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

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May 3, 2010

Mr. Brian Ernewein
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Dear Mr. Ernewein

Re: March 4, 2010 Budget Proposals for Non-Resident Trusts and Foreign Investment Entities – Submission for Public Consultation Process

We are pleased to provide the attached submission for your consideration.

We would like to thank the Minister of Finance as well as your Department for providing the tax community and other interested persons with the opportunity to provide comments on the proposals before the draft legislation will be released as well as the upcoming opportunity to provide comments on the draft legislation.

Our submission identifies a variety of issues raised by the members of the tax community related to the March 4, 2010 Budget proposals in respect of non-resident trusts and foreign investment entities.

We trust that 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.

Yours truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Elaine Marchand
Chair, Taxation Section
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CBA – CICA JOINT COMMITTEE ON TAXATION

Non-Resident Trust and Foreign Investment Entity Proposals

March 4, 2010 Federal Budget

Submission to the Department of Finance

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A. INTRODUCTION

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this written submission on the revised proposals with respect to the taxation of non-resident trusts and foreign investment entities as outlined in the March 4, 2010 Federal Budget materials.

The following abbreviations are used throughout this submission:

Act	Income Tax Act (Canada)
Budget	March 4, 2010 Federal Budget, including Annex 5 – Tax Measures: Supplementary Information and Notices of Ways and Means Motions
FIE	A "foreign investment entity" under the Former Proposals
Former Proposals	The proposed NRT and FIE rules that were included in former *Bill C-10, An Act to Amend the Income Tax Act*
ITCIA	Income Tax Conventions Interpretation Act.
NRT	A non-resident trust which is deemed to be resident in Canada under the Former Proposals
OIF	An "offshore investment fund property" as defined under the existing Act
Previous Submission	Our letter dated January 7, 2009 to the Minister of Finance, including the attachment thereto, a copy of which is attached to this submission.

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the Act.

In our Previous Submission to the Minister of Finance, we provided a list of examples that we had previously discussed with Department of Finance officials, illustrating situations where, in our view, the Former Proposals affected a much wider range of taxpayers than is necessary to address the Department of Finance's tax policy concerns.

Some of these concerns were addressed in the Budget, but many of them could remain, depending on how the revisions to the Former Proposals are drafted. We submit that the remaining concerns raised in the Previous Submission should be addressed in the revisions to the Former Proposals. In some cases, our comments below elaborate on these concerns.

B. PROPOSED NRT AMENDMENTS

1. Date of Application

The Budget proposes that the NRT provisions will be effective for 2007 and subsequent taxation years. The only grandfathering is that the proposed attribution rule will apply to taxation years that end after March 4, 2010.

In the January 17, 2009 federal budget, the Minister of Finance acknowledged that the Canadian Government had received submissions and recommendations on the proposed NRT provisions in the Former Proposals, including from the Minister's Advisory Panel on Canada's System of International Taxation. In the 2009 budget papers, the Minister announced that Government will review the NRT and FIE proposals in light of the submissions before proceeding with measures in this area. In our Previous Submission, we recommended that the Government defer the implementation of the proposed NRT rules until any review is completed.

Under the Former Proposals, the NRT rules were effective commencing in the 2007 taxation year. In light of the uncertainty in this area, however, non-resident trusts did not know whether the reconsidered proposals would apply for 2008 or 2009 and, if such provisions applied, in what manner they may be changed.

Recommendation

We recommend that the effective date of the NRT proposals be changed to taxation years commencing after 2009, with an ability to elect to have the final rules apply commencing in any of the 2001 and subsequent taxation years.

If the effective date is not deferred (or an election is made to have the final rules apply to a taxation year that commenced before 2010), a transitional rule should be introduced to allow taxpayers to amend returns and late file returns. In the case of late filing of returns the transitional rule should provide that no late filing penalties or interest would be assessed on the late payment of income tax or Part XIII withholding tax.

2. The Proposed Attribution Rule

The Budget proposes to add a new feature to the Former Proposals that will attribute certain income of a NRT to "resident contributors" of the trust. Under the proposals, a NRT's assets would be separated between those contributed by Canadians (resident portion) and those contributed by others (non-resident portion). The income from the resident portion is then attributed to the Canadian resident contributors.

