BARE TRUSTS: NEW TAX REPORTING REQUIRED

NOVEMBER 2023

HOW JUST HAVING YOUR NAME ON SOMETHING COULD MAKE YOU LIABLE TO FILE ANOTHER TAX RETURN

BACKGROUND

You are now required to file a tax return for bare trusts under the new trust reporting rules or face significant penalties.

These rules came into effect on December 15, 2022 when it received Royal Assent.

The new trust reporting rules apply to trusts with tax years ending on or after December 31, 2023.

Failure to comply with the new reporting rules may result in penalties, including the new gross negligence penalty based on the value of assets being held.

But before we get into the new rules, lets give you some of the basics to show just how far reaching this new rule might be.

In this newsletter

There are many informal (and formal) trusts that are now subject to filing a T3 Trust tax return that might not even be aware of it.

One such type is what is commonly called a Bare Trust but can sometimes be referred to as a Naked Trust, or a Simple Trust.

Informal ones occur in everyday life, which is what makes the requirement to file, or face steep penalties, very concerning.

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WHAT IS A BARE TRUST?

In a ***bare trust*** there is no obligation on the part of the trustee to handle the trust property other than following the instructions of the beneficiaries.

This trust relationship is very different than the more common formal trusts where the trustee exercises control and makes decisions that directly impact the assets held in the trust and the beneficiaries of them.

Although the trustee of a bare trust holds the legal title to trust property, the beneficiary holds the beneficial title to it.

Bare trusts are essentially principal-agent relationships, where the beneficiary controls the trustee's actions related to trust property, whereas the trustee has **NO** independent power, discretion, or management *(decision making)* responsibility over the trust.

EVERYDAY EXAMPLE OF A BARE TRUST

An everyday example of a bare trust can be illustrated through the simple act of saving a seat at a table for someone else.

In this scenario, imagine you are at a busy coffee shop or food court and a friend has asked you to save a seat for them. You agree to the request, and place your jacket on the chair to indicate it's taken.

In this situation you *(the person saving the seat)* are acting like the trustee in a bare trust. The chair *(the seat at the table)* represents the trust property. Your

friend, *(for whom you are saving the seat)* is like the beneficiary of the trust.

Your role in this scenario is very limited and straightforward:

- **Holding the Property:** Just as a trustee holds legal title to the property in a bare trust, you are holding the seat for your friend.
- **No Active Management:** You don't have to make any decisions regarding the seat. Your role is not to manage or use the seat for any purpose other than keeping it for your friend. This is similar to how a trustee in a bare trust does not actively manage or make decisions about the trust property.
- **Transfer Upon Condition:** Once your friend arrives, you will give up the seat to them. This is similar to a trustee transferring the property to the beneficiary upon a specified event *(in this case, the arrival of your friend)*.

In this simple act of saving a seat, you are essentially fulfilling the role of a trustee in a bare trust, where your responsibilities and powers are minimal and entirely directed towards holding the property (the seat) for the sole benefit of the beneficiary (your friend).

COMMON USES OF A BARE TRUST

In more formal arrangements, bare trusts are commonly used to:

- Ensure ownership information, such as land registration records, remains private and anonymous;
- Reduce provincial land transfer taxes or probate fees in transactions in which a property is beneficially owned by multiple parties, but the legal title remains with the trustee;
- Make property transfers more efficient in corporate reorganizations where legal ownership would otherwise need to be transferred and re-registered multiple times, or where administrative difficulties prohibit the transfer;
- Provide or gift a minor child or children with property they cannot legally own; or
- In a joint venture or partnership, hold title to a property on behalf of different owners

CANADIAN TAXATION OF BARE TRUSTS

In general, Canadian income tax does not apply to bare trusts. As a result of this tax treatment, transferring a property's legal title may be possible without triggering a taxable event when a beneficiary retains beneficial ownership.

Nevertheless, a taxable event commonly occurs when beneficial ownership changes, regardless of whether a legal title changes.

Income and capital gains from a bare trust are reported on the beneficiaries' tax returns and they are the ones taxed, not the trust.

In the past, bare trusts were not required to file trust returns, but with the new reporting requirements, this is no longer the case.

It is important to understand the **new reporting requirements only affect the reporting obligations** of bare trusts and does not impact their tax treatment.

THE NEW REPORTING REQUIREMENT

WHEN DOES IT APPLY?

For tax years ending ***after*** December 30, 2023, the trustee of a bare trust must file a T3 trust return. This means that trusts with calendar year ends will have to follow the new rules starting with the 2023 year ending on December 31, 2023.

WHAT DOES IT NEED TO REPORT?

