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

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February 28, 2005

Mr. Brian Ernewein
Director, Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade Laurier, 17th Floor East Tower
140 O'Connor St.
Ottawa, ON K1A 0D5

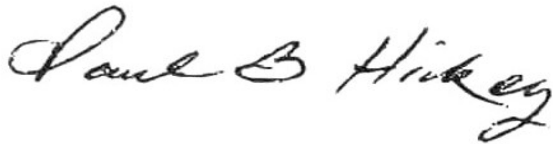
Dear Mr. Ernewein:

Re: Second Submission - 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 further comments on the October 30, 2003 Notice of Ways and Means Motion (the "Motion") relating to non-resident trusts ("NRT") and foreign investment entities. Our comments in this submission are limited to the proposed changes for NRTs. We hope that you will have time to consider our concerns before the enabling legislation is enacted. We would also like to express our thanks to the Department of Finance officials who have had discussions with us on the points raised in our April 27, 2004 submission on the Motion.

We trust you will find our comments and recommendations to be 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,



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Cc: Mr. Grant Nash, Dept. of Finance
Mr. Wally Conway, Dept. of Finance

Second Joint Committee Submission in respect of non-resident trusts Notice of Ways and Means Motions released October 30, 2003

I. The Application of Part XIII Tax

In our submission to the Department dated April 27, 2004, we provided comments on proposed subparagraph 94(3)(a)(viii) of the Income Tax Act (Canada)[1], which would impose Part XIII tax on income from certain sources that is distributed to a non-resident beneficiary. We indicated in our proposal that we did not believe that Part XIII tax should apply to foreign-source income. After considering this issue further, we want to provide you with additional comments.

In this submission, a trust that is deemed pursuant to paragraph 94(3)(a) to be resident in Canada will be referred to as a “94(3) Trust”.

Part XIII Tax on Foreign-Source Income

Proposed section 94 (like its companion provision section 94.1) is an anti-avoidance rule that is intended to restrict a Canadian resident taxpayer’s ability to defer or avoid Canadian tax on investment income. This intention was clearly indicated in the February 16, 1999 Federal Budget where it was stated that “non-resident trusts are not taxable in Canada and income can be accumulated in such trusts on a tax-deferred basis. When such trusts pay little or no foreign tax on their accumulated income and capital gains, taxpayers making use of such trusts may benefit from a deferral of tax or complete avoidance of tax. Avoidance occurs when the accumulated income is transformed into the capital of the trust, which is distributed to the Canadian beneficiaries tax-free”.

Accordingly, section 94 should not cause a Canadian tax liability to arise where foreign-source income earned in a 94(3) Trust is distributed to a non-Canadian resident and thereby cannot benefit a Canadian resident person.

A serious problem with Canada taxing non-resident beneficiaries on foreign-source income distributed to them by 94(3) Trusts is that this will result in double taxation. Given that a 94(3) Trust is not factually resident in Canada, it does not seem plausible that a distribution by the trust of foreign-source income to a non-resident beneficiary will be considered in their country of residence to be Canadian-source income. Thus, it is unlikely that such a beneficiary will be able to claim a credit for the Part XIII tax, and hence

[1] Unless otherwise indicated, the statutory references in this submission are to the Income Tax Act (Canada), including the proposed provisions in the October 30, 2003 Notice of Ways and Means Motion Regarding the Taxation of Non-Resident Trusts and Foreign Investment Entities.

the beneficiary could end up paying both Canadian tax and tax in the country of residence on such distributions. This is clearly inappropriate. Where a beneficiary resides in a treaty country, the beneficiary may be able to claim treaty protection from the tax, for example, under the "Other Income" Article of the treaty. However, unless the CRA agrees that various provisions of treaties preclude it from imposing the Part XIII tax, beneficiaries will be put to the trouble and expense of having to sort this out through the Competent Authority process or possible litigation.

If the Department is aware of transactions that can circumvent the intention of section 94, then it is recommended that specific rules be introduced to deal with those situations. For example, if there is a concern that foreign-source income earned by a 94(3) Trust that is payable to a non-resident person may ultimately be paid by the trust to a Canadian resident person, then the deduction under subsection 104(6) could be modified. Currently, subsection 104(6) allows a deduction in computing trust income for amounts that are payable to beneficiaries in the year. This subsection could be amended for 94(3) Trusts such that the deduction can only be claimed for foreign-source income if it is actually paid in the year it is earned or in the following year to a non-resident beneficiary.