We understand that the introduction of the attribution concept in the Budget is intended to address some concerns raised with respect to prior draft versions of these rules by attributing income from a property to the person who contributed the particular property to the non-resident trust. As a result, resident contributors should no longer be potentially liable for Canadian tax (because of the application of joint and several liability) on income or profits earned on or in respect of property that has no connection to the particular property contributed by them.

(a) Application of Attribution

While we acknowledge the benefit of this proposed change to Canadian contributors who may have otherwise been subject to joint and several liability in seemingly unfair situations, we are concerned that the proposed change will create complications and seemingly unfair tax results in situations where a Canadian resident contributor is liable for tax on the trust's income from the "resident portion" but is not and may never be entitled to distributions from the trust to fund the payment of that tax.

For example, a Canadian parent may have given money to a foreign trust for the benefit of a particular child and that child's children who all live in that foreign jurisdiction. There are legitimate non-tax reasons why the parent may have decided to give this money to a trust instead of to the child directly. Under the Former Proposals, the trust would have been subject to Canadian tax on its income (subject to the ability to claim foreign tax credits under those proposals or under any applicable tax treaty, such as Article XXVI of the Canada-US Tax Convention). Under the Budget proposals, the Canadian resident parent will be taxable on the attributed income for his 2010 and subsequent taxation years even though the parent has no entitlement to the income or capital of the trust. This would not have been contemplated if the gift was made before the date of the Budget. This creates a financial cost of the arrangement that the parent could not have predicted at the time the trust was established.

Also, a non-resident settlor may have established a foreign trust to hold certain foreign assets for the benefit of family members without any contemplation of immigrating to Canada. If the settlor subsequently immigrates to Canada, the settlor would be subject to tax in respect of income to which the settlor may have no entitlement under the provisions of the trust. If the trust was established at a time when the settlor had no thought of moving to Canada, it is not reasonable to expect that the non-resident would obtain Canadian tax advice in setting up this foreign trust.

The unfairness of the attribution taxing regime is made even more apparent when one considers the implications of the deemed disposition rules that can affect the foreign trust property (the 21 year deemed disposition rule under subsection 104(4) and the emigration deemed disposition under subsection 128.1(4)). In such a situation, the resident contributor may be subject to a significant amount of tax, but not be entitled to any of the trust property.

Furthermore, the trust may have no obligation to provide (and therefore may not provide) the resident contributor with the information necessary to determine and report any attributed income or loss.

Lastly, where this attribution rule applies in circumstances such as those described above and the taxpayer becomes aware of the legislation regarding non-resident trusts, some taxpayers may not voluntarily comply because of the personal financial hardship it may cause. In cases where Canadian tax has not been paid or the income has not been properly reported because of lack of knowledge of these matters it is more likely that a voluntary disclosure would be made of the failure to comply if the person who benefits from the income is also the person who is liable for the tax.

Recommendation

We submit that the use of an attribution rule should not apply for personal trusts. In these cases, it is unusual for the settlor to be entitled to distributions from the trust and as discussed above it is often more appropriate to impose the tax on the trust that received the funds from the settlor. Under this approach, the personal trust could be made liable for the Canadian tax on the "resident portion" and the resident contributors would be jointly and severally liable with the trust for this tax.

At the very least, the attribution rule should not apply to personal trusts created before March 3, 2010. For these trusts, planning and analysis were based on the current enacted rules as well as the Former Proposals which did not make the contributor solely liable to pay the tax on income earned in the trust. The Budget proposals fundamentally alter the Canadian tax consequences of contributions to a non-resident trust in a manner that could not have been contemplated at the time of the creation of the trust.

Where attribution applies, we recommend that consideration be given to allowing a trust to elect to pay the tax otherwise imposed on its resident contributors under the attribution rule applying. We recognize that it may be that the fiduciary obligations of the trustee could prevent the trust from paying the tax or making the election, but in some cases the terms of the trust may permit the trust to pay this liability, either explicitly or implicitly (this could be the case for trusts created after March 3, 2010 when the attribution concept was first introduced). We submit that, in those cases, the trustee should be given the flexibility under the Act to bear this tax, especially where doing so is consistent with the wishes or intention of the settlor of the trust.

