 150(1.3) of the Act has the general effect of making a bare trust subject to the reporting requirements in section 150 of the Act. Subsection 150(1.3) provides that a bare trust includes an arrangement where the trust can reasonably be considered to act as an agent for its beneficiary(ies) with respect to all dealings in all the trust's property.

The proposed amendments repeal the existing requirements for bare trusts in subsection 150(1.3) for taxation years ended after 30 December 2024 and introduce new proposed subsections 150(1.3) and (1.31) for taxation years ending after 30 December 2025. As a result of these proposed changes, bare trusts will be exempt from the enhanced reporting requirements for the 2024 taxation year, and the number of bare trusts that will be subject to the filing requirements for 2025 and later taxation years will be reduced.[2]

Broadly speaking, the proposed amendments introduce the concept of "deemed trust" to address bare trusts and clarify what constitutes a bare trust arrangement. A bare trust would only be subject to the enhanced reporting requirements if it is a deemed trust. As noted in the Department of Finance explanatory notes, the changes are intended to provide clarity on the arrangements that are subject to the reporting requirements.

Specifically, under proposed subsection 150(1.3) of the Act, an express trust is deemed to include an arrangement where one or more persons, referred to as the "legal owner," have legal ownership of property that is held for the use of, or benefit of, one or more persons or partnerships. In addition, under the arrangement, the legal owner is reasonably considered to act as agent for the persons or partnerships who have the use of, or benefit of, the property. Such an arrangement is often referred to as a "bare trust arrangement" and is referred to as a "deemed trust" in the proposed amendments. Each of the legal owners is deemed to be a trustee of the trust, and each person or partnership that has the use or benefit of the property under the arrangement is deemed to be a beneficiary of the trust. Since an express trust is deemed to include a bare trust, the enhanced reporting rules applicable to express trusts would also apply to deemed trusts.

[2] On 28 March 2024, the Canada Revenue Agency (CRA) announced that bare trusts are not required to file a T3 return and Schedule 15, *Beneficial Ownership Information of a Trust*, for the 2023 taxation year, unless the CRA requests these filings. For more information, see New – Bare trusts are exempt from trust reporting requirements for 2023 - Canada.ca.

However, proposed subsection 150(1.31) provides exceptions from the enhanced reporting rules to certain bare trusts or deemed trusts if certain conditions are met. Some notable conditions include an arrangement for a taxation year if:

(a) Each person or partnership that is deemed to be a beneficiary at any time in the year is also a legal owner of the property, and there are no legal owners that are not deemed beneficiaries. This scenario often applies to circumstances where family members hold joint bank accounts.

(b) The legal owners are individuals that are related to each other, and the property is real property that would be the principal residence of one or more of the legal owners if it was designated as such. For example, this scenario applies to arrangements where a parent is on title to allow a child to obtain a mortgage.

(c) The legal owner is an individual; the property is real property that is held for the use of, or benefit of, the legal owner's spouse or common-law partner during the year; and the property would be the legal owner's principal residence if the legal owner designated it as such. For example, this scenario applies to situations where spouses jointly occupy a family home but only one spouse is on title.

(d) Property is held throughout the year solely for the use of, or benefit of, a partnership; each legal owner is a partner (other than a limited partner) of the partnership; and a partnership information return is filed by a member of the partnership. For example, this arrangement applies to common practice where a partner (usually a general partner) holds property for the use of, or benefit of, the partnership.

(e) The legal owner holds the property as a result of a court order.

Lastly, the amendments propose to include the requirement to provide the prescribed information of a partnership that is a beneficiary of a trust.

When coupling together the complexities of the proposed amendments, traditional use of a corporate bare trustee model in the ownership of real estate will still result in the requirement to file a trust income tax return as the arrangement does not fit any of the specific exclusions.

