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April 27, 2004

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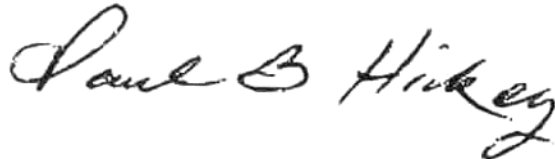
Dear Mr. Farber

**Re: October 30, 2003 Notice of Ways and Means Motion Relating to Non-Resident Trusts and Foreign Investment Entities**

We are pleased to provide you with our comments on the October 30, 2003 Notice of Ways and Means Motion (the "Motion") relating to non-resident trusts ("NRT") and foreign investment entities ("FIE"). We hope that you will have time to consider our concerns before the enabling legislation is enacted.

We trust that you will find our comments and recommendations helpful and, as always, we would be pleased to meet with you at a convenient time to elaborate on any of the issues discussed in this submission.

Yours truly,



Paul B. Hickey  
Chair, Taxation Committee  
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Brian Carr  
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Cc Mr. Brian Ernewein  
Department of Finance

**Joint Committee Submission in respect of  
Foreign Investment Entities and Non-resident Trusts  
Notice of Ways and Means Motion Released October 30, 2003**

**Foreign Investment Entities**

<b>I. Changes made to rollover provisions in subsections 51(4), 73(1), 85(1.11), 85.1(4), 85.1(6), 97(2), 98(7), 107(4.01), and paragraph 107.4(1)(k) .....</b>	<b>2</b>
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## **FOREIGN INVESTMENT ENTITIES**

### **I. Changes made to rollover provisions in subsections 51(4), 73(1), 85(1.11), 85.1(4), 85.1(6), 97(2), 98(7), 107(4.01), and paragraph 107.4(1)(k)**

All of these rollover provisions are being amended to insert exclusions for the transfer of a “specified participating interest”; all transfers of such interests must take place at fair market value, thereby triggering any unrealized gain inherent in the investment. We understand that the reason for these changes is to prevent the transfer of participating interests in foreign investment entities in order to circumvent the application of the foreign investment entity (FIE) rules.

There are a number of concerns that arise as a result of these changes.

- (i) A taxpayer will generally not know for certain at the time of the transfer whether a participating interest in a non-resident entity is a specified participating interest, and thus whether the participating interest can be transferred on a rollover basis. This is because the determination of status as a FIE occurs at the end of the entity’s taxation year, rather than at the time of the transfer of the participating interest. Information used to make this determination may not be available until well after the entity’s year-end.
- (ii) The proposed changes are very broad and will not allow the transfer of a specified participating interest on a tax-free basis, no matter what a taxpayer’s motivation is for the transfer. This seems to be unfair for those taxpayers who undertake the transfer for true business or personal reasons, and not in order to circumvent the application of the FIE rules.
- (iii) The coming-into-force provisions for these changes indicate that they will all apply to taxation years that begin after 2002. However, the draft proposals were only made public on October 30, 2003. Taxpayers may have transferred participating interests prior to this date under the legislation in effect at that time, believing that the transfers would not result in current taxation. It is unfair to apply the draft proposals retroactively to transactions completed prior to their release.
- (iv) Paragraph (b) of the definition of “specified participating interest” in subsection 248(1) includes a participating interest in a tracking entity that would not be subject to the tracking interest rules in subsection 94.2(9) if the transferor continued to hold the interest. In particular, subsection 94.2(9) will not apply if the condition in paragraph 94.2(9)(e) is not met. Since there can be no concern with avoiding the application of the FIE rules for such interests, it does not seem appropriate that they be excluded from rollover treatment.

*Recommendation:*

The exclusion of transfers of specified participating interests from the various roll-over provisions in the Act should only apply where it is reasonable to consider that one of the main reasons for the transfer is to avoid the application of the FIE rules.

## **II. Non-resident entities held by partnerships**

### *a) Double taxation*

Where a partnership holds an interest in a non-resident entity that is both a controlled foreign affiliate of the partnership and a foreign investment entity, there appears to be a potential for double taxation. The partnership may have income in respect of the interest under the FAPI rules and also under the FIE rules. The fact that the non-resident entity is a controlled foreign affiliate of the partnership will not result in the partnership's interest being an exempt interest and hence being excluded from the FIE rules. By virtue of clause 96(1)(d)(iii)(A), the non-resident entity must be a controlled foreign affiliate of a Canadian-resident member of the partnership in order for the interest to be an exempt interest. Section 94.4 does not provide any relief from the combined application of the FAPI rules and the FIE rules.

*Recommendation:*

Only one regime should apply in this situation, either the FAPI rules or the FIE rules.

