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THE TAX FACTOR

MAINTAINING THE TAX BENEFITS FROM FAMILY TRUSTS

Setting up a family trust can create substantial planning opportunities by allowing the benefits of ownership to flow to the beneficiaries while permitting the trustee(s) to maintain control and ownership of the property. (Although a trust can have more than one trustee, we'll refer to a single trustee in the balance of this article.) Such trusts can be used for a variety of purposes, including estate planning and multiplying access to the capital gains exemption. However, it is often the potential for income splitting amongst family members that provides the biggest motivation for setting up a family trust.

Much time and planning is required when establishing a family trust to ensure that the trust does not run afoul of any punitive tax rules which may restrict its effectiveness. Once a family trust is set up in a manner that ensures that these rules do not apply and once the income producing property is in place, one might assume that all there is left to do is to simply start paying out the trust's income amongst its beneficiaries, right?

Unfortunately, it's not as simple as that. There are numerous requirements that a trustee must meet in the ongoing administration of a family trust. Not meeting these requirements may result in the trust losing the ability to meet the tax planning goals, like income splitting, that it was originally set up to accomplish. In this regard, it is vital that the trustee be diligent in managing the affairs of the trust with the utmost care.

The trustee of a trust is appointed by the person setting up the trust and contributing assets to it, to manage and control these assets in the manner set out in the trust agreement. For all types of trusts, the trustee is legally bound to carry out certain duties and obligations, a detailed discussion of which is outside the scope of this article. Yet in the interest of providing some guidelines, in this article we have itemized several of the more vital considerations in administering family trusts, with a focus on discretionary family trusts.

As mentioned above, a fairly common use for a family trust is to allow for family income splitting. Splitting income is accomplished when trust income is taxed in the hands of the beneficiaries of the trust. Generally, this is achieved by either paying the income to the beneficiary directly or by declaring that the income is payable to the beneficiary at the end of the year. For non-discretionary trusts, allocating income is an easy task since income and capital gains generally become payable under the terms of the trust itself. As its name implies, the trustee of a discretionary family trust has the additional duty of exercising judgment when determining how to allocate income between beneficiaries while minimizing the overall tax burden.

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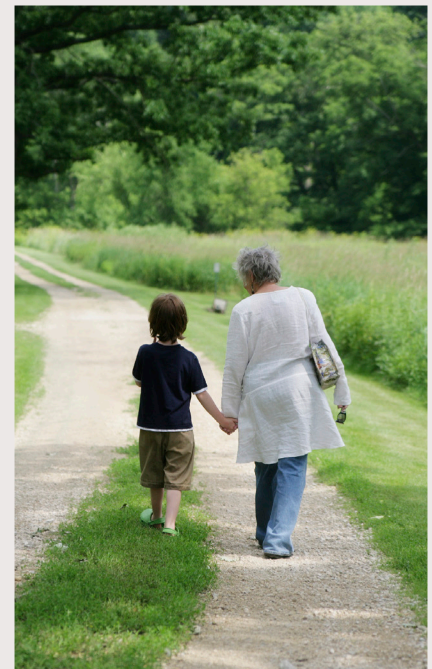

To this end, the trustee must assess each beneficiary's financial position and personal situation at least annually. While not limited to the following, it would be prudent for the trustee to ask themselves questions such as:

- ☑ *Have any minor beneficiaries reached the age of 18 in the year?* Special care must be taken when distributing income to minor beneficiaries since certain distributions could result in running afoul of the "kiddie tax" rules. However, once a beneficiary turns 18, these rules cease to apply.
- ☑ *Have any beneficiaries over the age of 18 started attending university or college in the year?* There may be important interactions to consider between the dividend tax credit and the tuition and education amounts. In order to ensure that the maximum credits can be utilized, the trustee may need to reconsider the amount and type of income being allocated to a beneficiary who is pursuing a post-secondary education.
- ☑ *Have there been any changes in a beneficiary's employment or business earnings?* Depending on each beneficiary's other sources of taxable income, the trustee may need to reconsider the trust's income allocations. If a beneficiary left or entered the workforce, their taxable income for the year would undoubtedly fluctuate, thereby impacting the ability of the trust to utilize the beneficiary's marginal tax rates.
- ☑ *Have any beneficiaries moved outside of Canada or to another province within Canada?* Moving to another income tax jurisdiction, whether it is inside or outside of Canada, will have tax implications to the beneficiary, and possibly to the trust. It is important that the trustee be familiar with the residency status of each of the trust's beneficiaries.

