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TAX LETTER

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DEADLINE PENDING! MUST YOU FILE A TRUST RETURN?

We have written before about the new **trust reporting rules** that were enacted by Parliament in December 2022, and which first apply for the 2023 tax year.

The first reporting under these rules is required by April 2, 2024. (The deadline is 90 days after year-end. Because this year is a leap year, this means March 30, but that's a Saturday, and April 1 is Easter Monday, so the deadline is extended to Tuesday April 2, the next business day.)

Trusts have always been required to file a T3 return, but the CRA has allowed a trust not to file in most cases if it has income of $500 or less and no tax to pay. And a "bare trust" was not required to file a return at all.

A **"bare trust"** is a common-law arrangement where the nominal or legal owner of property has no rights to the property, and must simply follow the instructions of the real owner, such as to hold the property and eventually transfer it to another party. (In Quebec, where the *Civil Code* applies instead of the common law, a "prête-nom" is similar to a bare trust.)

Thus, for example, real estate is often held by a numbered company as bare trustee for the real owners, who might be individuals, corporations, a limited partnership or some combination of these. Or a lawyer might have title to a home or cottage as bare trustee for a group of family members.

Under the new rules (*Income Tax Act* subsection 150(1.3)), **a bare trustee must file a T3 trust return**.

A regular trust must also file, even if it has no income, unless it falls into one of several very specific exceptions.

Starting now, the T3 includes **"Schedule 15"**, which requires disclosing the **name, address, social insurance number** (or other tax number), **and birthdate** (if human) of every **trustee, beneficiary and settlor**.

CRA information about the new T3 and Schedule 15, and a detailed Q&A, can be found on its web page "New trust reporting requirements", at tinyURL.com/cra-trust-rep.

The CRA has said that it will not apply a penalty for failing to report a bare trust for 2023 only. However, this does not apply to a failure that is done knowingly or with gross negligence. **If you are aware of the obligation, you must file. Otherwise, the penalty is very severe:** 5% of the highest value of the trust property during the year, minimum $2,500. For example, if you fail (knowingly or with gross negligence) to report a bare trust for a property worth $4 million, and you are even 1 day late, the penalty is $200,000. (If the failure to report was innocent and unknowing, there is still a penalty of $25 per day up to 100 days, i.e. $2,500 once the return is 100 days late.)

So make sure a T3 and Schedule 15 are filed for every trust you are involved with!

ESTATE PLANNING AND ESTATE FREEZING

Overview

Estate planning encompasses a number of areas:

- You should have a Will that takes into account both your desires and tax considerations.
- You may wish to consider steps to minimize probate fees (called Estate Administration Tax in some provinces) on your death.
- You should carry enough insurance to meet your family's needs on your death.
- If you own assets in other jurisdictions or if you are a U.S. citizen, you must consider the effects of foreign estate taxes.
- If you are leaving assets to your children who are or may be married, you can plan around the provincial family laws that apply on marriage breakdown.

In this article we focus on the **income tax aspects** of estate planning, and specifically on **"estate freezing"** techniques that can be used to reduce the tax cost of death.

Taxes on death

Canada has no estate or inheritance taxes, although provincial probate fees ("estate administration tax", in some provinces) can be up to 1.5% of the value of your estate.

The primary *income tax* effect of death is a **deemed disposition of capital property** at its fair market value. All of your capital property (essentially, all property except inventory in a business) is treated as though you had sold it immediately before your death at its current value. Thus, any accrued **capital gains are recognized and taxed** in your final tax return, which is filed by your executor (or administrator / estate trustee).

Capital gains are half-taxed, so the tax rate on such gains can be as high as 27%, depending on your province of residence. In planning for your death, you should assume that the tax resulting from the deemed disposition will be substantial.

One way of deferring the tax on your death is to leave assets to your **spouse** or a qualifying **spousal trust**. Provided certain requirements are met, the deemed disposition on death will be at your cost of the assets rather than at their current *value*, so there will be no tax to pay. That cost will then be "rolled over" (transferred) to your spouse, so that the tax deferred will in effect be paid on your spouse's death. (The same rules apply to a "common-law partner", if your common-law relationship meets certain conditions.)

