The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

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November 25, 2005

Mr. Brian E. Ernewein
Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade Laurier, 17th Fl., East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

Re: Issues for Consideration – July 18, 2005 Draft Legislation in respect of Non-Resident Trusts and Foreign Investment Entities

We are pleased to provide the attached submission for your consideration. Our submission identifies a variety of issues raised by members of the tax community relating to the July 18, 2005 Draft Legislation in respect of non-resident trusts and foreign investment entities (the "2005 Proposals").

We note that many of the provisions of the October 30, 2003 Notice of Ways and Means Motion have been carried over to the 2005 Proposals without reflecting the recommendations made in our submissions of April 27, 2004 and February 28, 2005. We believe our earlier concerns continue to be valid. This submission does not repeat those concerns and recommendations. However, we ask you to reconsider them. For your ease of reference, we attach a copy of those earlier submissions.

We trust you will find our comments and recommendations helpful. We would be pleased to meet with you and your colleagues to elaborate on any of the issues discussed in this submission or our earlier submissions.

Yours truly,

Paul B Hickey

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Joint Committee Submission on Draft Legislation Released on July 18, 2005

Foreign Investment Entities and Non-Resident Trusts

Non-Resident Trusts

Foreign Investment Entities

Joint Committee Submission
July 18, 2005 Draft Legislation
Non-Resident Trust Rules

I. Definition of "Restricted Property"

"Restricted property" is defined in subsection 94(1) to include a share of a closely-hold corporation if the share (or property for which the share was substituted) was at any time acquired as part of a transaction or series of transactions under which a specified share of a closely-held corporation was acquired. A "specified share" is defined to mean any share that is not prescribed for the purpose of paragraph 110(1)(d). In general terms, it is any share other than an ordinary common share.

According to the explanatory notes, the concept of "restricted property" is intended to serve an anti-avoidance function. While the notes do not elaborate, we understand that the main types of shares intended to be included in this definition are shares issued in the course of implementing estate plans. However, the definition includes much more than this. For example, it includes preferred shares of some widely-held public corporations (Canadian or foreign), even when issued for cash, and can also include common shares of such corporations. The overreaching of the definition is of particular concern given that a commercial trust will only qualify as an exempt foreign trust under the second category (clause (h)(ii)(B) of the definition of "exempt foreign trust") if it does not hold restricted property.

This problem is attributable, in part, to the broad definition of the term "closely-held corporation", which is used in the definition of "restricted property". A corporation will be considered closely held if an entity (or group of non-arm's length entities) holds shares carrying 10% or more of the votes, or having a fair market value equal to or exceeding 10% of the fair market value, of all shares. Consequently, many corporations that are not normally considered to be closely held will be included in the definition.

In addition, if a share is a restricted property to a holder because of the circumstances in which the share was acquired, it will be a restricted property to any subsequent holder, as long as the corporation that issued the share remains a closely-held corporation.

While subsection 94(14) will sometimes provide relief, many preferred shares will not qualify as shares of a "specified class", as referred to in paragraph 94(14)(a) – for example, shares with a floating dividend rate. With respect to paragraph 94(14)(b), it is unrealistic to expect foreign commercial trusts to attempt to identify all shares held by them each year that might be restricted property – a task which could be difficult given that the circumstances in which shares are issued can be a relevant factor – and then to apply to the Minister pursuant to this paragraph to have the shares excluded from being restricted property. The procedure under paragraph 94(14)(b) is really only suitable where a trust holds shares of a single corporation (or a group of corporations) that fall within the definition of "restricted property".

Recommendation

We urge the Department of Finance to reconsider the definition of "restricted property", with a view to devising a definition that is more narrowly targeted to the types of shares that are of concern, and that does not create compliance problems for commercial investment trusts. Alternatively, consideration could be given to some other approach for excluding shares from the definition that would not impose an undue burden on such trusts.

II. Paragraphs (f) and (g) of the Definition of "Exempt Foreign Trust"

Paragraphs (f) and (g) of the definition of "exempt foreign trust" in subsection 94(1) refer to certain non-resident trusts used in the delivery of benefits to employees. The conditions that must be satisfied for a trust to be included under either of these paragraphs are quite restrictive and, in the case of paragraph (g), have been tightened from the October 30, 2003 Notice of Ways and Means Motion. Some non-resident trusts used for delivering employment benefits will not qualify as exempt foreign trusts, even though there should be no concerns about inappropriate tax advantages being obtained.

a. Employee Share Plans

Multinational corporations sometimes establish a trusteed share plan for all eligible employees of the corporate group. We understand that such plans are commonly established, for example, by multinational corporations based in the United Kingdom. Participation is offered to eligible employees of the parent corporation's affiliates around the world, with Canadian employees ordinarily being a small percentage of participants. Shares held in the trust may be acquired from treasury or on the open market. Where a Canadian employer is required to contribute to a non-resident trust in respect of its employees who participate in the share plan, the employer will be a resident contributor. Hence, the non-resident trust rules will apply unless the trust is an exempt foreign trust.

