By Stuart Bollefer

Foreign Investment Entities in Canada

Stuart Bollefer discusses some of the controversial proposals contained in Bill C-10

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The Canadian Senate is on the verge of passing controversial proposals contained in Bill C-10 which will, in certain situations, subject Canadian resident beneficiaries of non-Canadian trusts to immediate tax and reporting in Canada irrespective of whether or not they actually receive a distribution from the trust. Although the Senate hearings have been postponed pending possible last minute changes, the rules discussed in this article may not change.

The proposed changes now contained in Bill C-10 deal with both non-resident trusts (NRT) and interests in foreign investment entities (FIEs). Both sets of rules are far reaching, but until recently, the international community has been more aware of the proposed rules dealing with NRTs. These rules have the effect of deeming trusts that are otherwise not resident in Canada to be resident for most Canadian tax purposes.

The rules are exceedingly wide in application, but generally speaking, apply where a Canadian resident has contributed property or provided financial support to such a trust or a corporation or partnership owned by the trust.

The companion FIE rules were originally aimed at forcing an annual income inclusion on Canadians with interests in offshore hedge funds or similar investments. Surprisingly, the current FIE provisions of Bill C-10 appear to go beyond the original intent of the proposals and can result in phantom income being imputed to Canadian residents who have "specified interests" in trusts that are not resident in Canada, even where the trusts themselves have no connection with Canada. The provisions now capture discretionary interests in foreign trusts that are not purely discretionary. This would include, for example, a Canadian resident's interest in a trust containing mandatory distribution language found in standard termination clauses. It is important to note that these rules will only apply to trusts where generally speaking the assets of the trust are used in carrying on an investment business or where more than one-half of either the fair market value or book value of the assets are comprised of investment property.[1]

Under current rules, where the distribution is made from capital, there is no income inclusion for Canadian tax purposes although beneficiaries who receive distributions of capital from inter vivos trusts are required to complete and file an information return. (No information return is required for capital distributions received from stamentary trusts.) Where the distribution is made from capital, there is no income inclusion for Canadian tax purposes although beneficiaries who receive distributions of capital from inter vivos trusts are required to complete and file an information return. (No information return is required for capital distributions received from stamentary trusts.)

SPECIFIED INTERESTS IN OFFSHORE TRUSTS

Under the new rules, where a Canadian resident has a "specified interest" in a foreign trust that owns predominately investment property at the end of 2007 (or at the end of any subsequent year), the FIE rules will require an income inclusion for that year.

A Canadian resident will not have a "specified interest" in a testamentary trust if at the end of the particular calendar year the testamentary trust has been in existence for not more than 12 months. (It is possible to extend this 12 month period by application to Canada Revenue Agency, but one wonders how sympathetic it will be to such an application.) After the 12 month period (unless extended) such it will be necessary for the testamentary trust to fall within one of the two exceptions noted below.

The definition of "specified interest" will include any interest as a beneficiary under a foreign trust, unless subject to one of two exceptions noted below:

(i) The "purely discretionary interest exception" requires that the Canadian resident have a purely discretionary interest as to both income and capital where the discretion is exercised by someone other than the beneficiary. Therefore, a life interest in a trust where the individual is only entitled to receive capital, but no income would not be excepted here. Or, where the trust is completely discretionary until the time of division, with a gift over to the Canadian resident beneficiary, the exception would not apply.

(ii) The "successor beneficiary exception" applies to a Canadian resident if the Canadian resident is a beneficiary under the trust solely because of the Canadian resident's right to receive income or capital only arises after the death of an intervening person where the intervening person is alive and is a contributor to the trust or related to a contributor. For example, suppose Settlor X, a resident of the UK established a trust for the benefit of his son Y, a resident of Germany and on Y's death the assets are held in trust for the issue of Y. Suppose A is a child of Y who lives in Canada. A will be a successor beneficiary and therefore not be subject to these rules during Y's lifetime, but on Y's death, A's interest in the trust would become a participating interest unless the interest arising on Y's death was purely discretionary meeting the test in (i) above.

However, if A were to have a discretionary interest during Y's lifetime and an entitlement to receive income or capital on Y's death, neither exception would apply because A's entitlement was not purely discretionary because of the gift over and because A's interest did not only arise because of Y's death.