Estate freezing

Estate freezing is the term used to describe steps taken to "freeze" some of your assets at their present value, so that future growth can go to your children or grandchildren and not be taxed on your death.

It is most worthwhile if you have an incorporated business that is expected to grow significantly in future years, and in which your children are actively involved.

There are many different forms of estate freeze, and the appropriate one for you will depend on many different factors, such as: the value and nature of your assets; the expected growth of your estate; the number, ages and spousal status of your children; your age; the availability of the capital gains exemption; your and your spouse's financial needs, both now and on retirement; and many other factors including the "Tax On Split Income" (TOSI) rules that took effect in 2018.

Below we describe just one example of an estate freeze.

Example — a "Section 86" freeze

The is the simplest estate freeze. Section 86 of the *Income Tax Act* allows an exchange of one class of shares in a corporation for another class with no tax consequences, as long as all of the shares of the first class are being exchanged.

Suppose you run an incorporated business, XYZCo. The corporation has 1,000 issued common shares, all registered in your name. You originally invested $1,000 in the corporation ($1 per share), and the shares are now worth $200,000. You expect that in a few years they may be worth as much as $1 million. You have an adult daughter who works full-time in the business, and you want her to inherit it.

If you simply leave your shares to your daughter in your Will, the deemed disposition on your death will trigger a substantial capital gain. If the shares are indeed worth $1 million when you die, your estate might have to pay up to $270,000 in tax. (Assume the shares aren't eligible for the lifetime capital gains exemption, or that you've used up your exemption.)

Let's look at how you can use an estate freeze in this situation.

You **exchange** your 1,000 common shares in XYZCo for **1,000 preferred shares** (with share conditions that we'll explain below). Your daughter then invests $100 in 100 new common shares of XYZCo, at $1 each.

The object is to "freeze" the value of your investment at $200,000, which is what the shares are worth now. Any increase in value *above* the $200,000 level will accrue to your daughter, and not to you. Therefore, your preferred shares need to be set up to have a value of exactly $200,000 – a value that does not increase even though the value of the company as a whole increases.

However, you want to keep control of the business as long as you are alive.

With this in mind, here is how you might design the preferred shares that you will own:

- The preferred shares will be **voting shares**. Each preferred share should carry 1 vote, and each new common share should carry 1 vote. Since you will have 1,000 votes to your daughter's 100, you can elect the board of directors, and thus you will continue to control the corporation.
- The preferred shares should be **retractable**, at the option of the holder (you), for $200 each, or $200,000 in total. In other words, you will have the legal right to force the corporation to pay you $200,000 for your shares at any time. That makes it clear how much the shares are worth – since you can cash them in whenever you want.
- Preferred shares must pay a **dividend** in preference to the common shares. The dividend could be in the discretion of XYZCo's directors, or could be fixed at, say, $6 per year per share (i.e., 3% of their value), payable quarterly. The dividend can be made "**non-cumulative**", so that if XYZCo chooses not to declare a dividend in any given quarter, the unpaid dividends will not accumulate to prevent dividends from being paid to your daughter on the common shares.

The specific details should be worked out with your professional advisers as part of your customized estate plan. Everyone's situation is different.

Now, what have you accomplished?