Definition of settlor

Lastly, relief is provided through the proposed amended definition of "settlor." Under the enhanced reporting requirements, a trust must report, among other things, information with respect to the settlors of the trust. The existing definition of "settlor," as defined in subsection 17(15) of the Act, includes any person or partnership that has loaned or transferred property, directly or indirectly in any manner whatever, to or for the benefit of the trust. An exception is provided for a person or partnership that deals at arm's length with the trust who made a loan to the trust at a reasonable interest rate, or who made a transfer to the trust for fair market value consideration. This definition may be broad enough to capture individuals who undertook common Canadian tax and estate planning strategies, such as an estate freeze, or those who loaned even a nominal amount of money to a trust or corporate entities indirectly owned by the trust, with which they do not deal at arm's length.

The proposed amendments narrow the definition of settlor (in new proposed subsection 204.2(3) of the *Income Tax Regulations*) to provide an exception for persons and partnerships that made transfers to the trust for fair market value consideration or pursuant to a legal obligation to make the transfer. Such persons and partnerships will not be considered a settlor for purposes of subsection 204.2(1) of the Regulations as long as they receive fair market value consideration for the transfer, irrespective of whether or not they have an arm's length or a non-arm's length relationship with the trust.

The proposed definition would apply for taxation years ending after 30 December 2024.

Post-mortem tax planning undertaken by a trust

A major consideration in post-mortem planning is the deemed disposition of property on death at fair market value. On the death of the owner of a private corporation, capital gains and the related income taxes would arise due to the deemed disposition. Taxes would become payable again when the shareholder's estate extracts funds from the private corporation, resulting in double taxation.

There are generally two strategies to address the double taxation: the loss carry-back strategy under subsection 164(6) of the Act and the pipeline strategy. Both strategies have limitations under the current legislation, and the proposed amendments released on 12 August 2024 aim to address certain limitations.

Loss carry-back strategy under subsection 164(6) of the Act

Broadly speaking, under the loss carry-back strategy, a graduated rate estate (GRE) can elect to carry back a capital loss from the first year after the death of the shareholder to the terminal year of the deceased. The election is available to the extent the capital loss exceeds any capital gains that arise in the first taxation year of the GRE. The capital loss carry-back can offset capital gains realized from the deemed disposition on death.

However, only net capital losses incurred in the first year of the GRE can be carried back to the terminal tax return. This timing restriction presents a significant challenge to executors and trustees who plan to take full advantage of the subsection 164(6) planning strategy. Specifically, for subsection 164(6) to apply, the executor or trustee must dispose of properties held by the GRE within the first taxation year of the GRE. Practically speaking, many executors and trustees often encounter delays in administering the GRE and may not be in a position to dispose of any properties within the first taxation year of the GRE, hence losing the opportunity to use the subsection 164(6) loss carry-back strategy.

The proposed amendments will allow executors and trustees three taxation years to dispose of properties of the GRE. In other words, the net capital losses incurred in any of the three first taxation years of the estate can be carried back to the terminal year of the deceased.

This is certainly a welcome relief. Executors and trustees now have more time for dispositions while benefiting from the loss carry-back opportunity under subsection 164(6) of the Act.

Pipeline strategy

The pipeline strategy can be used to avoid double taxation but, as a result of the anti-surplus stripping rules in section 212.1, it does not appear to be effective when the GRE has a nonresident beneficiary. Section 212.1 is an anti-avoidance rule designed to prevent the stripping of taxable corporate surplus out of Canada as a tax-free return of capital through a non-arm's length transfer by a nonresident of shares from one Canadian corporation to another Canadian corporation. The rule deems certain non-share consideration paid to be a dividend paid, subject to withholding tax, and reduces the paid-up capital of the shares of the purchaser corporation that may otherwise have been increased as a result of the transaction.

Broadly speaking, a pipeline strategy is generally implemented by having the GRE sell the shares of a Canadian private corporation (Canco) held at the time of the shareholder's death to a new Canadian corporation (Newco) in exchange for a promissory note equal to the GRE's adjusted cost base of the Canco shares, which is generally equal to the fair market value of the shares at the time of death. When the required conditions are met, income tax would only be payable with respect to the deemed disposition on death of the shareholder, rather than when the funds are extracted from Canco or Newco. Any extraction of funds will occur by way of the repayment of the promissory note, which is usually on a tax-free basis.