Once the amounts being allocated to each beneficiary have been decided, the trustee is obligated to act with due care by taking the proper steps to execute the allocations. Doing so will require that certain compliance and recordkeeping requirements are met. Some examples of things that the trustee must consider on an ongoing basis include:

- ☑ *Documenting that the trust's income and capital gains will be payable to certain beneficiaries.* This documentation could be set out in terms of fixed dollar amounts or percentages of income (including capital gains), but the fact that income is payable must be recorded and retained.
- ☑ *Paying the income to the particular beneficiary or ensuring that there is a bona fide obligation to pay.* If the trust is ever audited, the Canada Revenue Agency will be looking for proof of payment (i.e. cheques) or documentation, such as promissory notes, substantiating an obligation to pay amounts to the beneficiary.
- ☑ *Ensuring that evidence exists in support of any payments made to third parties for the benefit of a beneficiary.* The trustee will need to document the payments made and also provide evidence that the payment benefitted a particular beneficiary. Such proof may include relevant invoices or receipts.
- ☑ *Paying all family trust expenses with funds from the trust's bank account.* The trust must pay its own expenses. Such expenses may include accounting fees, bank charges and the like.
- ☑ *Maintaining proper records, including those in support of the trust's bank and investment accounts.* Only the trustee should be making deposits, withdrawals, transfers or payments from a family trust's account.
- ☑ *Ensuring that the trust's income has been calculated and reported properly.* This includes complying with any applicable income tax filing requirements.

Bear in mind that in this article, we have looked mostly at those considerations generally facing a trustee of a discretionary family trust. Of course, there are other types of trusts that are established for a variety of different purposes. Depending on the type of trust, as well as the objectives for having set up the trust, the issues impacting the duties of the trustee will vary. For example, an executor of an estate will have additional administrative obligations beyond the ones discussed here. That being said, many of the above requirements may still apply.

It is clear that administering a trust can be a complex undertaking, but the benefits provided by trusts can be significant. For a family trust to continue to meet the goals for which it was originally set up, it is critical that certain administrative requirements are met. The responsibility for meeting these guidelines rests on the trustee of the trust who is appointed to control and manage the trust's assets. A greater degree of care may be needed where it is also incumbent on the trustee to exercise discretion when distributing the trust's income and capital gains.

If you have a family trust, or if you are a trustee of a family trust, speak to your BDO advisor about the ongoing requirements and obligations of trust administration.

TAX CONSIDERATIONS FOLLOWING THE LOSS OF A SPOUSE OR COMMON-LAW PARTNER – PART I

Losing one's spouse or common-law partner is not only extremely distressing, it can also be overwhelming. In addition to the sadness of this situation and having to adjust to life as a widow or widower, a surviving spouse or partner is often faced with the task of sorting out their deceased loved one's financial affairs. This article is Part I of a two-part article and it highlights many of the steps that should be followed after the death of a spouse or common-law partner. In Part II, which will be published in a subsequent issue of the *Tax Factor*, a number of key income tax consequences resulting from an individual's death will be addressed. Please note that for the balance of this article, all references to spouse include common-law partner.

This article addresses the steps to be followed after the death of a spouse from a federal perspective only. Similar rules apply in Québec, with some modifications, for the death of a spouse who files a Québec income tax return.

Contact the Canada Revenue Agency and Service Canada

It is very important that the Canada Revenue Agency (CRA) be notified shortly after the death of a loved one. This can be done by completing a *Request for the Canada Revenue Agency to update records* (included with RC4111) or by calling the CRA at the number indicated on the form instructions. This will help facilitate the arrangements that must be made to stop payments or, if applicable, transfer credits or payments to you, where the deceased individual was receiving:

- The goods and services tax/harmonized sales tax credit;
- Working income tax benefit advance payments; and/or
- Canada child tax benefit payments and/or universal child care benefit payments for a child.

To help determine if you are able to transfer specific amounts to yourself and for assistance with any transfers, contact your BDO advisor.

Keep in mind that Service Canada should also be informed of the death so that benefits such as Old Age Security, Canada Pension Plan (CPP) and Employment Insurance can be cancelled. In addition, you may be entitled to a CPP death benefit and to survivor benefits. Service Canada will also provide resources on how to order a death certificate and cancel the deceased person's identification cards, registrations and other personal documents. On occasion, the funeral home will notify the CRA and Service Canada on your behalf. If so, it would be useful to confirm what steps the funeral home is taking in order to avoid any duplication.

Note that tax instalments are not required to be made after the date of death. Instead, any balance of tax owing by the deceased will be due upon filing of their final tax return.