(b) Segregation of Resident and Non-Resident Portions

The Budget proposes that income not distributed to beneficiaries will be deemed to be a contribution by the trust's connected contributors and will form part of the resident portion of the trust. The only proposed exception to this deeming rule is for income accumulated from the non-resident portion if it is kept "separate and apart" from the property of the resident portion.

As a practical matter, it may be difficult for Canadian contributors to require the trustees of a trust to monitor the source of contributions and undistributed income and keep the related property "separate and apart." It would be unusual for the terms of the trust to require the trustee to do this – especially for trusts established before March 4, 2010. Furthermore, it is difficult to see why a trustee would keep a non-resident portion of its property separate and apart unless the trustee knew it was desirable to do so. This suggests that, at least for pre-March 4, 2010 trusts, it is unlikely that the exception to the deeming rule would be available.

Recommendation

We recommend that a tracing rule be added to the Budget proposals that would allow for accumulated income of a non-resident trust to qualify as part of a non-resident portion where the income can be traced to income earned and accumulated on non-resident contributions.

(c) Resident Contributors that are not "Connected Contributors"

A person may be a "resident contributor" but not a "connected contributor." This situation could arise, for example, where a person has contributed property to a trust before they became a Canadian resident. The contribution may have been made at a time that would be a "non-resident time" as defined in the Former Proposals. Once the person has been a resident of Canada for at least 60 months the person becomes a resident contributor. However, the person would not be a connected contributor because the contribution was made at a non-resident time.

The Budget states that a resident contributor will be attributed income from the resident portion based upon the proportion of the fair market value of their contribution to the fair market value of contributions from connected contributors. In this case, the use of this proportionate formula will produce anomalous results because the resident contributor's contributions will not be included in the amount used as the contributions from connected contributors.

Recommendation

We recommend that the above issue be addressed.

(d) Non-Resident Contributor becomes Resident in Canada

Anomalous consequences could follow when a non-resident contributor subsequently becomes resident in Canada.

For example:

> Two non-resident individuals (A) and (B) who have never been resident of Canada each contribute property to a non-resident trust in year 1 of the trust. A becomes a resident of Canada in the 10th year of the trust. A will become a resident contributor to the trust after he has resided in Canada for 60 months (i.e. year 16 of the trust). Income will have accumulated with respect to the funds contributed by both A and B for the first 15 years of the trust and that income would have been accumulated and included in the non-resident portion.

In the above example, once A becomes a resident contributor, his contribution would appear to no longer be included in the non-resident portion and would be included in the resident portion. It is unclear how the income accumulated on the funds from both contributions over the 15 year period should be allocated between the resident and non-resident portions of the trust.

Also, the Former Proposals provided that, if a person (who at some earlier time was a Canadian resident) made a contribution to a non-resident trust that would have been made at a non-resident time but was determined not to be because the contributor became a resident of

Canada within 60 months from the time of the contribution, the trust will be subject to Canadian tax retroactively from time of the contribution. In this situation the proposed attribution rule could produce anomalous results.

For example:

> An individual (X) is a former Canadian resident that has been a non-resident of Canada for more than 60 months. X makes a contribution of $100 to a non-resident trust. A Canadian resident individual (Y) contributes $150 to the trust and is a resident contributor. The resident portion would be $150 and the non-resident portion would be $100. The resident portion is segregated from the non-resident portion. Income from the resident portion ($150) is attributed to Y. If X returns to Canada within 60 months from the time of his contribution (say in the 5th taxation year of the trust) then X also becomes a resident contributor.

In the above example, would the $100 contributed by X retroactively form part of the resident portion? If so, then the income attributed to Y should have been $150/$250 of the income from both contributions. This suggests that Y will have to amend his or her returns for the amount of attributed income reported. The trust would also have to amend its Canadian returns to report the income from the resident portion which was also the case under the Former Proposals.

Recommendation

We recommend that the above matters be addressed.