Such trusts generally do not qualify as exempt foreign trusts under paragraph (f) because benefits are provided in respect of services rendered by Canadian resident employees primarily in Canada. As well, if the share plan is a plan to which section 7 of the Act applies, the trust will be a subsection 7(2) trust and so will not satisfy the condition in clause (f)(ii)(A) (i.e., it will not be described in amended paragraph (a.1) of the definition of "trust" in subsection 108(1)).

We submit that it is inappropriate not to allow such trusts to qualify as exempt foreign trusts. Employee share plans are, in substance, compensation arrangements, not investment arrangements. Participation in a share plan can form an important part of an employee's compensation package. If trusts used to implement employee share plans are not exempted from the non-resident trust rules, the consequence may be that Canadian resident employees are excluded from participation in such plans. Where the number of Canadian employees who would otherwise be eligible to participate is small, it is unlikely that a separate Canadian-based plan would be established.

Recommendation

We recommend that the definition of "exempt foreign trust" be expanded to include non-resident trusts governed by employee share plans that are primarily for the benefit of non-resident persons.

b. Multi-Employer Health and Welfare Plans

Occasionally, Canadian employers make contributions to US health and welfare trusts in respect of US residents providing services in Canada on a temporary basis. In these situations, the health and welfare trust is generally collectively bargained and maintained for employees of a large number of employers, e.g., all individuals employed in a particular trade in a region. Because the employers who contribute to the trust are not all related to each other, the condition in subclause (f)(ii)(B)(II) of the definition of "exempt foreign trust" is not satisfied, and hence the health and welfare trust is not an exempt foreign trust. This seems an inappropriate result.

Recommendation

Paragraph (f) of the definition of "exempt foreign trust" should be revised to permit multi-employer health and welfare trusts to qualify under this paragraph.

c. Pension Plans

Clause (g)(ii)(A) of the definition of "exempt foreign trust" requires that a trust must be operated *exclusively* for the purpose of administering or providing superannuation or pension benefits. We are concerned that this may be too restrictive. For example, US 401(k) plans permit members to receive lump sum payments on retirement, and allow amounts to be withdrawn prior to retirement in situations of hardship. Other foreign pension plans may permit partial or full lump sum payments at retirement. While the primary purpose of such plans is to provide pension benefits, this may not be considered their *exclusive* purpose.

Recommendation

We suggest that it be clarified that benefits of the sort described would not preclude a pension plan from complying with the condition in clause (g)(ii)(A).

d. Transitional Relief

In the October 2003 Notice of Ways and Means Motion, paragraph (g) of the definition of "exempt foreign trust" referred to a non-resident trust that was operated exclusively for the purpose of administering or providing superannuation, pension, retirement or employee benefits. In the current version of this paragraph, the reference to "employee benefits" has been removed, thereby narrowing the types of trusts encompassed by the paragraph. This revised version of paragraph (g) applies to taxation years of trusts beginning after July 18, 2005 (with the ability for a trust to elect an earlier application).

We believe that some employee share plans qualified as exempt foreign trusts under the former version of paragraph (g), and will not qualify under the current version as a result of the change referred to above. There may be other types of employee benefit plans in the same position. For such plans that do not now qualify as exempt foreign trusts under paragraph (f) (or under any new provision that may be introduced), the transitional relief is inadequate in two respects. First, it does not allow the plans a sufficient period of time to satisfy the benefit entitlements of Canadian resident beneficiaries. There may be a period of several years between the time at which an employee acquires an entitlement under a trust and the time at which the entitlement is satisfied. Where benefits were granted in reliance on previous versions of the draft legislation, there should not now be a requirement for the payment of benefits to be accelerated. Second, since such a trust will generally have a resident contributor (e.g., a Canadian resident employer), the non-resident trust rules will apply to it once it ceases to be an exempt foreign trust.

Recommendation

As indicated in section a. above, there needs to be a permanent exclusion of such trusts from these rules if they satisfy suitable conditions. However, if such an exclusion is not permitted, we submit that further transitional relief is required, to address the concerns identified above. A reasonable deadline for the satisfaction of existing benefit entitlements is, we suggest, the end of 2008.

III. Paragraph (h) of the Definition of "Exempt Foreign Trust"

a. Subclauses (h)(ii)(A)(II) and (B)(II) – "Reasonable to Conclude"

Subclauses (A)(II) and (B)(II) of subparagraph (h)(ii) of the definition of "exempt foreign trust" require that it be *reasonable to conclude*, determined by reference to all the circumstances, that certain resident contributors to a trust are specified contributors. It is unclear what is intended by "reasonable to conclude" in this context. The definition of "specified contributor" itself contains "reasonable to conclude" tests. These tests will require objective determinations of certain matters which may not be black and white. Presumably, the further "reasonable to conclude" test in these subclauses is intended to allow the determination of whether a resident contributor is a specified contributor to be made on the basis of incomplete information.