Where Part XIII Tax is Appropriate

Based on the current proposals, most types of Canadian-source income earned by a 94(3) Trust and paid to a non-resident beneficiary will be subject to Part I tax in the trust as a result of the addition of subsection 104(7.01). This includes designated income (as defined in subsection 210.2(2)), and investment income that would otherwise be subject to withholding tax if subparagraph 94(3)(a)(vii) were not applicable.

This approach may be inappropriate for capital dividends. A capital dividend received by a 94(3) Trust and distributed to a non-resident beneficiary will be included in determining the cap in subsection 104(7.01) on the amount that the trust may deduct under subsection 104(6). However, this may result in little or no additional Canadian tax being payable by the trust. For example, if the trust does not receive or become entitled to any amounts in the year that are includable in its income, it will not be claiming any deduction under subsection 104(6). In this case, the cap on the subsection 104(6) deduction will have no effect, and the trust will not be required to pay any tax as a consequence of the distribution of the dividend to the non-resident beneficiary. On the other hand, if the trust does receive or become entitled to other amounts that are included in its income, and it claims a deduction under subsection 104(6) in respect of the distribution of part or all of this income, the inclusion of the capital dividend in the calculation of

the cap on the deduction will result in additional Canadian tax being payable. However, depending on all the factors, the additional tax may not be commensurate with the amount of the capital dividend.

The solution appears to be to impose Part XIII tax on non-resident beneficiaries who receive distributions out of capital dividends, rather than attempt to increase the amount of tax payable by 94(3) Trusts. If this change were made, subsection 104(7.01) would need to be amended to exclude capital dividends.

Recommendation

It is submitted that a non-resident beneficiary of a 94(3) Trust should not be subject to tax under Part XIII except in those specific circumstances where Canadian-source income (such as capital dividends) may otherwise escape taxation in Canada. If Part XIII tax is levied on such amounts, then a corresponding amendment to subsection 104(7.01) would be necessary to exclude the amounts from that subsection.

If the Department is concerned with transactions that could be designed such that foreign-source income that is payable to a non-Canadian resident could at some later time become payable or be paid to a Canadian resident, then we would recommend that specific rules be introduced to address those avoidance concerns.

II. The Purposes for which a Non-Resident Trust is Deemed Resident in Canada

A 94(3) Trust is deemed resident for the purposes listed in paragraph 94(3)(a), which include section 2 and the computation of the trust's income. Subsection 94(4) limits the effect of paragraph 94(3)(a), by deeming a 94(3) Trust to not be a resident of Canada for certain specified purposes. It is our view that further provisions of the Act need to be added to the list in paragraph 94(3)(a) to ensure that inappropriate or anomalous tax results do not occur. We list below a number of provisions and situations where we believe inappropriate tax results could arise.

a) Subsection 111(9) - Carry-Over of Losses

If in a particular year, a 94(3) Trust realizes a capital loss from property that is not taxable Canadian property, subsection 111(9) would appear to prevent the trust from carrying over the loss to a subsequent (or prior) taxation year as a net capital loss. For the same reason, a business loss from a business that was not carried on in Canada could not be claimed in a subsequent or prior year.

Although proposed subparagraph 94(3)(a)(i) deems a 94(3) Trust to be resident in Canada for section 2 and for the purposes of computing its income, the provision does not deem the trust to be a resident of Canada for the purpose of computing the trust's taxable income or for applying the loss carryover rules. Therefore, subsection 111(9) would appear to apply to restrict the ability of the trust to carry over net capital losses and non-capital losses.

We believe that this is an inappropriate result and therefore we recommend that paragraph 94(3)(a) also deem the trust to be resident in Canada for the purposes of computing its taxable income and determining its loss carry-overs from other taxation years.

b) Excluded Right or Interest

A 94(3) Trust is not deemed to be resident for the purposes of paragraph (j) of the definition of "excluded right or interest" in subsection 128.1(10). Consider the situation where a husband and wife immigrated to Canada from a foreign country and were resident in Canada for 10 years. A number of years before coming to Canada, the husband had created a trust for his spouse. The trust was a personal trust and was factually resident in the foreign country. Assume that the husband and wife decide to return to the foreign country and therefore depart Canada. Subsection 94(5) together with paragraph 128.1(4)(a) would deem the trust to have a year-end immediately prior to the time of departure. In addition, pursuant to paragraph 128.1(4)(b) the trust will be deemed to have disposed of its capital property immediately prior to the time of departure (this time is referred to as the "disposition time"). As a result, the trust will be taxable on any accrued capital gains on properties held by it at the disposition time.