- First, because of section 86 of the Income Tax Act, there is no cost to exchanging your common shares for preferred shares. In other words, the $199,000 accrued gain on your shares isn't taxed for now. (The preferred shares take on the cost base of your original common shares, so they have a deemed cost to you of $1,000.)
- Second, you have "frozen" the value of your investment at $200,000, since the preferred shares will be worth only that much in the future. (They can't go up in value because of the fixed dividend.) So if the value of the business increases, the growth will be allocated to the common shares. On your death, if the business is worth $1,000,000, you have a capital gain of just under $200,000 instead of just under $1,000,000, so the tax cost is far less. (Again, we're ignoring the capital gains exemption on small business shares for purposes of this example.)
- Third, you have kept control of the business. You can continue to elect the board of directors that hires employees and runs the company. And you can continue to be the sole director, if you wish.
- Fourth, if you need income, you can cause the directors of the corporation to declare dividends on the preferred shares, in addition to any salary, bonus or consulting fees the corporation pays you. Since the dividends are non-cumulative, you can also choose to have the corporation not pay them, as long as you are not paying dividends on the common shares during the same quarter.
- Fifth, if you ever need the capital, you can require the corporation to redeem the shares for $200,000. This will result in a "deemed dividend" to you of $199,000, on which you will pay tax of up to about 40%. (It will also leave your daughter in full control of the company.)

The possibilities are endless...

The above is only one example. Estate freezes can be much more complex, and can involve such features as: family trusts owning shares for your children; "section 85 rollovers" whereby you transfer shares or assets to a holding company; crystallization of the capital gains exemption on small business corporation shares; and many other techniques.

There are *many* technical traps and pitfalls in the Income Tax Act to watch out for, however. These include attribution rules, the Tax On Split Income, deemed dividends, stop-loss rules, surplus stripping rules, capital gains stripping rules, and others too numerous to mention.

If you have significant assets that are or can be incorporated, you should definitely explore ways of protecting your estate from significant tax costs on your death.

TFSA LIFETIME LIMIT

The Tax Free Savings Account (TFSA) rules allow you to invest a substantial amount of money in a TFSA. All interest, dividends and capital gains earned in the account are tax-free.

For 2024, $7,000 is added to the amount you can contribute. If you (or a family member) have never contributed to a TFSA, how much contribution room do you have?

TFSA eligibility starts at age 18 and TFSAs started in 2009 (originally at $5,000 per year, now $7,000). Your cumulative TFSA contribution limit as of 2023 is based on your **birthdate**.

Thus, if you were born before 1992 and have never contributed to a TFSA, you can now put $95,000 into a TFSA to earn tax-free income.

You can withdraw funds from a TFSA at any time with no tax cost, and the amount you withdraw becomes available to recontribute, but **only from the following January 1**. If you recontribute too soon, a penalty tax applies.

WHEN CAN THE CRA NO LONGER REASSESS YOU?

If you have invested in a tax shelter, or claimed some deduction or credit that you think the CRA might disallow, when can you stop worrying?

The normal rule is that the Canada Revenue Agency (CRA) can reassess you up to **three years from your original assessment**. The three-year clock starts running from the date shown on the Notice of Assessment that you receive shortly after filing your return. In most cases, if you haven't been reassessed by the time the clock runs out, you are safe for that year. But not always!

Note, first of all, that the clock is not "restarted" by a reassessment. If the CRA reassesses you at some point during the three-year period, the time limit for any further reassessment is still three years from the *original* assessment date.

There are many specific exceptions to the three-year rule. The following are the most notable:

- *Fraud*. If you have committed any fraud in filing your return or in supplying any information under the *Income Tax Act*, you can be reassessed at **any time**. The clock never runs out. If you go to court, the CRA must prove that you committed fraud.
- *Neglect, carelessness or wilful default*. If you have made a misrepresentation that is attributable to "neglect, carelessness or wilful default", you can be reassessed **at any time**. Again, the clock never stops running. If you go to court, the onus is on the CRA to prove that there has been neglect, carelessness or wilful default on your part. Note, however, that the term "carelessness" is quite broad. There is extensive case law interpreting the meaning of these words.
- *Tax shelters*. If you're involved in a tax shelter where you're required to file a tax shelter information form with the CRA, and you don't file the form, then you can be reassessed **at any time**. If you file the form late, that starts a 3-year clock for the CRA to assess you.
- *Not reporting sale of real property*. If you fail to report a sale of real property – including a principal residence where the entire gain is exempt – then the CRA can assess you **at any time** for the gain or profit on that disposition. If you report the sale later, that starts a 3-year clock for the CRA to assess you on the disposition. This rule applies to sales in 2016 and later years.
- *Failing to file an accurate T1135*. If you own foreign property with total cost over $100,000, and you don't properly report all of it on Form T1135 with the level of detail the form requires, and you have any foreign income that you haven't reported, then you can be reassessed up to **six years** from the original assessment date.
- *Not reporting a "reportable transaction" or "notifiable transaction"*. We have written about the new "mandatory reporting" rules in recent Tax Letters. If you do not report a transaction that you are required to report, then the CRA can assess you **at any time** in relation to that transaction. If you report the transaction later, that starts a 3-year clock for the CRA to assess you. This rule applies to transactions in 2023 and later years.