### *b) Exempt interest and the CFA election*

There is an inconsistency between the definition of exempt interest and the CFA election in paragraph 94.1(2)(h) as they apply with respect to a participating interest of a partnership in a non-resident entity. Paragraph (a) of the definition of "exempt interest", as modified by clause 96(1)(d)(iii)(A), includes the participating interest as an exempt interest only if the non-resident entity is a controlled foreign affiliate of the Canadian-resident member of the partnership for whom income is being computed. However, if paragraph 94.1(2)(h) applies, it deems the non-resident entity to be a controlled foreign affiliate of the partnership, not of the members of the partnership. This is because the taxpayer referred to in that paragraph is the partnership, and subparagraph 96(1)(d)(iii) does not alter this. Thus, the election to have paragraph 94.1(2)(h) apply is ineffective and does not achieve the intended result of having the FAPI rules apply and not the FIE rules.

*Recommendation:*

A further rule should be included in subparagraph 96(1)(d)(iii) to provide that where paragraph 94.1(2)(h) applies, the non-resident entity is deemed to be a controlled foreign affiliate of each Canadian-resident member of the partnership. The non-resident entity also needs to be deemed to be a controlled foreign affiliate of the partnership, as at

present, so that the FAPI rules apply to the partnership in respect of its interest in the non-resident entity. An alternative solution would be for clause 96(1)(d)(iii)(A) to modify paragraph (a) of the definition of “exempt interest” so that it includes an interest in a non-resident entity if the entity is deemed by paragraph 94.1(2)(h) to be a controlled foreign affiliate of the partnership.

*c) Qualifying interest condition for application of paragraph 94.1(2)(h)*

Subparagraph 94.1(2)(h)(ii), as it applies with respect to an interest in a non-resident entity held by a partnership, imposes the following condition: the non-resident entity would, if subsection 93.1(1) were applicable, be a foreign affiliate of each Canadian-resident member of the partnership in respect of which each such member would have a qualifying interest (as defined in paragraph 95(2)(m)). This version of subparagraph 94.1(2)(h)(ii) applies by virtue of clause 96(1)(d)(iii)(E). In our view, this condition is too restrictive. It will preclude taxpayers electing out of the FIE rules in situations where there does not appear to be any reason not to allow them to do so.

As an example, consider a partnership that has two related Canadian resident members, one of which holds a 99% interest and the other of which holds the remaining 1% interest. The partnership holds all of the shares of a non-resident corporation. The above-noted condition will not be met as the non-resident corporation will not be a foreign affiliate in respect of which *each* Canadian resident member has a qualifying interest. This is because the determination of qualifying interest in paragraph 95(2)(m) does not take into consideration the holdings of related corporations, and proposed paragraph 95(2)(n) contained in the draft amendments released on February 27, 2004, which does take such holdings into account, does not apply for purposes of the FIE rules.

If the shares of the non-resident corporation were held directly by the members of the partnership, it would be a controlled foreign affiliate of both members. It would therefore seem appropriate in this case that the controlled foreign affiliate election should be available under the FIE rules.

Another example is a partnership in which a number of Canadian taxpayers hold very small percentage interests (under 10%), and an unrelated Canadian taxpayer holds a majority percentage interest. The partnership holds all the shares of a non-resident corporation. If those shares were held directly by the Canadian taxpayers in proportion to their interests in the partnership, the non-resident corporation would be a controlled foreign affiliate of the majority interest partner. In this case, it seems appropriate that the majority interest partner be able to have the FAPI rules, and not the FIE rules, apply in determining its income in respect of the non-resident corporation. In fact, it would make sense for the FAPI rules to apply with respect to all the Canadian members of the partnership.

*Recommendation:*

The condition in subsection 94.1(2)(h)(ii), as it applies with respect to non-resident entities held by partnerships, should be relaxed. At the very least, the following two changes should be made: (i) proposed paragraph 95(2)(n) should apply in determining whether taxpayers have qualifying interests in the non-resident entity; and (ii) the condition should be satisfied vis-à-vis a particular Canadian-resident member of the partnership if the non-resident entity would be a controlled foreign affiliate of the member if shares were deemed to be owned by members of the partnership based on their proportional interests in the partnership. Moreover, we think it would be appropriate to allow a partnership itself to elect to have the FAPI rules apply, rather than the FIE rules, with respect to any foreign corporation that is a controlled foreign affiliate of the partnership and possibly any foreign corporation in which the partnership has a qualifying interest.

### **III. Double tax relief in section 94.4**

*a) Interaction of subsections 94.4(2) and (4)*

The preamble to subsection 94.4(2) excludes amounts included in the total determined under clause 94.4(4)(a)(i)(A). Clause 94.4(4)(a)(i)(A) picks up all amounts that have been included in income (other than because of the mark-to-market regime). Because of the exclusion in the preamble to subsection 94.4(2), this does not appear to leave any amounts to be included in the total determined under 94.2(2)(a)(i)(A). Consequently, no deduction can be claimed under paragraph 94.4(2)(a).