(e) Character of Attributed Income

The Budget does not state whether income attributed to a resident contributor will retain its character. In the situation where a NRT receives a dividend from a corporation resident in Canada, for example, and a portion of that dividend is attributed to a Canadian individual, it would seem appropriate to allow the individual to claim the dividend tax credit in respect of the attributed portion of the dividend.

Recommendation

We recommend that the character of income attributed to resident contributors under these new rules be maintained in the hands of the resident contributor.

3. Deemed Transfer Rules

Items A.1 and A.2 of the Previous Submission set out examples encountered in applying the deemed transfer rules in subsection 94(2) of the Former Proposals.

In addition, we have the following comments.

(a) Paragraph (a) of the Definition of "Arm's Length Transfer"

We understand that paragraph (a) of the definition of "arm's length transfer" is intended to provide that a "contribution" to a trust includes a transfer of property that may otherwise be for arm's length consideration, if a reason for the transfer was because a Canadian resident or former Canadian resident person would acquire an interest as a beneficiary of a non-resident trust. We understand that Finance is concerned that such a person may become a beneficiary after the time of the transfer of property – i.e., a "springing beneficiary".

We are concerned that this provision is so broad that it can include a situation where no such beneficiary has been, or ever will be, a resident of Canada.

For example:

> A non-resident contributes funds to a foreign trust with no Canadian beneficiaries. The trust uses the funds to subscribe for shares of a wholly-owned Canadian corporation (Canco). Under paragraph 94(2)(g) of the Former Proposals, the issuance of shares to the trust is deemed to be a "transfer" by Canco to the trust. This would be a "contribution" by Canco to the trust (and therefore the NRT rules would apply) unless it is an "arm's length transfer." The issuance of shares by Canco to the trust will not qualify as an arm's length transfer if a reason for the acquisition of the shares is the acquisition by any entity of an interest as beneficiary of the trust.

In the above example, the subscription for shares of Canco and a contemporaneous contribution to the trust by the non-resident settlor would cause Canco to be a Canadian resident contributor to the trust.

Similarly, there could be a deemed contribution to the trust in the above example if the trust uses funds contributed by a non-resident settlor to purchase an asset from a Canadian resident seller, even if the sale is at fair market value. It would be unfair to deem the Canadian seller to be a resident contributor subject to tax under these circumstances. Furthermore, the Canadian seller may not even be aware of this potential liability.

Even if the non-resident trust is funded by a Canadian resident contributor, a Canadian seller may not know that it could be a resident contributor of the trust. If a Canadian settlor contributes funds to a foreign trust and the trust uses the funds to purchase property from a Canadian seller at fair market value in a transaction that does not qualify as an arm's length transfer, the Budget proposals suggest that both the Canadian settlor and the Canadian purchaser would be resident contributors under the attribution rule.

We note that, because of the broad definition of "beneficiary" under the Former Proposals, the concept of an acquisition of an "interest" as a beneficiary in the trust is very broad and includes persons who would be "beneficially interested" (as defined in subsection 248(25)) in the trust as well as other persons who would not otherwise be beneficiaries.

Recommendation

We recommend that paragraph (a) of the definition of arm's length transfer be replaced with a targeted anti-avoidance rule that specifically addresses the Department of Finance's concern with respect to "springing beneficiaries" or transfers of restricted property.

(b) Paragraph (b) of the Definition of "Arm's Length Transfer"

Under the preceding heading, we referred to a transaction whereby funds contributed to a non-resident trust by a non-resident are used by the trust to acquire shares of a wholly-owned Canadian corporation. This example also illustrates a concern under paragraph (b) of the definition of arm's length transfer, which essentially requires that the transfer must be on an arm's length basis, having regard only to the transfer.

For example, assume that a non-resident contributes $100 to a foreign trust with no Canadian beneficiaries. The trust uses the $100 to subscribe for 100 shares of a wholly-owned Canadian corporation (Canco) in order to make investments into Canadian businesses. Subsequently, the trust subscribes for a further 100 common shares for cash of $100. Since Canco would be a wholly-owned subsidiary of the trust, it is reasonable to conclude that the result of the additional subscription is that the overall value of all of the shares of Canco is increased by the amount of the subscription no matter how many additional shares are issued (or, in fact, whether any shares are issued at all). Nevertheless, if the additional common shares are not acquired for a price exactly equal to the fair market value of those additional shares, the test in paragraph (b) may not be satisfied.