- *Dealings with related non-residents*. If the reassessment relates to a transaction between you and a non-resident with whom you "did not deal at arm's length" (typically a family member, or a corporation or trust controlled by you or a family member), then the reassessment can be issued up to **six years** from the original assessment date.
- *Loss carrybacks*. If you are carrying back a loss, which generally can be done to any of the three years preceding the loss, then your return will have to be reassessed to allow this. A reassessment resulting from any one of a large number of such carryback provisions can be done **up to six years** from the original assessment date. (Normally it's to your benefit to have such a reassessment.)
- *Foreign tax credits*. If your tax payable to another country changes (e.g., due to a reassessment by that country), your foreign tax credits may change. The CRA can reassess you to reflect these changes (which could be good or bad for you) **up to six years** from the original assessment.
- *Consequential assessments*. If a reassessment is made to a return that is still open for reassessment, and as a result a "balance" changes which is carried over (forward or back) to another year, then that other year can be reassessed even if it would otherwise be past the deadline.
- *Waiver*. If before the deadline expires you **sign a waiver** with respect to any taxation year, that year will remain "open" forever for the CRA to reassess on the issues listed in the waiver, unless you revoke the waiver (which requires six months' notice). Usually you should only sign a waiver with respect to a particular, identified issue, rather than giving the CRA blanket power to reassess a given year. Also, remember that you are under no obligation to sign a waiver. If the deadline is approaching and you think it will expire before the CRA can get an assessment issued, you might choose not to sign a waiver.
- *Time spent contesting a demand for information*. If the CRA makes a formal demand for information from you (via a Requirement for Information, or seeking a Compliance Order from the Federal Court), and you bring a Court application to try to have the CRA's demand struck down, any time spent in that legal process stops the clock from running, so the deadline is extended.
- *Corporations that are not CCPCs*. For a Canadian-controlled private corporation (CCPC), the limit is three years, as it is for individuals and most trusts. For any other corporation (or a mutual fund trust), the limit is **four years**. This would apply, for example, to a corporation controlled by a non-resident or by a public corporation. For such corporations, the limit is one year more than for individuals; thus, in the examples above where individuals have six years, it is seven years.

AROUND THE COURTS

Foreign income must be reported to CRA at the spot rate

If you earn income in a foreign currency, section 261 of the *Income Tax Act* says that you are required to convert it to Canadian dollars, for purposes of reporting it on your tax return, using the "spot rate" – the "official" currency exchange rate on the day the income arose (which for a pension payment or investment income, means the day you receive it).

In a recent case, *Petcu v. The King*, 2023 TCC 155, Mr. Petcu received a pension from Romania. His Canadian Old Age Security (OAS) Guaranteed Income Supplement (GIS) was reduced because of this pension income. He appealed to the Tax Court of Canada.

The Tax Court judge explained that the Court can hear OAS appeals on the question of a person's income, so the appeal was properly brought to the Tax Court. The pension from Romania was part of Mr. Petcu's income, and so his GIS was indeed properly reduced.

The judge also noted that the CRA's Income Tax and Benefit Guide "specifically refers to using the Bank of Canada exchange rate in effect on the day the income is received for this conversion". Thus, the Court ruled, the Bank of Canada exchange rate (spot rate) had to be used.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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