



TAXATION OF NON-RESIDENT TRUSTS AND OFFSHORE INVESTMENT FUND RULES

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INTRODUCTION

- 1982 Section 94 broadened to catch purchased/appointed interests
- 1984 Section 94.1 introduced to counter offshore investment funds
- 1995 FAPI definition broadened
- 1996 Foreign asset reporting
- 1996 *Beneficially interested* definition broadened
- 1998 Section 94 broadened to catch foreign affiliate dividends/capital gains



BACKGROUND

- 1999 Federal Budget
- June 22, 2000 draft legislation
- August 2, 2001 draft legislation
- October 11, 2002 draft legislation
- October 30, 2003 draft legislation
- July 18, 2005 draft legislation
- November 9, 2006 draft legislation
- Bill C-10 – 1st Reading Senate - December 4, 2007
- 2010 Budget
- August 27, 2010 draft legislation



NON-RESIDENT TRUSTS (NRTs)



RESIDENCY OF A TRUST

- Different taxing regime for resident vs. non-resident trusts
- Starting point is determining where a trust is resident
- Traditional Test – the jurisdiction where the majority of trustees that make decisions reside: *Thibodeau Family Trust v. The Queen*



RESIDENCY OF A TRUST

- However, recent FCA decision in *St. Michael Trust Corp. et al v. The Queen* (previously known as *Garron*) suggests that this test is no longer appropriate
- In *St. Michael Trust Corp.*, the FCA approved the “central management and control” test for trusts that was proposed by the TCC
- The TCC concluded that for the purposes of considering residency, trusts and corporations are similar, they both deal with the management of property and therefore, the “central management and control” test is appropriate with such modifications as are necessary to make the test work in the trust context
- Leave to appeal to the SCC has been sought



EXISTING RULES – Section 94

- Only applies if both of the following conditions met:
 - Beneficiary Resident in Canada
 - Definition of “beneficially interested” in 248(25) very broad
 - Includes a person who may become a beneficiary under a discretionary power
 - Canadian Resident Contributor
 - Must be beneficiary of trust or related to beneficiary of trust



EFFECT OF SECTION 94

- **Discretionary Trust:**

- deemed resident in Canada with income equal to Canadian-source income and FAPI
- beneficiaries jointly and severally liable for reporting obligations, and for tax obligations to extent of distributions/proceeds for sale

- **Non-discretionary (Fixed Interest) Trust:**

- deemed to be a corporation, interests >10% deemed to be shares in the corporation
- FAPI rules apply



NEW OFFSHORE TRUST RULES

- OVERVIEW

- August 27, 2010 draft legislation proposes:
 - Elimination of requirement for resident beneficiary. Trust can be caught even if no Canadian resident beneficiary
 - Expansion of concept of contribution to a trust
 - Trust property will be divided into resident portion and non-resident portion.



NEW OFFSHORE TRUST RULES

- OVERVIEW

- Trust deemed to be a resident of Canada and all income of the trust relating to the resident portion is taxable
- Income from resident portion will be attributed to resident contributors in proportion to relative contributions to the trust
- Income from non-resident portion will not be taxable in Canada



NEW RULES – s.94(3)

- New subsection 94(3) applies if either of the following conditions satisfied:
 - *resident contributor*, or
 - *resident beneficiary and connected contributor*
- Exemption for *exempt foreign trust*
 - New expanded carve out for interests in non-resident commercial trusts



COMMERCIAL TRUST EXCEPTION

- Proposed paragraph (g) of the definition of *Exempt Foreign Trust* will exclude a trust if:
 - The only beneficiaries of the trust who may receive income or capital hold “specified fixed interests” in the trust and
 - Any one of the following applies:
 - There are at least 150 beneficiaries of the trust, each holding specified fixed interests with a fair market value of at least \$500



COMMERCIAL TRUST EXCEPTION

- All specified fixed interests in the trust are listed on a designated stock exchange and traded on the exchange on at least 10 of the 30 immediately preceding days;
 - Each outstanding specified fixed interest in the trust was issued for at least 90% of the interest's proportionate net asset value or for FMV; or
 - The trust is governed by a Roth IRA
- Consider if proposed subsection 94.2 applies



RESIDENT CONTRIBUTOR

- Resident of Canada
 - if an individual, must be resident in Canada for more than 60 months
- Has made a *contribution* to the trust at any time
 - expansive rules in new subsection 94(2)
 - excludes *arm's length transfers*



RESIDENT BENEFICIARY

- Resident in Canada
 - Not a *successor beneficiary*
 - Not an *exempt person*

and
- Trust has a *connected contributor*
 - Any *contributor* other than:
 - Individual who has not been resident in Canada for more than 60 months, or
 - A person whose only contribution is during a *non-resident time*



KEY DEFINITIONS

■ ***Contribution***


- Transfer or loan to trust
- Extensive deeming rules in s.94(2)
 - Back-to-back loans or transfers
 - Provision of services to trust
 - Issuance of shares, partnership units, debt