TAX IMPLICATIONS UNDER THE NEW FIE RULES

If a Canadian resident has a "specified interest" there are three methods available to calculate the income inclusion: the default "imputed income" method and two elective methods: the "mark-to-market" and "accrual" methods. The "mark-to-market" method will not be available to beneficiaries of personal (non-commercial) trusts. The "accrual" method may be a useful alternative method of computing income and is discussed below.

Under the default "imputed income" method, the amount required to be included is determined, in general terms, by multiplying the "designated cost" of the taxpayer's investment by an annual imputed interest (set quarterly at 2% over prevailing T-bill rates and currently 6%).

In the case of an interest in a foreign trust that is not purely discretionary, the "designated cost" of the interest is equal to the greater of (i) the fair market value of the individual's interest in the trust and (ii) the trust's "cost amount" in its property divided by the number of Canadian resident beneficiaries under the trust (irrespective of whether or not there are non-resident beneficiaries). It appears totally unjustifiable from a tax policy perspective to take into account only the number of Canadian resident beneficiaries. Complicated rules are applicable where the trust holds preferred shares and other property that may have been received in connection with an estate freeze.

This default method, when applied in extreme situations, could give rise to a bankrupting event to a Canadian resident beneficiary. For example, assume a trust is settled with $100 million by a grandparent of a large family on non-Canadian resident trustees. The assets are managed outside of Canada and have no direct connection with Canada. The trust benefits 20 grandchildren around the world with Andrew being the only Canadian resident beneficiary. The trust is completely discretionary as to income and capital until the trust's time of division, defined as the earlier of the applicable perpetuities date and a date determined by the trustees. At the time of division, the assets are divided equally among the number of grandchildren alive at the time.

Andrew would be viewed as having a "specified interest" if on December 31, 2007, a Canadian resident beneficiary has a "specified interest" in an offshore trust. If the imputed interest method applied, Andrew's designated cost would be $100 million (since he is the only Canadian resident beneficiary). Andrew would be required to include $3 million in income for 2007 irrespective of whether or not he actually receives anything from the trust. This would still be the case where the actual income earned by the trust is distributed to the other beneficiaries under the trust.

This would also be the case even if Andrew was a capital beneficiary. This seems particularly unfair since Canadian resident beneficiaries are normally able to receive tax free capital distributions from offshore trusts.

The second method of computing income may be more desirable. Under the "accrual" method, the Canadian resident beneficiary will be required to include a pro-rata portion of the income of the trust determined in accordance with a modified set of Canadian tax rules. For example, the income of the trust determined under these rules would assume the trust is a resident of Canada and would impute income to the trust in respect of any participating interests in foreign investment entities owned by the trust itself (including shares of corporations controlled by the trusts). Therefore, if the trust simply had all of its assets owned by corporations and therefore never earned income itself, the FIE rules would impute income to the trusts in respect of any shares of corporations owned by the trust which were FIEs of the trust presumably using one of the three methods described above.

The pro-rata share of the income of the trust is then attributed to the particular Canadian resident beneficiary based on the ratio of the fair market value of the person's interest in the trust to the fair market value of the interests of all beneficiaries.

A pro-rata share of any income tax payable by the trust is also allocable to the Canadian resident beneficiary.

The "accrual" method is only available by election and only if the Canadian resident beneficiary makes the election in the first year in which the "specified interest" arises. This will obviously require not only significant knowledge of the trust's holdings, but knowledge of the actual interest in the trust. The Canadian resident will also be obliged to provide Canada Revenue Agency with additional information to substantiate the filing upon request.

WHAT TO DO

Absent any last minute changes in the Canadian Senate, the new legislation will be effective for taxation years beginning after 2006 (i.e., January 1, 2007). Consideration should be given to whether any Canadian resident beneficiaries' interest in the particular trust is caught by Bill C-10 or whether the interests are excepted under the purely discretionary exception or successor beneficiary exceptions noted above.

If it is, one possibility is to vary or amend the terms of each trust arrangement (without triggering an indirect contribution) to ensure that the proposed rules will not apply to Canadian resident beneficiaries' interests in each trust for the 2008 and subsequent years. Other possible solutions could include the resettlement of the trust or a disclaimer of the interest by the beneficiary.

[1] *The terms "investment business" and "investment property" are extensively defined with many supporting rules. It is beyond the scope of this article to discuss these rules at length.*