Under these new rules, ***trusts are required to report additional information about all parties*** such as name, address, date of birth, jurisdiction of tax residence, and tax identification number *(Social Insurance Number in Canada, Social Security Number in*

the United States, etc.) on T3 Schedule 15, *"Beneficial ownership information of a trust."*

These parties include trustees, beneficiaries, and settlors of the trust. They also ***include anyone*** *who has the ability (through the trust terms or a related agreement) to exercise control or override trustee decisions* on the income or capital of the trust. A ***protector*** would be considered such a person.

WHEN IS THE DEADLINE TO FILE?

The deadline to file a trust return is 90 days after the taxation year-end. For those with a December 31st year end, this usually means March 31st. However, since ***the rule is 90 days, not 3 months,*** the deadline is actually March 30th during a leap year.

DOES EVERY BARE TRUST HAVE TO FILE?

Bare trusts that have only been in existence for less than three months, or that hold less than $50,000 in assets throughout the year *(provided their holdings are limited to deposits, government bonds, and listed securities)* may be exempt from the new reporting requirement.

However, this means as an example, bare trusts holding real property would not be exempt.

PENALTIES YOU CAN BE HIT WITH

Although there is commonly no tax that a bare trust will likely owe, this does not mean you can ignore the filing requirement.

There are two different penalties that can apply, and before you know it, these penalties could result in you losing a huge value of the assets held in the bare trust.

FILING LATE

If a bare trust fails to file a trust return on time, under the new legislation, the late-filing penalty is $25 per day late (minimum $100) to a maximum of $2,500.

KNOWINGLY FAILING TO FILE

Where a failure to file was made knowingly or due to gross negligence a penalty that is equal to the ***greater*** of:

- $2,500; or
- ***5% of the maximum value of the property*** held during the taxation year by the trust;

would be applied ***in addition to*** the late filing penalty.

This means a filing that is more than one-hundred days late, and knowingly or wilfully neglected (ie: ignored) the filing requirement, the combined penalty would ***start*** at $5,000 for just that one year of filing.

CONCLUSION

There are many situations where an informal bare trust may exist, and as a result, there would also be a filing requirement.

For an example of how bad things could get, take a look at the attached Scenario: **THE GIFT THAT KEEPS ON TAKING -** *A Bare Trust Filing Nightmare.*

If you think you may have a bare trust situation, we suggest you contact our office to discuss your particular circumstances with one of our team. The price you pay for a consultation is much cheaper than ending up with severe penalties!

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THE GIFT THAT KEEPS ON TAKING

A BARE TRUST FILING NIGHTMARE SCENARIO

BACKGROUND

Imagine a scenario where your last surviving parent has passed away in the year and, as you find out that they had separate life insurance policies of $50,000 each left to each grandchild that paid out on their passing.

The grandchildren have each received their $50,000 payout in September of Year 1. One of these grandchildren is your minor child.

Please note, this is a hypothetical and high-level example for tax compliance illustration purposes only. Nothing in this example should be considered as advice.

SEPTEMBER, YEAR 1

You are not quite sure to do with the $50,000 yet, so you put it into their youth chequing account at your local financial institution that you have started for them until you can figure out what to do with it.

After funeral arrangements, filling out probate forms, and gathering all the personal belongings of the deceased, Halloween, and Christmas just fly by.

Entering into the new year, the money is just sitting there. Your siblings are now fighting over every item, like who gets to keep the wedding ring.

FEBRUARY, YEAR 2

In February, Year 2 you go to talk to your Certifed Financial Planner (CFP) to do an RRSP contribution for yourself, and they are very busy.

You don't want to take up too much of their time, so you convince yourself you will talk to them after their busy RRSP season is over about what to do with your child's inheritance in the bank account. I mean there isn't any rush right?

APRIL, YEAR 2

Spring is in the air, and you are starting to go outside more. You received your T-slips (T4, T5 etc.) by snail mail and gathered all your tax info.

As you debate whether to meet up with your still-feuding siblings for Easter or not, you take your tax information to your Chartered Professional Accountant (CPA).

You can also see your CPA is busy with deadlines now too, and you think to yourself:

"Well, I haven't made any income with the money, so there won't be any tax to pay. Clearly there is nothing to file ...right?"

You decided to wait until after tax season to talk to your CPA about any tax issues on investment options when it hits you that you never asked your CFP about them in February.

MAY, YEAR 2

You make an appointment to speak to your CFP about investing the $50,000 just sitting there in your child's youth chequing account.

After speaking with your CFP and talking about pros and cons like rates of return and market risks, you start to think that the deceased grandparent would likely not want you to do anything too risky with the money.

You decide to invest in a non-redeemable, one-year term-deposit, that will pay 4% on the maturity date.

No rush on the tax matters, you say to yourself, I'll talk to my CPA at tax time next year.

APRIL, YEAR 3

Fast forward to tax season in Year 3, and with less drama going on with your siblings, you have gathered all your slips and delivered them to your CPA.