*Recommendation:*

The wording in subsections 94.4(2) and (4) needs to be revised so that double tax relief is available no matter which method of computing FIE income is used.

*b) Time at which adjusted cost base (ACB) to be determined*

Subsections 94.4(2) and (4) refer to amounts that are required by the accrual regime to be added or deducted in computing “at the particular time” the ACB of the taxpayer’s participating interest. The references to “the particular time” do not appear to make sense. The subsections provide for the calculation of amounts for full taxation years. The calculations are not made at each time in a taxation year.

The intention is clearly to take into account amounts that have been recognized under the accrual regime to the end of the taxation year for which a deduction is being determined under subsection 94.4(2) or (4). In order to include the accrual amount for that year as well as preceding years, the time that should be referred to is “immediately after the end of the particular taxation year”. If the time used were “the end of the particular taxation year”, this would exclude the current year’s accrual amount, the reason being that

subsection 94.3(5) adjusts the ACB of the participating interest at a particular time for accrual amounts for taxation years ending *before* that time.

*Recommendation:*

The references to “at a particular time” in subsections 94.4(2) and (4) should be corrected as described above.

#### **IV. Application of paragraph 94.1(2)(a) to the income accrual regime**

The rules of application for the income accrual regime in subsection 94.3(2) state in paragraph (a) that subsection 94.1(2) applies for the purpose of section 94.3. However, it does not seem intended that a non-resident entity’s notional income be calculated with reference to paragraph 94.1(2)(a), which deals with financial statements of a non-resident entity that are prepared using either consolidation or equity method accounting principles. Under paragraph 94.1(2)(a), a non-resident entity is deemed to own all of the property and to have earned all of the net accounting income of other entities in which it owns an interest that meets the criteria for either the consolidation (which could include minority interests) or equity methods. The use of such statements does not seem appropriate when the income accrual regime is being used.

*Recommendation:*

We recommend that paragraph 94.1(2)(a) not apply in respect of the income accrual regime.

#### **V. Order of dispositions of FIE interests that have been subject to the prescribed rate regime**

The designated cost of identical participating interests acquired at different times may differ. The reason is that the amounts included in the taxpayer’s income in respect of the interests, and hence quantity B in the formula for the designated cost of the interests, may differ. If the taxpayer disposes of some, but not all, of the participating interests, it is necessary to know which interests have been disposed of for purposes of computing amounts to be included in income thereafter under the prescribed rate regime and determining whether any amount may be deducted under subsection 94.1(5). There is no ordering rule for this purpose, as there is in paragraph 94.2(2)(a) for the mark-to-market regime.

*Recommendation:*

We recommend that an ordering rule be added to the prescribed rate regime.

## **VI. Definitions in subsection 94.1(1)**

### *a) “Arm’s length interest”*

This new definition replaces the “widely held and actively traded” test that was previously included in paragraph 94.1(2)(f) of the October 11, 2002 version of the proposed legislation. Clause (B) of subparagraph 94.1(2)(f)(iii) allowed interests that could be purchased from and sold to the particular non-resident entity by any member of the general public to meet the “widely held and actively traded” test.

The new definition of “arm’s length interest” does not contain this same wording. As a result, interests in a non-resident entity that can only be purchased and sold by the non-resident entity itself to members of the general public will not meet this definition. This seems to be an inadvertent change to the scope of the definition that will now exclude certain interests that should not in fact be excluded.

#### *Recommendation:*

The definition of “arm’s length interest” should be amended to include the same wording as that which previously applied to the “widely held and actively traded” test contained in clause (B) of subparagraph 94.1(2)(f)(iii) of the October 2002 version of the proposed legislation. (We note that a comfort letter dated February 5, 2004 states that Finance intends to make this change in the next version of the rules.)

### *b) “Designated cost”*

Quantity A in the formula for calculating the “designated cost” of a participating interest is the cost amount (defined in subsection 248(1) to be the adjusted cost base [ACB] if the participating interest is a capital property) of the interest, determined without reference to certain provisions (for example the addition to ACB under paragraph 53(1)(m) in respect of FIE income). If a taxpayer acquires identical participating interests at two or more times, the identical property rule in subsection 47(1) will apply to establish the cost of the interests at the time of the second and subsequent acquisitions.

When subsection 47(1) applies, it appears that any prior ACB adjustments will be subsumed in the cost of the identical properties. This is the case, in particular, for amounts that have been added to the ACB under paragraph 53(1)(m) in respect of imputed FIE income. Thus, quantity A will no longer exclude amounts that should not be in the cost amount for the purpose of computing designated cost.