Recommendation

It is recommended that an exception to the arm's length transfer requirement be provided for the acquisition of shares of a corporation that is wholly-owned by a foreign trust. This exception should also be subject to the targeted anti-avoidance rule referred to in (a) above.

(c) Paragraph 94(2)(c)

In item A.1 of the Previous Submission, we commented that paragraph 94(2)(c) of the Former Proposals is unnecessarily broad and catches arrangements where there is no tax-avoidance motive. In the Previous Submission, we set out the example of a non resident trust that acquires a portfolio investment in shares of Pubco, a widely held Canadian public company that has subsidiaries throughout Canada and the world. One subsidiary loans funds to (or guarantees the debt of) another subsidiary for inadequate consideration. Under the Former Proposals, the first subsidiary will be a contributor to the trust (the second subsidiary may be a contributor as well) and if the first subsidiary is a Canadian resident, it would be a resident contributor to the trust. Paragraph 94(2)(c) of the Former Proposals is so broadly written that even if the transaction between the PubCo subsidiaries had occurred before the trust owned any shares of PubCo, the first subsidiary of PubCo (and possibly the second subsidiary) will still be considered to be a contributor to the trust once the trust, or a corporation in which the trust has an interest, acquires a share of PubCo.

We understand that the purpose of paragraph 94(2)(c) of the Former Proposals was to deal with transfers to a trust (or to an entity in which the trust has an interest) that may be for fair market value consideration, or under terms which would be acceptable to persons dealing at arm's length, but that would result in the future growth from the transferred property benefitting the trust and its beneficiaries (which at some future time could include a Canadian resident or former Canadian resident). If so, we recommend that the provision be redrafted to specifically identify and address the concern.

Recommendation

Many of the technical issues raised in the Previous Submission could be addressed if a targeted anti-avoidance rule were to be introduced for springing beneficiaries and restricted property as discussed in 3(a) above where the value of the trust properties after the transfer was not increased by virtue of the transfer (as described in paragraph 94(2)(a)) .

If our recommendation that a targeted anti-avoidance rule is not accepted then a possible approach to deal with the above issues would require a modification to both proposed paragraphs 94(2)(a) and 94(2)(c). The modification to paragraph 94(2)(c) would be to add, after the reference to "arm's length transfer" in subparagraph (i): "(if that definition were read without reference to subparagraph (b))."

Proposed paragraph 94(2)(a) currently would apply to those transfers where there was an economic transfer of value to the trust (or an entity in which the trust had an interest). This paragraph would be modified by replacing clause 94(2)(a)(ii)(A) with "the fair market value of one or more properties held by the trust increases at that time (except where the increase of one property is equal to the decrease in the fair market value of one or more properties held by the trust at the time of the transfer)".

The intended purpose of the modification to paragraph 94(2)(c) would be that if the transfer was not for arm's length consideration or under non arm's length terms then there should not be a deemed transfer to the trust unless the transfer was made where there was a springing beneficiary (e.g. where the transfer was made in a circumstance where a Canadian resident or former Canadian resident may acquire an interest as a beneficiary in the trust). Paragraph 94(2)(a) should apply only where there was an economic transfer of value or property to the trust considering the trust properties as a whole as opposed to individually as drafted in the Former Proposals.

(d) Paragraph 94(2)(f) – Services

Paragraph 94(2)(f) of the Former Proposals deems services provided (other than trust administrative services) to a trust for inadequate consideration to be contributions of property to the trust.

In item A.2 of the Previous Submission, we set out the example of a person such as an accountant or lawyer who provides assistance to a non-resident trust (other than trust administration), or a corporation that is owned by the trust, because the person is related or has a personal relationship to the beneficiaries or trustees of the trust. The provision of such services in a large number of cases would not be to avoid or defer Canadian tax on the properties held in the trust or a corporation owned by a trust.

We assume that the reason the Department of Finance has deemed the provision of services to be a transfer of property to a trust is to address the concern that significant value could be indirectly transferred to a trust if services were not adequately paid for by the trust (or by an entity owned by the trust).