KEY DEFINITIONS


- ***Arm's length transfer***

- Loan or transfer where:
 - Reasonable to conclude that none of the reasons for transfer is acquisition by any entity of interest at any time under a non-resident trust; and
 - Specific circumstances one would expect in arm's length relationship (ie. payment of dividends, interest, rent)




CONSEQUENCES IF NEW RULES APPLY

- Trust property divided into resident portion and non-resident portion – resident portion will consist of property acquired from residents and certain former residents; non-resident property, everything else
- All income attributable to resident portion is subject to tax (not just FAPI and Canadian source income)
- Canadian withholding obligation on payments to trust, however trust entitled to refund



CONSEQUENCES IF NEW RULES APPLY (Con't)

- Flow-through of trust income to beneficiaries same as domestic trusts – subject to restriction in subsection 104(7.01)
- Deemed disposition of trust assets if cease deemed residence
- New attribution rules will attribute trust income back to resident contributors in proportion to relative contributions



CONSEQUENCES IF NEW RULES APPLY (Con't)

- Resident contributors entitled to make election to be attributed income relating proportionate share of contributions by resident contributors
- There will be a deduction to the trust for distributions payable to beneficiaries and income attributed to resident contributors
- If income is not distributed, the accumulated income will be considered a contribution by resident contributors and will form part of resident portion



CONSEQUENCES IF NEW RULES APPLY (Con't)

- If income earned on non-resident portion is not distributed and kept separate, it will not form part of resident portion
- An ordering rule will apply to distributions: to resident beneficiaries, distributions will be first out of resident portion, then non-resident portion. The rules will be reversed for non-resident beneficiaries
- Distributions out of resident portion to non-resident beneficiaries will be subject to Part XIII



CONSEQUENCES IF NEW RULES APPLY (Con't)

- A deemed resident trust will be entitled to claim a foreign tax credit for income tax paid to a foreign country that treats the trust as resident of that country. The amount of the foreign tax credit will be limited to the Canadian tax rate
- Trust will be able to attribute foreign tax credits to resident contributors to which the attribution rules apply
- Proposed subsection 94(4) deemes the trust not to be resident for purposes of ss. 73(1) and 70(6)



CONSEQUENCES IF NEW RULES APPLY (Con't)

- Reassessment period for trusts subject to the 2010 NRT rules will be extended by 3 years
- *Income Tax Conventions Interpretation Act* amended to provide that a deemed resident trust is considered to be resident in Canada for treaty purposes



COMING INTO FORCE

- Effective date for 2010 NRT rules will be as of January 1, 2007.
- An election will be available to have new rules apply as of January 1, 2001.
- The attribution rules will only apply starting with the 2010 taxation year.
- The Income Tax Conventions Interpretation Act amendment applies after March 4, 2010.



JOINT AND SEVERAL LIABILITY

- As a consequence of attribution rule, no more joint and several liability for resident contributors to the trust – resident contributors will be primarily liable for the tax
- *Resident beneficiaries* will be jointly and severally liable for tax and reporting obligations of trust
- Liability may be limited to *recovery limit*



JOINT AND SEVERAL LIABILITY

- A person or partnership's liability is limited only if:
 - Person or partnership is solely liable as *resident beneficiary* or *resident contributor* that contributed less than \$10,000 and less than 10% of total contributions
 - Trust has filed all information returns, unless less than \$10,000 has been contributed to the trust;
 - Reasonable to conclude that each transaction which occurred at direction or acquiescence of person or partnership was not designed to limit exposure



WHAT STILL WORKS?

- Immigration trust
- Inbound trust (granny)
- Outbound trust



OFFSHORE INVESTMENT FUND PROPERTY (OIFP)



CURRENT RULES – s.94.1

- Offshore investment fund property rules apply where:
 - Taxpayer holds an interest in a property that is a shares in, interest in, or debt of a non-resident entity (other than a CFA or prescribed non-resident entity)
 - The interest may reasonable be considered to derive its value primarily from *portfolio investments*
 - One of the main reasons for holding the interest is that the taxes would be significantly less than if held the investment directly
 - Walton v. The Queen, 98 DTC 1780



CURRENT RULES – s.94.1

- If all three conditions met then taxpayer will have a deemed income inclusion equal to “designated cost” multiplied by prescribed interest rate
- “Designated Cost” includes cost amount **plus** amounts transferred by 3rd parties that it is reasonable to assume increased the value of the taxpayer’s interest in the property **plus** prior years’ section 94.1 income inclusions



Proposed Changes – s.94.1

- The outstanding FIE rules will be replaced with the existing OIFP rules with the following enhancements:
 - Does not apply to a trust to which section 94.2 applies
 - the deemed inclusion rate will be increased to the prescribed rate plus 2%
 - Reassessment period will be extended to 6 years



Proposed Changes – s.94.2

- If a resident beneficiary holds 10% or more (with non-arm's length persons) of specified fixed interests in a commercial trust, the resident beneficiary is required to include a participating percentage of the Trust's FAPI (as if the trust were a corporation)
- If less than 10%, then section 94.1 may apply