Recommendation

We recommend that it be clarified what is intended by the reference to "reasonable to conclude" in subclauses (h)(ii)(A)(II) and (B)(II). With respect to subclause (h)(ii)(A)(II), this recommendation is subject to the next recommendation.

b. Subclause (h)(ii)(A)(II) – Impracticality of Condition

It will generally be impossible for an investor in a non-resident trust to determine whether the condition in subclause (h)(ii)(A)(II) of the definition of "exempt foreign trust" is satisfied. The investor would have to know, on an ongoing basis: (i) which of the other investors in the trust are resident in Canada, (ii) which investors deal at non-arm's length with each resident investor, (iii) for each resident investor, the total fair market value of the interests held by the investor and non-arm's length investors, and (iv) whether certain resident investors are specified contributors. Clearly, this information will rarely, if ever, be available to an investor. It is also likely that the non-resident trust will find it difficult, if not impossible, to determine whether the condition in subclause (h)(ii)(A)(II) is met.

We submit that it is not appropriate to impose such an impractical condition, particularly given that, if the condition is not satisfied, there could be adverse consequences for all the investors in the trust. Thus, we suggest that this condition be replaced by a more limited condition. Since it is not clear to us what specific concerns are intended to be addressed by the condition, we are not proposing an alternative to it.

c. Subclause (h)(ii)(A)(II) – Resident Contributor

The condition in subclause (h)(ii)(A)(II) applies where the total fair market value of the interests in a trust, of a class of specified fixed interests, held by a resident contributor to the trust or any other entity with whom the resident contributor does not deal at arm's length exceeds 10% of the total fair market value of interests of that class. It is not clear whether this 10% test is to be applied only with respect to resident contributors who hold specified fixed interests, or with respect to all resident contributors. If the latter, then trusts with second-tier resident contributors will never satisfy the condition that the resident contributor must be a specified contributor. By second-tier contributor, we mean an entity that is a contributor solely by reason of being a contributor to a trust that is a direct contributor (paragraph 94(2)(n)) or a general partner of a partnership that is a direct contributor (paragraph 94(2)(o)).

The ambiguity arises because the subclause does not expressly state that the resident contributor referred to is an entity that holds a specified fixed interest in the trust. Nor is there anything in the test that implicitly requires this. The test makes sense even for a resident contributor that does not hold a specified fixed interest. One first identifies a group of entities – any resident contributor and all non-arm's length entities – and then adds up the fair market values of the specified fixed interests of a class held by this group. If the resident contributor does not hold a specified fixed interest, no amount would be included in the sum in respect of that entity. A further ambiguity stems from the fact that certain second-tier contributors are explicitly excluded from the reference to a resident contributor in subclause (h)(ii)(B)(II).

There does not appear to be any policy reason why a trust should be excluded from paragraph (h) simply because it has a second-tier resident contributor. Thus, we submit that the test should apply only with respect to resident contributors that hold specified fixed interests.

Recommendations

We recommend that the condition in subclause (h)(ii)(A)(II) be replaced by a narrower, more practical, condition. However, if the condition is retained, then we recommend that the reference to a resident contributor be expressly limited to a resident contributor that holds a direct interest in the non-resident trust.

d. Subclause (h)(ii)(B)(II) – Indirect Contributor

If a non-resident trust has fewer than 150 qualifying investors, one of the conditions that must be satisfied for the trust to be an "exempt foreign trust" pursuant to paragraph (h) of the definition is the following: it must be reasonable to conclude that each resident contributor to the trust, other than an indirect contributor, is a specified contributor to the trust (subclause (h)(ii)(B)(II)). The term "indirect contributor" is defined to mean an entity that is a contributor to the non-resident trust by virtue of being a contributor to a resident trust that has made a contribution to the non-resident trust and that is an "exempt trust" (determined without reference to subparagraph (b)(ii) of the definition). Thus, only certain second-tier resident contributors to the non-resident trust are excluded from the condition in subclause (h)(ii)(B)(II). If the non-resident trust has any other second-tier resident contributors, the condition in the subclause will not be met because such contributors will not be specified contributors.

In particular, the condition in subclause (h)(ii)(B)(II) will not be satisfied if a limited partnership whose general partner is resident in Canada has invested in a non-resident trust. In this case, the general partner would be deemed to be a contributor to the trust by virtue of paragraph 94(2)(o), and so would be a resident contributor but would not be a specified contributor. It seems unduly restrictive to exclude a non-resident trust from being an exempt foreign trust on the basis that a limited partnership is one of the investors in the trust.

Recommendation

We recommend that second-tier resident contributors that are contributors by virtue of being general partners in limited partnerships be excluded from the condition in subclause (h)(ii)(B)(II). Since both Canadian and foreign limited partnerships can have a Canadian general partner, this exclusion should apply regardless of where the limited partnership is formed.

IV. Definition of "Specified Contributor"

The definition of "specified contributor" in subsection 94(1) sets out several conditions that must be satisfied for a particular entity to be a specified contributor to a trust. One of the conditions that applies to a particular entity other than an exempt taxpayer is that, with respect to each contribution made to the trust after February 16, 1999 by the particular entity, it is reasonable to conclude that none of the reasons for the contribution is the acquisition at any time by any entity (other than the particular entity) of an interest as a beneficiary under the trust. (This condition is in the opening words of subparagraph (d)(ii) of the definition, combined with clause (B) of that subparagraph.)