Our concern is that there can be many services provided to a trust (or an entity in which the trust has an interest) in respect of which the arm's length transfer rule would not apply. In many cases, the definition of "exempt service" will not be satisfied simply because both those definitions require there to be arm's length consideration for the service having regard *only* to the service provided. An example of this is also included in item A.2 of the Previous Submission, where an individual resident in Canada is both a 50% shareholder and director of NRCo, a non-resident private company. The other 50% of the shares of NRCo are held by a foreign trust with unrelated foreign beneficiaries and the settlor of the foreign trust is the other director of NRCo. Since both the exempt service and arm's length transfer definitions require that *only* the service and the compensation for the service be considered, if the Canadian director acts without compensation, that person would be deemed under paragraph 94(2)(f) to have made a transfer of property to the trust and the trust would be deemed to be resident in Canada thereby creating potential Canadian tax liability for the Canadian director, the trust and its beneficiaries.

We are concerned that there could be many services provided that would not satisfy the exempt service definition and that do not result in any real accumulation of property in a non-resident trust.

Recommendation

Paragraph (a) of the definition of exempt service should be modified to refer to: "where the recipient is at that time a trust or a corporation that is controlled by the trust, administrative, accounting, legal or similar services provided to the trust or corporation" and clause (b)(iii)(A) of the definition of exempt service should be changed to delete the words "having regard only to the service and the exchange".

(e) Non-Resident Time Definition

In item A.6 of the Previous Submission we set out an example of the inappropriate application of paragraph 94(2)(n) and the definition of "non-resident time" under the Former Proposals, where a non resident trust with Canadian beneficiaries was settled by a non-resident individual who was not a connected contributor to the trust, but there is a subsequent transfer of property from the old trust to a new non-resident trust with Canadian beneficiaries that is formed following the death of the settlor. In that case, the new trust would be subject to section 94 because paragraph 94(2)(n) deems a contribution to the old trust to be a contribution to the new trust at the time of the subsequent transfer. As the settlor would no longer be alive at the time of the subsequent transfer, the time of the subsequent transfer cannot be at a "non-resident time" because the definition of non-resident time ends at the time of death. As a result the new trust would be caught by proposed section 94.

Recommendation

Paragraph 94(2)(n) of the Former Proposals should not deem a contribution made by one trust to another trust to be made by an individual who was a contributor to the first trust if that individual was deceased at the time the first trust contributed property to the second trust and the individual was not a connected contributor to the first trust.

4. Foreign Tax Credit Rules

The Budget proposes to expand the application of the foreign tax credit rules so that a trust deemed resident in Canada will receive a full tax credit for the taxes paid to the other country that considers the trust resident. While this is a welcome change, we are concerned that flexibility is necessary with respect to the timing of the foreign tax credit because other countries may include amounts in income, including investment income, in taxation years that are different from the taxation years in which the income is included in income for Canadian tax purposes.

For example, some countries may include interest in income on a cash basis and other countries on an accrual basis. For Canadian tax purposes, depending upon the circumstances, interest may be included in income on a cash basis or on a modified accrual basis (per subsection 12(4)). Further examples are set out in item A.4 of the Previous Submission.

As mentioned in the Previous Submission, we are also concerned that that the Canadian tax payable under the NRT provisions would be determined based on income calculated in Canadian dollars, whereas foreign tax will be calculated based on income calculated in a foreign currency. The 21-year deemed disposition of the trust's assets could also result in a mismatch between Canadian and foreign taxes.

Recommendation

We recommend that foreign tax credits, including non-business foreign tax credits, in respect of deemed resident trusts be permitted to be carried back to previous taxation years of the trust and forward to future taxation years of the trust to ensure that the trust gets credit for all foreign taxes paid. The same concept with the carry over of foreign tax credits should apply for any income attributed to a resident contributor.

We recommend that a taxpayer should be entitled to make a functional currency election in determining the income of a non-resident trust. Where a non-resident trust has never held taxable Canadian property, the 21-year deemed disposition rule should not apply until 21 years after the trust becomes subject to the NRT rules.