Determine the legal representative

The legal representative of your deceased spouse has a number of key income tax related responsibilities. As a result, it is important to ensure that the legal representative is identified and completes their many responsibilities. Keep in mind that you will be considered to be the legal representative in cases where you are:

- Named as the executor in the deceased's will;
- Appointed as the administrator of the estate by a court; or
- The liquidator for an estate in Québec.

File all required tax returns for the deceased individual

T1 Income Tax and Benefit Return

The legal representative is required to file the deceased individual's final *T1 Income Tax and Benefit Return*. This tax return includes all income earned in the year of death from January 1 up to and including the date of death. Income taxable on the final tax return includes income arising from the distribution of property or the deemed disposition of capital assets, both of which will be discussed in Part II of this article.

It is very important to file the final T1 return on time as the CRA will impose penalties and interest when this return is late and there is a tax balance owing. Having noted that, if the death of your spouse occurred between January 1 and October 31 (or from January 1 to December 15 for individuals carrying on a business), the due date for the final return is April 30 of the following year (or June 15 for individuals carrying

on a business). If the death occurred between November 1 and December 31 (or from December 16 to December 31 for individuals carrying on a business), the due date for the final T1 return is six months after the date of death. Keep in mind that as the surviving spouse, the due date for filing your personal T1 return is the same as the due date for your deceased spouse's final T1 return. However, any balance owing on your T1 return must be paid on or before April 30 of the year following the year of death in order to avoid interest and penalties.

If your spouse died early in the calendar year, and before the due date of their previous year's income tax return, then the deadline for that previous year's return is extended until six months after the date of death. The due date for the payment of income taxes is also extended to six months after the date of death. As the surviving spouse, take note that your T1 return has the same extended due date, but any balance owing on this return will still be due on April 30.

In addition to filing the deceased individual's final T1 return, the following information and documents must be sent to the CRA:

- Copy of the death certificate;
- Your spouse's social insurance number; and
- A complete copy of the will or other legal document, such as a grant of probate or letters of administration, showing that you are the legal representative.

T3 Trust Income Tax and Information Return

Income earned in your spouse's name in the year of death, but after the date of death, must be reported on a *T3 Trust Income Tax and Information Return*. The legal representative must file the T3 return and pay all balances owing no later than 90 days after the end of the year of the estate. Note that the estate can choose a year-end, and the first year-end cannot be more than a year after the date of death. For deaths that occur after 2015, this rule will only apply if the estate is a graduated rate estate. Note that if an ongoing trust is provided for, the legal representative will have further T3 return filing responsibilities.

Consider filing optional income tax returns for the deceased individual

There are three optional income tax returns that may be filed for your deceased spouse, if applicable, which may eliminate or reduce income taxes otherwise owing. By filing more than one income tax return, your spouse's income earned in the year of death may be split amongst the applicable returns which can be offset against certain additional deductions and tax credits. The optional returns include:

- Return for rights or things;
- Return for a partner or proprietor; and
- Return for income from a testamentary trust.

You should note that the filing due dates for these returns and the payment of any balances owing are the same as those for a final T1 return, with an exception for the return for rights or things. For this return, the filing and payment deadlines are the later of one year following the date of death or 90 days after the date a notice of assessment or reassessment is mailed in respect of the final T1 return.

Your BDO advisor can help determine if any of these optional returns are beneficial to file and if so, they can assist with preparing and filing the return(s).

Obtain a clearance certificate

In addition to filing the required returns for the deceased individual, the legal representative must ensure that all taxes owing for the year of death and all previous years are paid prior to making any distribution of property from the estate. To do this, a clearance certificate should be obtained from the CRA which certifies that all amounts for which the deceased is liable to the CRA have been paid, or that the CRA has accepted security for the payment of amounts owing. This is an important step to take. If a clearance certificate is not obtained, the legal representative can be liable for any amount of tax that the deceased individual owes. A clearance certificate covers all taxation years to the date of death. Keep in mind, however, that this is not a clearance for any amounts that a trust or the estate owes. As a result, a separate clearance certificate would be needed. Note that if the executor and beneficiary are the same individual, this may eliminate the need for a clearance certificate since the executor will ultimately bear the cost of any unpaid tax by virtue of being a beneficiary.

Dealing with the loss of a spouse is sad and overwhelming. There are many decisions to be made and tasks to be accomplished. Armed with a good understanding of what needs to be done following the death of your spouse may make this difficult time less daunting. Talk to your BDO advisor as they can help you navigate your way through this time.

The information in this publication is current as of May 1, 2015.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO Canada LLP to discuss these matters in the context of your particular circumstances. BDO Canada LLP, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

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