Where a Canadian resident trust invests in a non-resident trust, it is unclear whether this condition would be satisfied. Each beneficiary of the Canadian resident trust would, by reason of subsection 248(25) and the definition of "beneficiary" in subsection 94(1), be a beneficiary of the non-resident trust. The Canadian resident trust makes its contributions to the non-resident trust to enable its own beneficiaries (the "second-tier beneficiaries") to participate in the investment experience of the non-resident trust. This may provide enough of a connection between the contributions, the second-tier beneficiaries and their indirect interests in the non-resident trust to conclude that the condition in question is not satisfied. The uncertainty in this regard is increased by the fact that the term "beneficiary", as used in the remainder of the definition of "specified contributor", is to be interpreted without reference to subsection 248(25).

This issue is problematic, for example, in connection with the requirement in subclause (h)(ii)(B)(II) of the definition of "exempt foreign trust" that each resident contributor (other than an indirect contributor) be a specified contributor to a non-resident trust. A Canadian resident trust may not be able to satisfy this requirement.

Recommendation

We recommend that the condition in clause (d)(ii)(B) of the definition of "specified contributor" be modified so as to clarify that it can be satisfied by Canadian resident trusts.

V. Definition of "Successor Beneficiary"

A beneficiary under a trust is a "successor beneficiary", as defined in subsection 94(1), in respect of the trust only if the beneficiary's right to receive amounts from the trust is contingent on the death of an individual who is a contributor to, or related to a contributor to, the trust (or would be related to a contributor if deceased persons were still alive). We submit that this class of persons on whose death a beneficiary's interest must depend is too narrow.

Personal trusts often include as beneficiaries the nieces and nephews of the contributor, their descendants, or both. Such beneficiaries are not related to the contributor for the purposes of the Income Tax Act. Thus, if the entitlement of a particular beneficiary is contingent on the death of one or more such beneficiaries, the particular beneficiary will not satisfy the definition of "successor beneficiary".

For example, assume that an individual who does not have any children establishes an inter vivos trust for the benefit of his nieces and nephews. The trust includes a gift over to the children of a niece or nephew who dies before receiving his or her full entitlement from the trust. The children will not be successor beneficiaries, because their entitlements are contingent on the death of individuals who are not related to the contributor.

The Income Tax Act contains a number of provisions that treat members of the "extended" family the same as related members in order to produce an appropriate tax result. Paragraph 191(3)(d) is a good example. That provision deems a trust not to have a substantial interest in a corporation for purposes of the tax in respect of dividends on taxable preferred shares. Certain trusts are excluded from the application of the paragraph, including trusts all of whose beneficiaries are related. The paragraph deems certain persons who are related in the ordinary sense of this term, but not under the meaning in subsection 251(2), to be related for the purposes of the paragraph.

Another example is the definition of "non-arm's length indicator" in subsection 233.2(2) (which is being repealed). A non-arm's length indicator applies as a result of a transfer of property to a trust if the transferor is related to a beneficiary or is an aunt, uncle, niece or nephew of a beneficiary. In effect, aunts, uncles, nieces and nephews are regarded as analogous to related persons.

The income attribution rule in subsection 74.1(2) and the definition of "designated person" in subsection 74.5(5), which applies for the purposes of section 74.4, include references to nieces and nephews.

It would therefore seem appropriate to treat members of the extended family as being related for the purposes of the definition of "successor beneficiary".

Recommendation

We recommend that the definition of successor beneficiary be amended to deem extended family members to be related to each other. A deeming rule similar to that in paragraph 191(3)(d) would be appropriate.

VI. Distributions Dependent on Discretionary Powers

In order for a trust to qualify as an exempt foreign trust pursuant to paragraph (h) of the definition, the trust must be an "eligible trust" and the beneficiaries' interests must be "specified fixed interests" (this latter requirement is contained in the definition of "qualifying investor"). Whether these requirements are met depends, *inter alia*, on whether distributions are dependent on discretionary powers.

Paragraph (f) of the definition of "eligible trust" in subsection 94(1) excludes a trust where "the amount of income or capital that any entity may receive directly from the trust at any time as a beneficiary under the trust depends on the exercise by any entity of, or the failure by any entity to exercise, a discretionary power".

The definition of "specified fixed interest" contains a similar condition, but expressed in the negative. One of the conditions (in paragraph (d) of the definition) for an interest of a beneficiary in a trust to be a specified fixed interest is that "no amount of income or capital of the trust that any entity may receive directly from the trust at any time as a beneficiary under the trust depends on the exercise by any entity of, or the failure by any entity to exercise, a discretionary power".

If a trustee has discretion to determine the amount of income or capital of a trust to distribute in a year, but no discretion as to the proportion of a distributed amount that is payable to each beneficiary, such a discretionary power would appear to preclude a trust from being an eligible trust and interests in the trust from being specified fixed interests.