5. Income Tax Conventions Interpretations Act

The Budget proposes to amend the ITCIA to clarify that a trust that is deemed to be a resident of Canada under the Budget proposals is a resident of Canada and subject to tax under the Act for tax treaty purposes. The Budget materials do not indicate whether this change to the ITCIA is intended to be a “treaty override”.

For example, where a trust is resident in both countries under each country’s domestic law the treaty Canada has with the other country may provide a “tie breaker rule” to determine the trust’s residency for the purposes of the treaty. If the residency of the trust is determined to be in the foreign country under the tie breaker rule of the particular treaty then subsection 250(5) should apply to deem the trust to not be a resident of Canada for the purposes of the Act.

In item A.3 of the Previous Submissions, we noted that many Canadians contribute to foreign trusts for legitimate family reasons unrelated to tax. Where it can clearly be demonstrated that there is no tax avoidance motive or potential for tax avoidance, a foreign trust should not be subject to the Budget proposals. In these cases, where the trust is otherwise resident in a treaty jurisdiction, it should be possible to resolve the matter of residence using the competent authority procedures under that treaty.

Recommendation

It is recommended that the amendment to the ITCIA clearly reflect that the amendment is meant to ensure that a trust subject to the NRT rules will be considered to be Canadian resident for the purposes of applying Canada’s treaties, but will not override a trust’s residency determination under tie breaker rules in a treaty or the possibility of a determination of residence under a treaty.

6. Commercial Trusts

We are pleased that the Budget reaffirms that the NRT provisions are not intended to apply to bona fide commercial trusts. The proposal to remove the reference to “restricted property” is a welcome change, but we are concerned that practical issues remain. Some of these concerns are set out in item A.9 of the Previous Submission.

In addition, we have the following comments.

(a) Transfer of Interest

The Budget proposals state that, in order to qualify under the proposed new exemption for commercial trusts, any transfer of an interest by a beneficiary must result in a disposition for the purposes of the Act and interests in the trust cannot cease to exist otherwise than as a consequence of a redemption or cancellation under which the beneficiary is entitled to receive the fair market value of the interests. It is also proposed that there will be a limited safe harbour which will permit unitholders to disclaim a *de minimus* interest in the trust. We assume that similar changes will be made to the exemption for commercial trusts in the existing provisions in the Former Proposals.

As indicated in the Previous Submission, there are cases where a unit of a commercial trust may cease to exist without a transfer that is a disposition. The example given in the Previous Submission is a merger whereby units of a trust cease to exist and unitholders receive units of a new trust or other entity, without a specific redemption or transfer of the old units. A further example is a unit that is issued to an employee under the equivalent of a "restricted stock plan"; in that case, the units may be redeemed for no consideration if the employee does not fulfil the requirements to become "vested" in the units under the plan.

Many commercial trusts also permit a compulsory redemption of units if the unitholder does not meet certain eligibility requirements which could relate to tax, securities or money-laundering laws. In such cases, the units may be redeemable for the net asset value of the units, which may not necessarily be equal to the fair market value of the units.

Some commercial trusts also permit the trust to withhold from, or delay payment of, amounts otherwise payable to redeeming unitholders, where permitted or required by law – i.e., to comply with tax or money-laundering requirements.

Recommendation

We recommend that the concept of "transfer" be drafted to exclude bona fide commercial arrangements whereby a unit may be redeemed or cancelled under a merger or in the case of an employee benefit arrangement.

We recommend that references to the "fair market value" of a beneficiary's interest be defined as including an amount determined by reference to the assets or earnings of the trust where the determination may reasonably be considered to be used to determine an amount that approximates the fair market value of the beneficiary's interest.

The concept of "entitlement" to the fair market value of units should be broad enough to cover the possibility of withholdings or delays in payment in order to comply with relevant laws.

(b) Discretionary Power

There are a number of definitions in the Former Proposals which refer to the exercise or failure to exercise a discretionary power: see the definitions of "eligible trust" and "specified fixed interest" for example.