#### *Recommendation:*

There needs to be clarification that the ACB adjustments specifically excluded in determining quantity A of the definition of “designated cost” are also excluded when the cost of identical properties is determined under section 47.



c) “*Exempt business*” and “*Exempt interest*”

Both of these definitions refer to the laws of a country. It is not clear that this includes the laws of a political subdivision of a country. This issue also exists for subparagraph 94.1(2)(g)(ii).

*Recommendation:*

A general rule should be added that deems the laws of a country to include the laws of a province, state or other political subdivision of a country.

d) “*Foreign investment entity*”

Paragraph (c) of the definition contains the condition that, throughout the relevant taxation year, the *principal undertaking* of a non-resident entity be the carrying on of a business that is not an investment business.

An entity can have numerous undertakings in a taxation year, particularly if consolidated financial statements are used such that all business and non-business activities of all consolidated entities are deemed to be activities of the particular entity. The entity in this case may not have one principal undertaking. It does not seem appropriate to apply a condition that looks to individual undertakings. Rather, all the undertakings that constitute the carrying on of businesses other than investment businesses should be treated as a single undertaking for the purpose of this condition. All other undertakings should also be treated as a single undertaking. Without such an aggregation rule, a large investment business could cause the condition not to be met, even though the investment business is small relative to all the non-investment businesses considered together.

*Recommendation:*

An aggregation rule should be introduced for the purpose of paragraph (c) of the definition of “foreign investment entity”. All businesses other than investment businesses would be deemed to be one undertaking, as would all other activities.

e) “*Qualifying entity*”

Subparagraph (b)(i) of the definition contains a test that the *principal business* of a non-resident entity not be an investment business. For the reason given in the discussion of the definition of “foreign investment entity”, there needs to be an aggregation rule for this purpose. Also, we note that this definition uses a *principal business* test whereas a *principal undertaking* test is used in the foreign investment entity definition. It is not apparent whether this difference is intended.

*Recommendation:*

An aggregation rule should be introduced for the purposes of the test in subparagraph (b)(i).

f) “Specified interest”

We understand that paragraph (b) of the definition of “specified interest” in subsection 94.1(1) was not intended to include an entity’s or individual’s interest in a trust where the only right of the entity or individual in the trust at the particular time is the right to be considered as a person eligible for a distribution of income or capital from the trust (such an interest is commonly referred to as a “discretionary trust interest” and such a trust is commonly referred to as a “discretionary trust”). If such an interest is not a specified interest, then it would not be a participating interest and would not be subject to the FIE rules.

We also understand that the Department of Finance would agree that a discretionary trust interest should not be a specified interest and thereby not subject to the FIE rules from a tax policy perspective. However, a recent technical interpretation released by the Canada Revenue Agency (CRA) (2004-0062291E5) provides that it is the CRA’s interpretation that a discretionary trust interest is a specified interest and therefore a participating interest for the FIE rules.

*Recommendation:*

The definition of specified interest in subsection 94.1(1) should be amended to clarify that a discretionary trust interest is not a specified interest.

## **VII. Application rules in subsection 94.1(2)**

a) *Paragraph 94.1(2)(e) – Determination of principal business*

Paragraph 94.1(2)(e) contains rules for the purpose of determining whether the principal business of an entity is an investment business. Since the definition of “foreign investment entity” has been revised to refer to the *principal undertaking* of a non-resident entity rather than the *principal business*, these rules do not apply for the purpose of that definition.

*Recommendation:*

This paragraph should be extended to apply to the determination of whether an entity’s *principal undertaking* is a business other than an investment business, or else parallel rules should be added for this purpose.

b) *Paragraph 94.1(2)(j) – Election to use look-through method*

- (i) There appears to be an inconsistency when this election is made at the same time that the election to use the fair market value as the carrying value of an entity’s property is also made under the definition of “carrying value” in subsection 94.1(1).

For example, assume that a Canadian taxpayer owns 100% of a non-resident entity (NRE1), which in turn owns a 40% interest in NRE2, which in turn owns a 30% interest in NRE3. Also assume that NRE3 owns non-investment property with a fair market value of \$100. The Canadian taxpayer elects to use unconsolidated financial statements, elects to have paragraph 94.1(2)(j) apply, and makes the fair market value election under the definition of “carrying value”.

Subparagraph 94.1(2)(j)(ii) will deem NRE2 to own the property of NRE3 (without proration), and will deem the property to have a carrying value of \$30 to NRE2 (30% of the fair market value of \$100). The subparagraph will then apply to deem NRE1 to own the property. Since NRE1 has a 40% interest in NRE2, it would be expected that the carrying value to NRE1 would be \$12 (40% of \$30). However, subparagraph 94.1(2)(j)(ii) provides that the carrying value of the property to NRE1 is a proportion of the full fair market value of the property. Thus, the property has a carrying value of \$40 to NRE1 (40% of \$100).