As the wife has a capital interest in the trust at the time of her departure, paragraph 128.1(4)(b) will also be applicable. She would be deemed under this paragraph to have disposed of this capital interest at the disposition time for proceeds equal to its fair market value at that time. The cost amount of her capital interest would be determined under subsection 107(1) and paragraph (b) of the definition of "cost amount" in subsection 108(1) to be the cost amount of the properties held by the trust at the disposition time. If the fair market value of the wife's capital interest exceeds her cost amount, she will be taxable on the resulting capital gain. Because the wife's deemed disposition occurs at the same time as the deemed disposition by the 94(3) Trust, the wife's cost amount would not be increased to reflect the gains realized by the trust. This represents double taxation of the same economic capital gain.

The issue could be resolved if paragraph 94(3)(a) deemed a 94(3) Trust to be resident for the purposes of paragraph (j) of the definition of "excluded right or interest" in subsection 128.1(10). We therefore recommend that this change be made.

A similar issue arises if a Canadian resident beneficiary of a 94(3) Trust departs Canada and subsection 94(5) does not apply because the trust continues to have a resident contributor. We submit that in such a circumstance, the interest of the beneficiary in the 94(3) Trust should be treated on the same basis as an interest in a domestic trust and therefore the interest in the 94(3) Trust should be an excluded right or interest under the definition in subsection 128.1(10).

c) Foreign Affiliate and FAPI Rules

The status of a taxpayer as a resident or a non-resident is relevant for the foreign affiliate and FAPI rules, and for other rules in the Act that refer to foreign affiliates. For example, the term "foreign affiliate" is defined with respect to a taxpayer resident in Canada, and the determination of whether a foreign affiliate of a taxpayer resident in Canada is a controlled foreign affiliate of the taxpayer may depend on the residency of other shareholders of the foreign affiliate.

Where the taxpayer is a 94(3) Trust, subparagraph 94(3)(a)(ii) will, in our view, have the effect of causing the foreign affiliate and FAPI rules to apply as if the trust were a resident, when the rules are being applied in connection with the determination of the trust's income for the particular year to to which subsection 94(3) applies. Otherwise, the trust will be a non-resident for the purposes of the rules. For some provisions, it may be unclear whether a 94(3) Trust is to be treated as a resident.

One situation where we think it is clear that a 94(3) Trust will be considered to be a resident is in determining whether any amount is to be included in the trust's income under the FAPI rules. In particular, a foreign corporation that is controlled by a 94(3) Trust will be treated as a controlled foreign affiliate of the trust for this purpose.

An example where the result would be unclear or inappropriate concerns the application of subsection 85.1(3). Assume that a 94(3) Trust exchanges shares of one foreign corporation ("FC1") for shares of another foreign corporation ("FC2"), and that both foreign corporations would be considered foreign affiliates of the trust if it were resident in Canada. In this situation, we would expect subsection 85.1(3) to

apply with respect to the determination of the trust's proceeds of disposition of the shares of FC1.[2] The reason is that the proceeds of disposition are a factor in determining the trust's income for the year. Hence, in determining whether subsection 85.1(3) is applicable to the determination of the proceeds of disposition, the trust is to be assumed to be resident, with the consequence that the two foreign corporations are considered foreign affiliates of the trust for this purpose. However, since paragraph 94(3)(a) only deems the 94(3) Trust to be resident in Canada for the purposes of computing its income *for the particular year*, it appears that subsection 85.1(3) would not apply to determine the cost of the shares of FC2 to the trust. Assuming that the trust does not dispose of those shares until a subsequent year, the cost of the shares would not be relevant for the purposes of computing the trust's income for the particular year but rather for the future year of disposition. In its application in the year of disposition, paragraph 94(3)(a) would deem the trust to be resident only in that year. Since paragraph 94(3)(a) would not deem the trust to be resident in the year it exchanged the shares, the application of the paragraph in the year of disposition would not cause subsection 85.1(3) to apply to determine the cost of the shares.

