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Don't let down your guard when it comes to discretionary family trusts

Trustee Training

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I recently spoke at the Ontario Bar Association about the proper administration of trusts. It's a topic that I first presented on and wrote about four years ago.

At the time, the CRA was in the midst of a special audit project aimed at family discretionary trusts.

When I was approached to repeat my presentation again this month, I was told that even if the audit project is a thing of the past, the fact remains that family trusts still need proper attention. And they were right – the topic is still a timely one.

Even though I no longer hear whispers on the street about the CRA focusing on these types of trusts, it does not mean that you can become more relaxed when dealing with your trust's compliance each year.

So I thought a refresher on the dos and don'ts might be in order.

To start with, some of the items that the CRA has focused on over the years in relation to discretionary trusts have been (been not limited to):

✓ the trustee's qualification, expertise and experience;

✓ the amount of fees received by the trustee, if any;

✓ a list of the trustee's duties and responsibilities with respect to the subject trust;

✓ how decisions are made in relation to the trust property;

✓ how distributions of income to beneficiaries are determined and whether such income is taxed in the hands of the trust or the particular beneficiary;

✓ whether parents, acting as trustees, were scooping funds for their own benefit despite being "paid" to the kids;

✓ absence of proper accounting records and trustee minutes for the trust;

✓ an absence of the original settlement property used to establish the trust (i.e., a gold coin or dollar bill); and

✓ proper compliance with the 21st anniversary deemed disposition rule.

So in light of the above CRA's scrutiny, what should you do?

Well, chances are that no documentation may be in place for your family trust. Unlike companies, these 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 return for the years they were in existence.

Unfortunately, this laissez-faire attitude will no longer pass mustard, what with the CRA potentially breathing down your neck.

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

Once that is done, you should turn your mind 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

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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 documents are put in place to show that the trustees are taking an active role in the trust assets.

These can include 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 (such as 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), and have asked for proof of the initial instrument's existence.

Chances are that no documentation may be in place for your family trust

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 of the evidence of the establishment of the trust.

For those of you who have put in place income splitting strategies such that income is actually being paid out of the trust to your minor kids: 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 paid or 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 beneficiaries with some form of acknowledgement or signed receipt, if possible (although this may not always be preferred, especially if the beneficiaries are minors).

But more importantly, the flow of actual funds should be evidenced. 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, you should have the trust give a promissory note to the beneficiaries as evidence of the payment (or rather, to evidence that a debt is actually due to the beneficiaries from the trust).

It's true that any amount payable or paid by a trust to the beneficiaries would be reflected in a T3 return for the trust.

While this would be evidence of an allocation, it's likely that this would not satisfy the CRA as the T3 return (or the T3 Supplementary which would show the allocation) would be issued after the end of the year. The CRA wants to see evidence of the amount payable or paid before December 31.

An interesting issue arises where amounts are paid to third parties, on behalf of the kids. For example, if you want to cut a cheque to your child's private school directly from the trust to pay your child's tuition.

In this 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:

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

☞ 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

☞ 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, I would recommend going the safe route: 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. ❒

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