A further issue is that the definition of “carrying value” also purports to apply to determine the value of the property to NRE1. Subparagraph (a)(iii) of the definition specifically contemplates the application of the definition to property that is deemed by paragraph 94.1(2)(j) to be owned by an entity. If the definition were to apply, it would provide that the carrying value of the property to NRE1 is its fair market value, i.e., \$100.

- (ii) There is a further inconsistency stemming from the fact that property of a lower-tier entity is deemed to be fully owned by the top-tier entity. This inconsistency relates to subparagraphs 94.1(2)(j)(iii) and (iv) and the application of the definition of “exempt property”.

Assume that NRE2 carries on an exempt business and uses all of its property in that business. Under subparagraph 94.1(2)(j)(ii), NRE1 will be deemed to own 100% of NRE2’s property. Subparagraphs 94.1(2)(j)(iii) and (iv) will apply to deem NRE1 to carry on 40% of NRE2’s exempt business as an exempt business of NRE1.

In applying paragraph (b) of the definition of “foreign investment entity”, it is necessary to determine whether the property of NRE2, which NRE1 is deemed to own, is investment property of NRE1. For the types of property listed in the definition of “investment property”, this depends on whether the property is exempt property of NRE1. It will be included under paragraph (a) of the definition of “exempt property” only if it is used or held principally in a non-investment business carried on by NRE1 or a related entity. Since NRE1 is considered to own 100% of NRE2’s property, but to carry on only 40% of its exempt business, NRE1 would not be considered to use the property principally in the exempt business it is deemed to carry on.

*Recommendation:*

Additional rules are required in paragraph 94.1(2)(j) so that (i) the appropriate carrying value is determined for property of the top-tier entity when the fair market value election in the definition of “carrying value” has been made, and (ii) the definition of “exempt property” applies in an appropriate manner with respect to deemed property of the top-tier entity. Also, the definition of “carrying value” should be revised so that it does not apply with respect to property that is deemed by paragraph 94.1(2)(j) to be owned by an entity.

*c) Paragraph 94.1(2)(q)*

This paragraph contains a reference to paragraphs (a) to (d) of the definition of “foreign investment entity”. There is no paragraph (d) in the definition. Also, it is unclear why paragraph 94.1(2)(q) applies with respect to paragraph (a) of the definition. If the taxpayer cannot establish that a trust is an exempt foreign trust, then presumably section 94 will apply with respect to the trust.

*Recommendation:*

Paragraph 94.1(2)(q) should be revised to refer to only paragraphs (b) and (c) of the foreign investment entity definition.

## **VIII. Treatment of foreign insurance policies – subsection 94.2(11)**

*a) Exclusions in paragraph 94.2(11)(c)*

Subparagraph (i) excludes a foreign insurance policy if the taxpayer acquired the policy more than 60 months before becoming resident in Canada unless, in the period that starts 60 months before the taxpayer became resident, the taxpayer has paid premiums in excess of the level contemplated when the policy was acquired. This subparagraph does not contain an ending time for the period in which premiums are to be tested. It should refer only to premiums that were paid before the end of the taxation year for which the exclusion is to apply. There is no reason why premiums paid after this time should be relevant to the application of the exclusion.

Subparagraph (iii) excludes a foreign insurance policy if the taxpayer can establish that the policy is an exempt policy (i.e., exempt from accrual taxation under section 12.2) or that the taxpayer has included in income for the year the amount required by section 12.2. It is not clear whether prescribed annuity contracts (i.e., annuity contracts that are exempt from accrual taxation) are excluded by this paragraph. The argument can be made that if the taxpayer can establish that section 12.2 does not apply to the annuity contract, then the taxpayer has included in income the amount required by section 12.2, namely an amount of nil. On the other hand, with an explicit exclusion for exempt policies, it can be argued that it is not intended that prescribed annuity contracts be excluded on this ground. There is no reason to tax prescribed annuity contracts under the FIE rules, since

the Act already taxes them. Thus, there should be an explicit exclusion for these contracts.

*Recommendation:*

These two subparagraphs should be amended as described above.

b) *Paragraph 94.2(11)(g)*

The word “and” is missing between subparagraphs (i) and (ii).

**IX. Foreign affiliates holding non-resident entities – paragraph 95(2)(g.3)**

a) *Exclusion from foreign investment entity rules contained in subparagraph 95(2)(g.3)(iii)*

Subparagraph 95(2)(g)(iii) expands the concept of exempt interest. It treats a participating interest of a foreign affiliate (that is not otherwise an exempt interest) as an exempt interest if it is property used or held by the foreign affiliate principally for the purpose of gaining or producing income from a business that is not an investment business. This requirement must be met throughout the relevant taxation year. Therefore if the participating interest is acquired or disposed of in a taxation year, this provision will not apply to treat it as an exempt interest in the year.