Another example involves paragraph 95(2)(f), specifically the exclusion of gains and losses contained in the last part of that paragraph. Assume that a 94(3) Trust distributes the shares of a foreign corporation to a Canadian-resident beneficiary, and that while the shares were owned by the trust, the foreign corporation would have been a foreign affiliate of the 94(3) Trust if the trust were resident in Canada. In determining the gains and losses of the foreign corporation after it becomes a foreign affiliate of the beneficiary, gains and losses that accrued while the shares were held by the trust would be excluded. This is because paragraph 94(3)(a) would not have the effect of causing the foreign corporation to be considered to have been a foreign affiliate of the trust for this purpose.

There are undoubtedly other provisions in the foreign affiliate and FAPI rules that will need to be addressed when a 94(3) Trust holds the shares of a foreign corporation. We therefore recommend that the appropriate residency status of 94(3) Trusts for the purposes of all these rules be considered.

Subsection 250(5)

Subsection 250(5) deems a person that would otherwise be resident in Canada for purposes of the Act not to be resident if the person is, under a tax treaty with another country, resident in that other country and not in Canada. It is unclear whether the condition that the person otherwise be resident in Canada for the purposes of the Act requires that the person be resident for *all* purposes, or whether it is sufficient that the

[2] This assumes that subsection 85.1(4) does not apply.

person be resident for only some purposes. Given that a 94(3) Trust is not resident in Canada for a number of provisions in the Act, including those provisions listed in subsection 94(4), it is unclear whether subsection 250(5) could apply with respect to such a trust (assuming Competent Authorities have determined the trust to be resident in a country other than Canada).

We understand that the Canada Revenue Agency has issued technical interpretations in which they express the view that subsection 250(5) can apply with respect to a 94(3) Trust[3]. However, we are concerned that the basis for this position is not clear and thus the position could change in the future. Therefore, we recommend that, for the purposes of applying subsection 250(5), a 94(3) Trust be deemed to be a person that is resident in Canada for the purposes of the Act.

Canadian Partnerships

A Canadian partnership is defined in subsection 102(1) to be a partnership all the members of which are residents of Canada. Canadian partnership status can be relevant for a number of the “rollover” rules for partnerships, such as those in subsections 97(2), 98(3), 98(5) and 98(6).

If a 94(3) Trust is a member of a partnership and all of its other partners are factual Canadian residents, the partnership will not be a Canadian partnership, except for the limited purpose of determining the trust’s income for a particular year. This can produce the anomalous result that a rollover rule may apply with respect to the trust, but not with respect to any other partner. Furthermore, a rollover rule may be only partially applicable. For example, if the trust transfers property to the partnership, subsection 97(2) may apply to determine the trust’s proceeds of disposition, but not the cost of the property to the partnership. This is because the proceeds are required in order to determine the trust’s income for the year in which the property is transferred to the partnership, but the cost is not used in connection with the determination of the trust’s income (as one of the partners) until a future year. Under paragraph 94(2)(a), the trust is deemed to be resident in Canada for the purpose of determining its income for the particular year in which the deeming applies, but not for the purpose of determining its income for any future year.

If two or more 94(3) Trusts are members of a partnership, it will not be possible for the partnership to qualify as a Canadian partnership for any purpose. This is because the deemed residency of any one of the trusts is only for the purpose of determining that trust’s income. Thus, the other trusts will be considered to be non-residents when determining the income of a particular trust.

[3] See technical interpretations 2001-0074395 and 2002-0180235.

To address these problems, we recommend that a 94(3) Trust be deemed to be a resident of Canada for the purpose of determining whether a partnership of which the trust is a member is a Canadian partnership.

Recommendation

The provisions referred to above are those that have been identified by the Joint Committee for which we believe that a 94(3) Trust should be deemed resident or where it needs to be clarified whether a 94(3) Trust is a resident for a purpose other than the computation of its income. The provisions are not based upon a comprehensive review of this matter. There may be additional provisions for which a 94(3) Trust should be deemed resident.

We believe that the tax policy underlying section 94 is to eliminate the advantages of using offshore trusts by deeming those trusts to be resident in Canada. Therefore, we believe that a 94(3) Trust should be deemed to be resident for the majority of the provisions of the Act in order that these trusts are treated the same as or very similar to domestic trusts. We would be pleased to assist the Department in determining whether there are additional provisions for which a 94(3) Trust should be deemed resident.