There is no slip for the term deposit because it hasn't paid any interest out yet - so it isn't even brought up.

MAY, YEAR 3

It is now May Year 3 and your CFP contacts you about renewal options on the term-deposit.

You have earned $2,000, so you now have $52,000 sitting in the account.

You have a mini-panic "was I supposed to report interest income?" But the CFP assures you there was no actual interest paid out until now, so the tax bill will be coming in spring after you get the T-slip.

You roll over the investment for another year with similar terms, and decide to wait until you get the slip before talking with your CPA.

APRIL, YEAR 4

It is now Tax Season in Year 4 and you have received the slip from the Term Deposit interest.

You make the appointment and you meet with your CPA and give them the slip for the interest on the term-deposit you are holding in trust for your minor child.

You talk about how your CFP was great in finding a high-interest product for such a short holding period, you're quite happy at making 4% ($2,000) in interest on the investment in only one year, and it will be another $2,080 coming next month!

You tell them you know that your child won't be taxable, because the interest earnings is less than the basic personal amount and they don't have any other income. Clearly, it won't be that big of a deal to file the personal T1 tax return for them.

Your CPA listens to everything you are finally telling them about the:

- Grandparent's death in September Year 1
- $50,000 life insurance payout to your minor child
- Youth bank account you are holding for them
- Interest income last year and soon this year

You feel quite happy that your parent has set up your child with a nice little kickstart that they will have when they get older.

You look across at your CPA, and wonder why they appear to be saddened to the point that they look like they are going to tell you something horrible.

THE NOT SO GOOD NEWS

Your CPA tells you that since you had control over more than $50,000 on behalf of your child this past year, you had to file a "T3 Return" for a bare trust.

Not only are you filing the personal return for your child's interest income by April 30 – but this T3 Return was due on March 31, and we're already into April.

Your CPA continues to tell you that you owe $25 per day as a late filing penalty for this T3 Return even though there is no tax to pay.

If it is filed this year on April 30, Year 4 the penalty would be $750.

You get a little frustrated, but think to yourself: "ok $750 – I messed up, but that's ok, there is $4,080 of interest in total I earned by next month, so I'm still ahead.

"Unfortunately, that's not all," your CPA mentions.

THE BAD NEWS

"Since you have held this $50,000 the prior year, there is also a penalty for Year 2 of $25 a day to a maximum of $2,500 as well."

You look at your CPA and ask: "How can this be? My CFP said that I didn't owe any tax until the interest was paid out! "

Your CPA assures you that your CFP was correct: there is no income tax. However, this penalty is not calculated on tax, it is calculated on whether or not an information return was filed. Since it wasn't filed, the penalty applies.

You think to yourself that it must be because it was earning income during the year, even though it wasn't paid out.

"Ok, so I'm now at $3,250 of penalties – but I will have made $4,080 by next month, so I guess I've learned my lesson, and will go forward from here. Thankfully that's when I first started the investment, so that should be it."

Your CPA assures you that in fact, it has nothing to do with the investment and that's not all.

THE WORSE NEWS

"Even though it was only sitting in a youth bank account that you were holding for them, the $50,000 was held for more than 3 months in Year 1. As a result, you are also late at filing that T3 return too, and so there is another $2,500 penalty for Year 1 as well." You cannot believe what you are hearing.

You now owe $5,750 in penalties, and the investments will have only made $4,080 in total next month.

You thought you were being smart by not investing in anything risky and your CPA is telling you that you lost $1,670 because of penalties.

You start to get upset at your CPA and say: "let's just pretend I never told you – I mean, what's the worst that could happen?"

THE TERRIBLE IDEA

Your CPA then goes on to tell you about the Gross Negligence Penalty that is the greater of $2,500 and 5% of the Maximum Asset value held in the year.

You reply, "Well you're telling me I have to already paying $2,500 which is 5% of the $50,000 so what's the difference? Besides, if I owe $2,500 in penalties for Year 1, doesn't that reduce the value below $50,000?"

Your CPA informs you that if you don't file, not only is a penalty over and above the late-filing penalty, and in fact, will be more than the late-filing penalty for the most recent year.

The 5% is based on the ***highest value of assets in that tax year***, and since your penalties would not be paid until Year 4, your value was higher in all three years, and even now in Year 4.

Year	*Highest Value*	*Gross Negligence Penalty*	*Late Penalty*	*Total Penalties*
1	*$ 50,000*	*$ 2,500*	*$ 2,500*	***$ 5,000***
2	*$ 50,000*	*$ 2,500*	*$ 2,500*	***$ 10,000***
3	*$ 52,000*	*$ 2,600*	*$ 2,500*	***$ 15,100***
4	*$ 54,080*	*?*	*?*	***?***

You realize now, you really have no choice, but to file late, and pay the penalties, but it doesn't mean you have to like it.

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