*Recommendation:*

The requirement regarding the use or holding of a participating interest by a foreign affiliate should apply only for the period in the relevant year during which the interest is property of the foreign affiliate.

b) *Partnerships and subparagraph 95(2)(g.3)(iii)*

If a controlled foreign affiliate is carrying on a business through a partnership, the FIE rules apply at the partnership level. If the partnership owns a participating interest in a FIE and the interest is used or held principally for the purpose of producing income from a business that is not an investment business, it is not clear that subparagraph 95(2)(g.3)(iii) applies to treat the interest as an exempt interest.

*Recommendation:*

A rule similar to that in subparagraph 95(2)(g.3)(iii) should apply with respect to a partnership of which a controlled foreign affiliate is a member.

## **NON-RESIDENT TRUSTS**

### **I. Definition of “closely-held corporation”**

The definition of “closely-held corporation” in subsection 94(1) is very broad, in that it includes a corporation if more than 10% of the corporation’s shares of any class (other than a specified class) are held by any one entity or group of non-arm’s length entities. Consequently, many corporations that are not normally considered to be closely held will be included in the definition. In particular, some publicly-traded corporations resident in Canada will be closely-held corporations. Thus, preferred shares issued by such corporations will be “restricted property”. There are instances where even some common shares of such corporations will be “restricted property”. If a non-resident trust acquires shares of such a publicly-traded corporation on their issuance, and the shares are restricted property, this would result in the corporation becoming a “resident contributor” to the trust, by virtue of paragraph 94(2)(g). The deemed transfer by the corporation would not be an “arm’s length transfer” because of the exclusions for restricted property. The only possible relief in these circumstances is the discretionary relief under subsection 94(14). It appears that this relief would not be available where the restricted property is common shares.

#### *Recommendation*

The 10% test should be eliminated. The requirement that each class of shares (other than a specified class) be held by at least 150 entities should be sufficient to ensure that a shareholder with a significant interest cannot use the corporation for the purposes of tax planning with a non-resident trust. If the test is retained, it should not apply with respect to a corporation that has a class of shares listed on a prescribed stock exchange.

### **II. Foreign-source income distributed to non-resident beneficiaries**

Under the previous proposals, Part XIII tax did not apply with respect to foreign-source income distributed to non-resident beneficiaries of a section 94 trust, nor was the trust limited in the deductions it could claim in respect of such distributions. Under the October 30, 2003 legislation, Part XIII tax will apply to such distributions. The policy rationale for imposing Part XIII tax in these circumstances is not apparent. The taxation of income which has no connection with Canada seems to be an inappropriate overreaching of the Canadian tax system, and contrary to the general principles on which the Act is based.

Furthermore, there is no grandfathering for this change. Thus, payments of foreign-source income made before the change was announced are subject to Part XIII tax. This is clearly a case of retroactive taxation. It is inherently unfair to tax transactions which have already occurred.

### *Recommendation*

Part XIII tax should not apply with respect to foreign-source income that is distributed to non-resident beneficiaries. If, for some reason, this change is not made, then the application of the tax should be subject to proper grandfathering.

### **III. Non-resident investment trusts**

#### *a) Subparagraph (h)(ii) in definition of “exempt foreign trust”*

The conditions in subparagraph (h)(ii) for an “eligible non-resident trust” to qualify as an “exempt foreign trust” will generally not be met when a Canadian resident trust has invested in the non-resident trust.

One reason relates to the requirement that the interest of each beneficiary under the non-resident trust be a “specified fixed interest”. For the purpose of subparagraph (h)(ii), “beneficiary” has the extended meaning given this term by subsection 94(1), and so a beneficiary includes an entity that is beneficially interested in the trust as defined in subsection 248(25). Thus, if a Canadian resident trust invests in a non-resident trust, the beneficiaries of the Canadian trust are considered to be beneficiaries of the non-resident trust. It is unclear whether an entity that is a beneficiary of a non-resident trust solely by virtue of the extended definition of beneficiary is considered to have an interest under the trust for the purpose of subparagraph (h)(ii). If the entity is considered to have an interest, the interest will not be a specified fixed interest, since the interest will not include a right to receive income or capital of the trust directly from the trust.

Another reason relates to the requirement in clause (h)(ii)(B) that each resident contributor to a non-resident trust be a “specified contributor” to the trust. Generally, at least some of the beneficiaries of the Canadian trust will be considered to have made contributions to the non-resident trust jointly with the Canadian trust, by virtue of paragraph 94(2)(n). Such beneficiaries who are resident in Canada will be resident contributors and therefore will be required to be specified contributors. For any beneficiaries who are not exempt taxpayers, the conditions in subparagraph (d)(ii) of the definition of “specified contributor” will apply. One condition is that the *only* consideration received for each contribution made by such a beneficiary to the non-resident trust is the beneficiary’s interest in the non-resident trust. However, the consideration for each contribution which a beneficiary of the Canadian trust is deemed to have made to the non-resident trust is an interest in the non-resident trust acquired *by the Canadian trust*. This is consideration other than that permitted by the condition. Thus, the condition will not be met. There are similar problems with the other conditions.

