

The TaxLetter®

Vol. 36, No. 6

Your Guide to Tax-Saving Strategies

June 2018

TAXSTRATEGY

Discretionary Trusts 102

Proper Administration

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Last month I wrote on the ABCs of a discretionary family trust. The article highlighted some of the benefits of family trusts, such as income splitting (as long as the right structure is in place), and exercising flexibility on how property may eventually be distributed among the next generation. So, you may have decided to go forward and set up that family trust. Now what? What should you be doing, and what should you be aware of when it comes to the CRA?

Items that the CRA has focused on over the years in relation to discretionary trusts include:

i) the trustee's qualification, expertise and experience;

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- ii) the amount of fees received by the trustee, if any;
- iii) a list of the trustee's duties and responsibilities with respect to the subject trust;
- iv) how decisions are made in relation to the trust property;
- v) how distributions of income to beneficiaries are determined, and whether such income is taxed in the hands of the trust or the particular beneficiary;
- vi) whether parents, acting as trustees, were scooping funds for their own benefit despite being "paid" to the kids;
- vii) the absence of proper accounting records and trustee minutes for the trust;
- viii) an absence of the original settlement property used to establish the trust (i.e. a gold coin, or dollar bill); and
- ix) proper compliance with the 21st anniversary deemed disposition rule.

What should you do?

If you have formed the trust in recent years, and your tax and trust advisor ensured that the trust was properly formed, with the property trust deed and settlement property in a safe place, you're ahead of the curve. However, if you recall that somewhere, some time ago, some form of trust might have been formed for your family, maybe by your parents, or your favourite uncle, but you're not quite sure... Sound familiar? Then chances are that the proper documentation may not be in place.

Unlike companies, trusts usually don't put in place annual minutes. And the likelihood is that a majority of family trusts in Canada have never filed a T3 tax return for the years they existed (which is required, even if the trust has no income). Unfortunately, this laissez-faire attitude will likely not pass muster, what with the CRA potentially breathing down your neck.

The first thing you should do if you are in this situation is to dig out the trust deed from the far recesses of your basement (or, hopefully, from your tax/trust advisor's file).

The Trustees

Once that is done, you should turn your attention to the role of the trustees. No longer is residency of a trustee enough to take the position that a trust is resident in Canada (or whatever jurisdiction you are aiming for).

Rather, there needs to be evidence that the trustees are taking an active role with respect to the trust, and not simply acting in an administrative or clerical capacity, or even as a nominee or agent. You should also make sure that the proper paper is put in place to show that the trustees are taking an active role in the trust assets, such as annual “minutes” for the trust by the trustees and resolutions relating to any actions by the trustees in respect of the trust. For example, the proper authorization requirements should be in place if the authority to invest is delegated to a third party (i.e. an investment advisor).

The CRA has also focused on whether the trustees have properly held on to the actual settlement instrument (i.e. the gold coin, or dollar bill used to settle the trust). The agency has been asking for proof of the initial instrument’s existence – so when you’re digging out the trust deed, make sure you also get your hands on that gold coin etc. so you can have proof that the trust was established.

Some of you have put in place income splitting strategies (i.e. a prescribed rate loan was made to the trust), with the result that income is actually being allocated and paid out of the trust to your minor kids and taxed in their hands. In this case, you should ensure that prior to the year-end for the trust (December 31), the trustees pass a resolution stating that a stipulated amount or proportion of the trust’s income be payable to the actual beneficiaries, and that such resolution is irrevocable. A copy of this resolution or other form of notification should be given to the kids with some form

of acknowledgement or signed receipt, if possible (although this may not always be preferred, especially if the kids are minors, in which case they can be acknowledged by the parent).

Transparency

But more importantly, the flow of actual funds should be apparent. It’s not enough to pass a trustee resolution if you can’t provide evidence that the money actually went to the kids. As I mentioned above, CanRev will be looking for instances where the parents “scoop” the cash for themselves. So to be extra safe, you should open up bank accounts for your kids and deposit the funds into the accounts. If you’re not actually paying the cash to them and keeping the funds in the trust (but allocating the income to the kids), you should have the trust give a promissory note to the kids as evidence of the payment, (or, rather to evidence that a debt is actually due to the kids from the trust).

It’s true that any amount payable or paid by a trust to the kids would be reflected in a T3 return for the trust. While this would be evidence of an allocation, the CRA’s position has been that this alone would not satisfy them that the allocation was properly made, as the T3 return (or the T3 Supplementary which would show the allocation) would be issued after the end of the trust’s taxation year and the CRA wants to see evidence of payment before December 31.

Third Parties

An interesting issue arises where amounts are “paid” to third parties on behalf of the

kids. One example is cutting a cheque to your child’s private school directly from the trust to pay your child’s tuition. In such a situation, you should ensure that you comply with the three requirements set out by the CRA in order to ensure that such payments to third parties will still be deductible to the trust:

i) the trustee must exercise their discretion per the trust to make an amount payable to the beneficiary before the payment is actually made;

ii) the trustee must initiate the steps to make the payment, the trustee must notify the parents of the exercise of the discretion, and the parents must direct the trustee to pay the amount to the appropriate person before the payment is made; OR the payment must be made pursuant to the parents’ request and direction, and the parent is advised of the exercise of discretion and payment of the amount either before or after the payment is made; and

i) it must be reasonable to consider that the payment was made in respect of an expenditure for the child’s benefit.

I personally find these conditions confusing, and hard to abide by. So if you need to pay a third party, play it safe and take the extra step of opening up an account for your child, distributing the funds to that account, and then paying the third party directly from such account. Yes, it means an extra step, but it avoids any confusion and will satisfy any nosy questions that the CRA might have. □