It is unclear whether this would also be the case by virtue of a discretion as to the timing of distributions. For example, assume that the trustee of an investment fund has the power to determine the days (within a specified range of days) on which the income of the fund is to be distributed. On any particular day on which the trustee could distribute income, the beneficiaries either will or will not receive a distribution. Hence, it could be maintained that the amount of income that the beneficiaries may receive *at any time* depends on the exercise of this discretion by the trustee.

We submit that discretionary powers of the sort described above should not preclude a trust from qualifying as an eligible trust or interests in the trust from qualifying as specified fixed interests. Each beneficiary of a trust containing such powers has a fixed interest in the trust which, we think, is the important factor. The type of discretionary power that should be referred to in the definitions of "eligible trust" and specified fixed interest" is a power to determine the proportion of a distribution that is payable to each beneficiary.

Recommendation

We recommend that the references to a discretionary power in the definitions of "eligible trust" and specified fixed interest" be limited to a power to determine the share of a distribution that is payable to each beneficiary.

VII. Quebec Trusts – Subsection 248(3)

While the following issue does not relate to non-resident trusts, the provision in question is included with the NRT and FIE draft legislation. Hence, we have included the issue in this submission. We are aware that this issue has already been raised in a letter sent to the Department of Finance by a law firm. Our reason for including it herein is to express agreement with the concern. Since the law firm's letter has not been circulated within the tax community, we have included a description of the concern (which is substantially the same as the description in the letter).

Paragraph 248(3)(d), which deems certain arrangements governed by Quebec law to be trusts for purposes of the Act, is being replaced by a similar provision in new paragraph 248(3)(c). However, the new provision is limited to arrangements established before October 31, 2003. The explanatory notes state that this change "recognizes that amendments to the *Civil Code of Quebec* have rendered unnecessary the provision's original purpose i.e., to allow for the characterization, in the province of Quebec, of certain entities as trusts under the Act even though they may not technically constitute trusts under the civil law of Quebec".

The May 14, 2004 decision of the Supreme Court of Canada in *ScotiaMcLeod Inc. v. Bank of Nova Scotia*, 39 C.C.P.B. 168 (the so-called "*Thibault*" case) raises concerns with respect to this amendment. The Supreme Court held in Thibault that a self-directed registered retirement savings plan ("RRSP") created by declaration of trust and governed by the laws of Quebec did *not* constitute a trust within the meaning of the *Civil Code of Quebec*. The Court based its decision on the ability of the RRSP annuitant to make withdrawals from the RRSP prior to maturity, as well as certain other elements of control over the RRSP assets that were enjoyed by the annuitant. This decision narrowed the scope of the expanded civil law trust concept as enacted in the new *Civil Code of Quebec* effective January 1, 1994.

In light of the *Thibault* decision, numerous commercial arrangements governed by Quebec law that were stated to be trusts may not in fact enjoy trust status under Quebec civil law. This would particularly be the case for self-directed RRSPs and self-directed registered retirement income funds. Hence, the proposed amendment to subsection 248(3) could inadvertently deprive such arrangements established after October 30, 2003 of trust status for purposes of the Act, as well. Given the way in which "retirement savings plan" and "carrier" are defined in subsections 146(1) and 146.3(1) of the Act, respectively, it is possible that this change would take such self-directed plans out of the ambit of sections 146 and 146.3 altogether, thereby threatening their tax-assisted status.

Recommendation

We recommend that the rule in proposed paragraph 248(3)(c) apply regardless of the date on which an arrangement is established.

I. Definition of "Specified Interest"

The interest of a beneficiary under a trust is excluded from the definition of "specified interest" in subsection 94.1(1) at a particular time if "every amount of income and capital of the trust that the [beneficiary] may receive at or after that time depends on the exercise by any entity or individual of, or the failure by any entity or individual to exercise, a discretionary power" (subparagraph (b)(ii) of the definition). It is not entirely clear how this statement should be interpreted.

We believe that what is intended is the following: an interest under a trust is not a specified interest at a particular time if, depending on how discretionary powers are exercised (or not exercised) at and after that time, the beneficiary may never receive any amount from the trust. The alternative interpretation is that the full amount of each distribution that may be made to the beneficiary must be contingent on the exercise, or failure to exercise, a discretionary power in respect of the distribution.

The difference between these two interpretations can be seen by an example. Assume that a beneficiary is to become entitled to receive a fixed share of the assets of a trust on reaching a specified age. However, the trustee has the discretionary power to make distributions out of trust income or capital at any time before then to the members of a class of beneficiaries, and can exhaust the trust assets in doing so. Under the first interpretation, the beneficiary's interest would not be a specified interest, since the trustee could distribute all the assets of the trust to other beneficiaries prior to the beneficiary reaching the specified age. Under the second interpretation, the interest would be a specified interest because the distribution to be made to the beneficiary on attaining the specified age is not a discretionary distribution.

Recommendation

We suggest that it be clarified, either in the legislation or in the explanatory notes, that the first interpretation is the intended one.