However, when the GRE disposes of the Canco shares to Newco, each beneficiary of the GRE is deemed to have disposed of their proportionate interest in Canco in exchange for their proportionate share of the consideration from Newco (i.e., the promissory note payable by Newco). Consequently, the conditions of section 212.1 would be met when there is a nonresident beneficiary. The nonresident beneficiary would be deemed to have received a dividend from Newco to the extent that the nonresident beneficiary's proportionate share of the promissory note from Newco exceeds the paid-up capital of the nonresident beneficiary's proportionate interest in the Canco shares. As a result, Canadian withholding tax would become payable on the deemed dividend to the nonresident beneficiary. This result clearly defeats the intention to avoid double taxation.

The Department of Finance announced in a comfort letter in December 2019 that it would seek to correct this unintended result. The correction has been included in the package of proposed technical amendments released on 12 August 2024 where an exception from the application of section 212.1 is afforded to a conduit such as a deceased's GRE when the GRE disposes of shares of a Canadian corporation that it acquired on and as a consequence of the individual's death and the individual had been resident in Canada immediately before their death. This proposed amendment will facilitate post-mortem estate planning.

The proposed amendments are applicable to dispositions that occur after 26 February 2018, and a related application rule allows a written application for a refund of excessive Part XIII tax paid to be made within 180 days of the enactment of the proposed amendment, irrespective of the time limit that would otherwise apply to such applications under subsection 227(6) of the Act.

Learn more

For more information on the proposed legislative amendments, please contact your EY or EY Law tax advisor or one of the following professionals:

Jin Wen
+1 416 943 5241 | jin.wen@ca.ey.com

Ameer Abdulla
+1 519 571 3349 | ameer.abdulla@ca.ey.com

Nima Afshani
+1 416 932 6174 | nima.afshani@ca.ey.com

Gabriel Baron
+1 416 932 6011 | gabriel.baron@ca.ey.com

Sharron Coombs
+1 416 932 5865 | sharron.coombs@ca.ey.com

Elena Doucette
+1 416 943 3193 | elena.doucette@ca.ey.com

Teresa Gombita
+1 416 943 3272 | teresa.gombita@ca.ey.com

Wesley Isaacs
+1 416 932 6003 | wesley.isaacs@ca.ey.com

Hayat Kirameddine
+1 780 412 2383 | hayat.kirameddine@ca.ey.com

Ken Kyriacou
+1 416 943 2703 | ken.kyriacou@ca.ey.com

Stéphane Leblanc
+1 514 879 2660 | stephane.leblanc@ca.ey.com

Benoît Millette
+1 514 879 3562 | benoit.millette@ca.ey.com

Jeremy Shnaider
+1 416 943 2657 | jeremy.shnaider@ca.ey.com

Marlène Vigneau
+1 514 228 3699 | marlene.vigneau@ca.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation is available via ey.com/privacy. For more information about our organization, please visit ey.com.

About EY's Tax Services
EY's tax professionals across Canada provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. We offer a range of tax-saving services backed by in-depth industry knowledge. Our talented people, consistent methodologies and unwavering commitment to quality service help you build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its potential. It's how we make a difference.

For more information, visit ey.com/ca/tax.

About EY Law LLP
EY Law LLP is a national law firm affiliated with EY in Canada, specializing in tax law services, business immigration services and business law services.

For more information, visit eylaw.ca.

About EY Law's Tax Law Services
EY Law has one of the largest practices dedicated to tax planning and tax controversy in the country. EY Law has experience in all areas of tax, including corporate tax, human capital, international tax, transaction tax, sales tax, customs and excise.

For more information, visit http://www.eylaw.ca/taxlaw

© 2024 Ernst & Young LLP. All Rights Reserved.

A member firm of Ernst & Young Global Limited.

This publication contains information in summary form, current as of the date of publication, and is intended for general guidance only. It should not be regarded as comprehensive or a substitute for professional advice. Before taking any particular course of action, contact EY or another professional advisor to discuss these matters in the context of your particular circumstances. We accept no responsibility for any loss or damage occasioned by your reliance on information contained in this publication.

ey.com/ca