Furthermore, for an entity to be a specified contributor to a non-resident trust, the entity’s interest as a beneficiary under the trust must be a specified fixed interest. This requirement will be relevant if the beneficiaries of the Canadian trust are considered to

have interests in the non-resident trust (see above). For the reason given above, such interests if they exist will not be specified fixed interests.

*Recommendation*

There does not appear to be any policy rationale for applying the conditions in subparagraph (h)(ii) with respect to the beneficiaries of a Canadian resident trust that has invested in a non-resident trust. Accordingly, we recommend that subparagraph (h)(ii) be amended so that the meaning of beneficiary is determined without reference to subsection 248(25). This would make the subparagraph consistent with subparagraph (h)(i). In addition, the condition in clause (h)(ii)(B) regarding resident contributors should be limited to entities that are direct contributors to the non-resident trust.

*b) 150-beneficiary requirement in clause (h)(i)(A) in definition of “exempt foreign trust”*

A newly-established trust must meet the 150-beneficiary requirement in clause (h)(i)(A) of the definition of “exempt foreign trust” at the end of the year in which it is established, in order to be excluded from the application of subsection 94(3) for that year. This is a stricter requirement than applies to a resident trust that wishes to qualify as a mutual fund trust. Pursuant to subsection 132(6.1), such a trust has until 90 days after the end of its first taxation year to meet the 150-beneficiary requirement for mutual fund trusts. Also, if the number of beneficiaries of a mutual fund trust drops below 150 in a taxation year, the trust continues to be a mutual fund trust for the remainder of the year pursuant to subsection 132(6.2). There is no similar relief with respect to the 150-beneficiary requirement in clause (h)(i)(A).

*Recommendation*

The 150-beneficiary requirement in clause (h)(i)(A) should be deemed to be satisfied at the end of the first taxation year of a trust if it is satisfied within 90 days after the end of the year. Also, the requirement should be deemed to be satisfied at the end of a taxation year if it is satisfied at any time in the year.

*c) Requirement in clause (h)(i)(B) in definition of “exempt foreign trust” that certain beneficiaries be specified contributors*

A non-resident investment trust will not qualify as an exempt foreign trust pursuant to subparagraph (h)(i) if a resident contributor owns more than 10% of the units of any class of the trust and the resident contributor is not a “specified contributor” to the trust. One of the conditions for an entity to be a specified contributor is that a prescribed form must be filed with the Minister. Thus, if neither the resident contributor nor the trust files the prescribed form, subparagraph (h)(i) will not apply. This appears unduly harsh for beneficiaries who do not hold more than 10% of the units of any class. As a result of this condition, they will often not know whether subparagraph (h)(i) applies.



*Recommendation*

The condition in clause (h)(i)(B) should be eliminated. If it is retained, it should apply only with respect to resident contributors referred to in the clause.

*d) Definition of “specified fixed interest”*

There are several concerns with the definition of “specified fixed interest” in subsection 94(1). Because of these concerns, it may be unusual for interests in non-resident investment trusts to qualify as specified fixed interests. Hence, such trusts may generally fail to be exempt foreign trusts, and paragraph 94(2)(r) may rarely apply to provide relief from joint liability.

First, it is unclear what is intended by paragraph (b) of the definition of “specified fixed interest”. When each interest is created, it would be acquired in circumstances that are described by subparagraph 94(2)(g)(ii). Thus, it seems that the condition in paragraph (b) would be satisfied for all interests.

Second, paragraph (c) of the definition appears to require that the terms of the trust prohibit the disposition of trust units otherwise than by way of a gift or a transfer or redemption for consideration equal to the fair market value of the units. There would not be any other source of prohibition of the type contemplated by paragraph (b). It would be very unusual to find such a prohibition in a trust agreement. The trust agreement would allow or prohibit the transfer of trust units, but would not specify the amount of consideration that must be received if the units can be transferred.

Third, it is not clear that the reference to “gift” in subparagraph (c)(ii) of the definition includes a transfer as a result of death. In this regard, paragraph 69(1)(c) refers to an acquisition of property “by way of gift, bequest or inheritance”, which suggests that at least some forms of transfer on death would not be considered to be gifts.

Fourth, a commercial trust may be a personal trust for the period from the time it is formed until interests are acquired by investors. This would generally be the case for a trust that is not a unit trust (as defined in subsection 108(2)), and also for a unit trust that was formed before 2000 (since the definition of personal trust in subsection 248(1) excludes unit trusts only after 1999). Thus, the condition in paragraph (d) that a trust not be a personal trust at any time is too onerous. This is also an issue for the definition of “eligible non-resident trust” in subsection 94(1).