II. Paragraph 94.1(2)(c) – Determination of Designated Cost

Subparagraph 94.1(2)(c)(ii) deems the designated cost of an interest in a trust (other than an exempt foreign trust) to be the larger of the designated cost otherwise determined and the amount determined under clause (B) of that subparagraph.

The amount determined under clause (B) in respect of a beneficiary's interest in a trust is equal to the total cost (or in the case of restricted property, fair market value) of all assets of the trust held for the purpose of satisfying the interest. This amount can significantly exceed the beneficiary's economic entitlement to the assets of the trust. The reason is that particular assets may not be held for particular beneficiaries, but rather may be considered to be held for the purpose of satisfying the interests of all (or multiple) beneficiaries.

The following example illustrates our concern with this paragraph.

Example

Mr. X, who has never been a resident of Canada, establishes a non-resident trust in 2005 for the benefit of his son and daughter, A and B, who are residents of Canada. Under the terms of the trust, A (who is older than B) is entitled to a distribution equal in amount to one-half of the trust assets upon attaining age 35. B is entitled to the remaining trust assets on reaching the same age. In the event that A or B dies before reaching age 35, gift over provisions apply in favour of the children of A and B. While A and B are both beneficiaries of the trust, the trust assets are maintained as a single fund, i.e., the assets are not divided into a share for A and a share for B. The trust holds no restricted property.

The interests of A and B in the trust are specified interests, and hence participating interests. Since the children of A and B are successor beneficiaries, their interests are not participating interests. Thus, while A and B are alive and A is under 35 years of age, the FIE rules will apply to their interests, but not to the interests of their children.

To apply subparagraph 94.1(2)(c)(ii) to the interests of A and B, it is necessary to determine which assets are held by the trust for the purpose of satisfying the rights of A in respect of his interest, and which assets are held for the purpose of satisfying the rights of B in respect of her interest. Since the assets form a single fund, any of the assets (or the assets substituted for them) could be used to satisfy either of the interests. There is no basis for maintaining that any particular asset (or partial interest in it) is held to satisfy the interest of only one of the beneficiaries. Thus, it must be concluded that each asset is held by the trust for the purpose of satisfying both of the interests.

It follows from this conclusion that the minimum designated cost determined under clause 94.1(2)(c)(ii)(B) in respect of each interest at any time is the total cost of all the trust assets at that time. Consequently, both A and B will be required to include amounts in their income under subsection 94.1(4) with respect to all the trust assets. This is clearly inappropriate. The maximum designated cost that it would be appropriate to assign to each interest under clause 94.1(2)(c)(ii)(B) is one-half of the cost of the trust assets.

Recommendation

We recommend that subparagraph 94.1(2)(c)(ii) be replaced by a rule that does not result in the cost of any trust asset (fair market value, in the case of restricted property) being included in the designated cost of more than one interest. A proration rule similar to that in the definition of the "cost amount" of a beneficiary's interest in subsection 108(1) or in subsection 107.4(4) (minimum fair market value of a vested interest) could be used. As a refinement, this might be combined with a rule that assigns the cost of particular assets to a particular interest, where the assets are held solely to satisfy that interest.

The same concern exists with respect to subparagraph 94.1(2)(c)(i), which applies to determine the designated cost of interests in trusts that are exempt foreign trusts described in paragraph (f) of the definition of that term. That subparagraph should also be modified so that it does not assign the same asset cost to more than one interest.

III. Subparagraph 94.1(2)(c)(ii) – Monthly Determination of Designated Cost

Since subparagraph 94.1(2)(c)(ii) applies to the determination of designated cost *at any time*, it must be applied at each time that the designated cost is required for purposes of subsection 94.1(4), i.e., at the end of each month. As a result, the designated cost will increase (or decrease) based upon the increase (or decrease) in the cost (or fair market value in the case of restricted property) of the trust's assets. For other participating interests in FIEs (such as shares), the designated cost is generally established at the time the interest is acquired and then increases by the amount included in the taxpayer's income under subsection 94.1(4).

The need to compute designated cost on a monthly basis under subparagraph 94.1(2)(c)(ii) will create an onerous compliance burden in many situations, since it will be necessary for a statement of trust assets to be prepared at the end of each month. More fundamentally, this requirement will result in the treatment of participating interests in personal trusts differing from the treatment of other types of participating interests (such as shares of corporations).

Recommendation

We recommend that any special rules for determining the designated cost of interests in trusts apply only when the interests are acquired (or become participating interests).

IV. Deduction of Capital Loss on Disposition of Participating Interest

Subsection 94.1(5) permits a deduction if a taxpayer sustains a capital loss on the disposition of a participating interest and amounts were previously included in the taxpayer's income under subsection 94.1(4). For participating interests in personal trusts, subsection 94.1(5) will often provide no deduction, or an inadequate deduction, in situations where the amounts included in the beneficiary's income under subsection 94.1(4) exceed the amounts received by the beneficiary out of the trust's accumulated income. (To simplify our comments, we are assuming that no income is distributed on a current basis.)

The problem stems, in part, from the fact that the interest of a beneficiary in a personal trust generally has no cost.[1] If there is no cost, the ACB will equal the amounts included in income under subsection 94.1(4). On the other hand, the proceeds of disposition of the interest will include the beneficiary's share of the capital of the trust. For this reason, the proceeds will generally exceed the ACB, and so the beneficiary will not realize a loss.[2]

Example 1

The problem can be seen by considering the example given above in the discussion of paragraph 94.1(2)(c), with the following additional facts: (i) A and B survive until A reaches age 35; (ii) the amount settled on the trust was $1,000,000; (iii) as a result of investment returns, the trust assets have a fair market value of $1,400,000 at the time the distribution is to be made to A; (iv) A's distribution of $700,000 takes the form of money; and (v) A was required to include $300,000 in income under subsection 94.1(4) while he held his interest in the trust.

Since A's share of the trust assets is 50%, it is reasonable to consider $500,000 of the $700,000 distribution to be a distribution out of the capital that was settled on the trust. Thus, the maximum amount on which he should be taxable is $200,000. However, he has actually been required by subsection 94.1(4) to include $300,000 in his income. Thus, he should be entitled to a deduction of $100,000.

This is not the result under subsection 94.1(5). The ACB of A's interest at the time of the distribution to him is $300,000 (nil cost plus the amounts included in A's income under subsection 94.1(4)). His proceeds of disposition are $700,000. Thus, A realizes no loss on the disposition of his interest in the trust, and so cannot claim any deduction in respect of the excess amount included in his income.

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[1] Generally, paragraph 107(1.1)(b) deems the cost of capital interests in personal trusts to be nil. However, that rule will not be applicable to participating interests in FIEs by virtue of proposed subparagraph (iii). Usually, there is no actual cost of interests in personal trusts. Paragraph 69(1)(c) would apply to deem such an interest to have a cost only if the interest is considered to be property acquired "by way of gift, bequest or inheritance". Unless a person's interest in a personal trust was acquired from a prior holder of the interest, we do not think the interest would be considered to be acquired in any of these ways.

[2] The beneficiary will not realize a capital gain either, because of the increase in ACB provided by paragraph 107(1)(a) for the purpose of computing a capital gain.

Example 2

A variation of the above example illustrates a more extreme case where no relief is available. Assume the following facts: (i) A dies suddenly in an accident at age 32; (ii) immediately before his death, he was in excellent health; (iii) the amount settled on the trust was $1,000,000; (iii) as a result of investment returns, the trust assets have a fair market value of $1,300,000 at the time of A's death; and (iv) A was required to include $200,000 in income under subsection 94.1(4) while he held his interest in the trust.

The ACB of A's interest at the time of his death is $200,000 (nil cost plus the amounts included in his income under subsection 94.1(4)). He is deemed by paragraph 70(5)(a) to have disposed of his interest in the trust for proceeds equal to the fair market value of the interest immediately before his death. It is reasonable to assume that this fair market value would be close to 50% of the fair market value of the trust assets, i.e., $650,000. Therefore, A would not realize a capital loss on the deemed disposition of his interest in the trust, and so would not be entitled to any deduction under subsection 94.1(5). The result is that A has included $200,000 in his income pursuant to subsection 94.1(4) with no offsetting relief, even though he has received nothing from the trust.

As these two examples show, subsection 94.1(5) does not always provide an appropriate amount of relief when participating interests are interests in personal trusts. One reason, as noted above, is that such interests generally have no cost. If A's interest in these examples had a cost of $500,000 (50% of the amount settled on the trust) instead of nil, A would be entitled to a deduction under subsection 94.1(5) for the excess amount included in his income by subsection 94.1(4).

Recommendation

We recommend that subsection 94.1(5) be revised, or further rules added, to ensure that adequate relief is provided to beneficiaries of personal trusts in respect of excess amounts included in their income by subsection 94.1(4). This could be achieved in some cases by deeming interests in trusts to have a suitable cost for purposes of determining the capital loss used in subsection 94.1(5). However, this approach may not be adequate as a general solution. In particular, a different approach may be needed to deal with interests that include both a fixed (possibly contingent) entitlement combined with an entitlement that is subject to the exercise of a discretionary power. Further consideration needs to be given to the best approach for providing relief to beneficiaries of personal trusts.

V. Designated Cost of Interest of Successor Beneficiary

Where a successor beneficiary in respect of a trust ceases to be such because of the death of an individual, and as a consequence the beneficiary's interest in the trust becomes a participating interest, it is unclear how component "F" in the definition of designated cost in subsection 94.1(1) applies to the interest. "F" refers to the fair market value of the participating interest at the time it was acquired less its cost amount at the time of acquisition. The interpretation difficulty stems from the fact that the interest is not a participating interest when acquired, but becomes one afterwards.

One view is that "F" applies only if a participating interest is a participating interest at the date of acquisition, in which case "F" would not apply to the interest of a successor beneficiary that becomes a participating interest. Another view, which we are inclined to think is the correct one, is that the amounts referred to in "F" are to be determined at the time of the acquisition of an interest, whether or not the interest was a participating interest at that time. The third view is that where an interest becomes a participating interest after acquisition, the participating interest is to be considered to have been acquired at that subsequent time for the purpose of applying "F".