*Recommendation*

Changes should be made to address the concerns identified above.

e) *Joint liability after sale of specified fixed interest*

Paragraph 94(2)(r) is intended to relieve a taxpayer from joint liability for tax payable by a commercial investment trust after a sale or redemption of the taxpayer's interest in the trust. However, the taxpayer will remain jointly liable for tax payable by the trust for the taxation year of the trust in which the taxpayer disposes of the interest. This is because paragraph 94(3)(d) imposes joint liability with respect to a taxation year on each entity that is a resident contributor or beneficiary at any time in the year. This result is inappropriate. Once an entity ceases to have any interest in a commercial investment trust in circumstances where paragraph 94(2)(r) applies, the entity should not thereafter be jointly liable for the trust's tax. Only entities that are beneficiaries at the end of the year, or that have ceased to be beneficiaries in the year in circumstances such that paragraph 94(2)(r) does not apply, should be jointly liable for the trust's tax for the year.

*Recommendation*

Where paragraph 94(2)(r) applies with respect to a taxpayer who has disposed of an interest in a trust and thereby ceased to be a beneficiary, the taxpayer should not be jointly liable for tax payable by the trust for the taxation year in which the taxpayer disposes of the interest.

#### **IV. Retroactive application of rules on contributor's return to Canada**

Subsection 94(10) applies where an individual who has made a contribution to a trust becomes resident in Canada within 60 months after making the contribution. It appears from the explanatory notes that the intention is to subject the trust to section 94 on a retroactive basis (assuming the trust had a resident beneficiary and the new immigrant exemption does not apply). From a policy perspective, it seems inappropriate that a subsequent event (becoming resident in Canada), which might not have been anticipated when the contribution was made, would trigger tax liability for a *prior* year. Not only could there be retroactive taxation of the trust, there could also be retroactive taxation of non-resident beneficiaries to whom distributions of foreign-source income have been made. In addition, the trust will be liable for interest on overdue tax.

It is unclear exactly how the Act is to apply once a trust becomes subject to the non-resident trust rules on a retroactive basis because of subsection 94(10). The literal effect of the subsection is that all the obligations under the Act apply without any adjustment for the fact that the rules are applying retroactively. For example, the trust could be liable for a penalty for the failure to file a tax return on time. While one would not expect the CRA to attempt to impose such a penalty for the period before the contributor became a resident, the question remains as to how the late-filing penalty is intended to apply. Another example is the obligation of the trust to withhold from distributions of foreign-source income made to non-resident beneficiaries before the contributor became a resident.

*Recommendation*

The non-resident trust rules should not apply retroactively. If the retroactive application is retained, then the obligations of a trust with respect to the period before subsection 94(10) applies should be clarified.

**V. Trusts terminated in 2003**

Under the previous proposals, a trust terminated at any time in 2003 would not be subject to the non-resident trust rules. Taxpayers therefore understood that they had until the end of 2003 to deal with non-resident trusts that would otherwise be subject to the new rules. This was changed in the October 30, 2003 legislation, which applies the non-resident trust rules to a trust in the year it is terminated, other than trusts that were terminated before October 31, 2003. For taxpayers who were planning to terminate trusts in 2003 and had not done so by October 30th, this change is unfair.

*Recommendation*

The grandfathering for trusts that ceased to exist before October 31, 2003 should be extended to all trusts that ceased to exist in 2003. Trusts that ceased to exist after October 30, 2003 should be permitted to elect out of the grandfathering.

**VI. Technical drafting points**

*a) Definition of “closely-held corporation” in subsection 94(1)*

The word “to” is missing between the words “reasonable” and “conclude” in the first line of paragraph (b) of the definition.

*b) Definition of “connected contributor” in subsection 94(1)*

Paragraph (b) of this definition refers to contributions made to the trust "at a non-resident time of the entity". The words "in respect of the particular time" should be added at the end, so that it is clear how the definition of "non-resident time" is to be applied. That term is defined with reference to a time, which is used as the ending point for the period of time referred to in the definition.

*c) Definition of “specified contributor” in subsection 94(1)*

The word “or” is missing between the words “on” and “before” in the preamble to subparagraph (d)(ii) of the definition.

*d) Subsection 128.1(1.1)*

Subparagraph 128.1(1.1)(a)(ii) appears to be superfluous. The purpose of subsection 128.1(1.1) is to preclude paragraph 128.1(1)(b) from applying when a trust becomes an actual resident of Canada, if the trust was a deemed resident immediately before becoming an actual resident. The particular taxation year referred to in subsection 128.1(1.1) is the taxation year that ends immediately before the trust becomes resident in Canada, and so the condition in subparagraph 128.1(1.1)(a)(ii) will always be satisfied. Also, there does not seem to be any situation in which paragraph 128.1(1.1)(b) would be relevant.