Recommendation

We recommend that it be clarified how component "F" applies with respect to trust interests that become participating interests after they are acquired.

VI. General Concern with Application of FIE Rules to Interests in Personal Trusts

As is evident from the previous comments, there are serious deficiencies in the FIE rules as they apply with respect to interests in personal trusts. The objective appears to be to ensure that Canadian resident beneficiaries of personal trusts who are or may be entitled to receive a portion of the income earned in such trusts pay tax in Canada on a current basis in respect of this entitlement, unless a beneficiary's interest is fully discretionary. This is a difficult objective to implement in a manner that is fair to taxpayers, given the variety of types of interests in personal trusts. The current draft of the rules produces results that can be considered unfair to many beneficiaries, in view of the problems described above.

Recommendation

We recommend that the Department of Finance reconsider the application of the FIE rules to interests in personal trusts, particularly if this cannot be done in a way that treats taxpayers fairly. The reason for applying the FIE rules to such interests represents an extension of the original motivation for the rules which, we believe, was to ensure that Canadian residents cannot obtain undue tax advantages by investing their money outside Canada. Where the assets in personal trusts do not originate from Canadian residents, Canada should have less concern that the income generated by the assets may ultimately end up in the hands of Canadian residents. If it is decided to maintain the application of the FIE rules to interests in personal trusts, and it is not possible to solve the problems identified above, then we suggest that consideration be given to narrowing the range of situations to which the rules are applied.

VII. ACB Addition in Paragraph 53(1)(m) in respect of FIE Income

Proposed subparagraph 53(1)(m)(iii) will add to the ACB of a taxpayer's property each amount that is included by subsection 94.1(4) in respect of the property in computing the taxpayer's income. Because of the reference to "income", it is unclear whether this ACB adjustment will apply where the taxpayer is a controlled foreign affiliate (CFA) of a Canadian resident.

The Act requires, in the case of a CFA, that the amount of its foreign accrual income (FAPI) be determined for each year. While FAPI includes the CFA's income from specified sources, FAPI is not the same as section 3 income. Where the CFA holds an interest in a FIE, the amounts determined under subsection 94.1(4) in respect of the interest are included in the CFA's FAPI.

Given that income and FAPI are different concepts, it is unclear whether the reference to "income" in subparagraph 53(1)(m)(iii) would be interpreted to mean FAPI in the case of a taxpayer that is a CFA. A further source of uncertainty is that subparagraph 53(1)(m)(i) specifically refers to "computing the foreign accrual property income of the taxpayer". This suggests that the term "income" as used in paragraph 53(1)(m) is not intended to have an expanded meaning that includes FAPI.

We assume that it is intended that subparagraph 53(1)(m)(iii) apply with respect to amounts included in a CFA's FAPI. The tax policy reason for increasing the ACB of FIE interests held by CFAs is the same as it is for residents who hold interests in FIEs.

Recommendation

We recommend that the uncertainty be eliminated by adding a specific reference to FAPI in subparagraph 53(1)(m)(iii).

VIII. Double Taxation of Income Under FIE and FAPI Provisions

The revised rules in subparagraph 96(1)(d)(iii) serve to ensure that the FIE rules do not apply in cases where a controlled foreign affiliate is owned by a partnership, and the Canadian members' interests in the partnership are such that rules in paragraph 95(2)(v) deem the controlled foreign affiliate to be a controlled foreign affiliate of the members of the partnership. The same is true of the rules in paragraph 95(2)(g.3), where a controlled foreign affiliate is held by another controlled foreign affiliate that is held by a partnership.

However, in cases where the members of the partnership do not own a controlling interest in the partnership, the rules in subparagraph 96(1)(d)(iii) and paragraph 95(2)(g.3) will not apply. This is because the controlled foreign affiliate that is owned by the partnership will not be deemed to be a controlled foreign affiliate of the members.

For example, assume that Canco1 and Canco2 each own a 25% interest in a partnership, and the remaining 50% interest is held by an unrelated non-resident. If the partnership owns all the shares of a non-resident entity which earns investment income, Canco1 and Canco2 will each be required to include FAPI in their income as the non-resident entity is a controlled foreign affiliate of the partnership.

At the same time, however, the rules in subparagraph 96(1)(d)(iii) will not apply to deem the partnership's participating interest in the non-resident entity to be an exempt interest. This is due to the fact that the non-resident entity can not be said to be a controlled foreign affiliate of Canco1 and Canco2 as their total deemed ownership interest will combine to only 50% of the shares of the non-resident entity.

As a result, the partnership will be required to compute FIE income, as well as FAPI, and Canco1 and Canco2 will then have to pick up their share of both. Effectively, the income of the non-resident entity is being double taxed in Canco1 and Canco2.

Recommendation

The application of both the FIE regime and the FAPI regime to a single Canadian taxpayer results in double taxation of income. We feel that this is not an appropriate result. We therefore recommend that in situations where a Canadian taxpayer is otherwise subject to the FAPI regime, there should be no application of the FIE rules.