The Explanatory Notes to the Former Proposals say that an example of a discretionary power is a "power to appoint beneficiaries of the trust." The Budget materials suggest that a discretion only with respect to the timing of distributions is not intended to be caught. It is not clear whether this exception will be drafted to apply to all uses of the term "discretionary power" in the Former Proposals. In item A.9 of the Previous Submission, we provided an example of a provision in a typical commercial trust which gives the trust administrator discretion to determine the amount of the "distributable cash" which is to be distributed to unitholders. This type of discretion is not objectionable as a commercial matter because it applies to all beneficiaries, so that no beneficiary may be prejudiced. Such provisions could apply on a class by class basis where, for example, the trust is a unit trust with classes of units with each class having a beneficial interest in segregated assets for unitholders of that class. Since this discretion relates to the amount of distributions to unitholders, it is not clear whether it will come within the exception for discretion relating to timing only.

Some trusts provide for discretionary distributions to address a concern that, absent such discretion, the trust's units would be classified as liabilities under International Financial Reporting Standards (IFRS).

In 1991, the Canada Revenue Agency issued a technical interpretation[1] which advised that, for the purposes of existing subparagraphs 94(1)(c)(i) and (ii) of the Act, the words: “where the amount of the income or capital of the trust to be distributed at any time to any beneficiary of the trust depends upon the exercise by any person of, ..., any discretionary power" would not apply where the proportionate entitlements of the beneficiaries are fixed and the only discretion of the trustees is as to the amount to be distributed at any time on a prorata basis to each beneficiary and the timing of such prorata distributions. The technical interpretation went on to state that those provisions only operated where the trustees, pursuant to the trust indenture, have the discretionary power to distribute the income and capital of the trust to one or more beneficiaries at the exclusion of others.

It would appear, however, the Canada Revenue Agency is unwilling to follow this approach in interpreting the exemption for commercial trusts under the Former Proposals. In response to Question 49 at the Table Ronde sur la Fiscalité Fédérale of the 2008 Congress of L'Association de Planification Fiscale et Financière,[2] Canada Revenue Agency officials stated:

> If the discretionary power of the trustee relates only to the choice of the payment date of an amount of income or capital and that amount does not change as a result of this choice, this power would not normally have an impact on the status as an eligible trust for the purposes of paragraph (h) of the definition of exempt foreign trust in subsection 94(1) of the legislation proposed in Bill C-10. On the other hand, our view is that the amount of income or capital of a beneficiary would depend on the exercise or the failure to exercise a discretionary power in a situation where the income or capital is allocated among the beneficiaries on the basis of the share held in the trust at a particular time and where the discretionary power as to the timing of the distributions, is also a discretionary power in respect of the particular time chosen for the allocation of the income or capital among the beneficiaries. In this last case, the share of income or capital allocated to each of the beneficiaries could vary in a taxation year depending on the exercise of this discretion.

The meaning of the above is not clear, but it appears that if a trustee has discretion to set a record date for distributions to unitholders, this could be considered to be a discretionary power in respect of the particular time chosen for the allocation of income or capital. This discretion is found in many bona fide commercial trusts and should not be objectionable since all unitholders of the same class would be treated in the same way.

[1] CRA document JA91_190 (January 15, 1991)
[2] CRA document 2008-0285471C6 (October 10, 2008)

Recommendation

We recommend that the provisions referring to discretionary power be revised to clarify that they apply only to discretionary powers to appoint new beneficiaries of the trust, or to prefer one beneficiary over another and not where all beneficiaries (of the same class) are treated alike.

(c) Issuance at Fair Market Value

The definition of "specified contributor" requires trust interests to be issued for fair market value consideration. As discussed in item A.9 of the Previous Submission, there are legitimate situations where a trust may issue units at an amount, such as net asset value, which may not be the same as fair market value. Examples in the Previous Submission are reinvestments of distributable income and rights offerings.

Recommendation

We recommend that an exception from the fair market value requirement in the definition of "specified contributor" should be available where all unitholders (of the same class) are treated alike. This would be analogous to the exception from the existing shareholder benefit rules in paragraph 15(1)(c).

See also our recommendation above regarding the use of a formula redemption price to approximate the fair market value of an interest in a trust. The reference to fair market value in the definition of "specified contributor" should include the same provision.

(d) Changes in terms of a Trust

The proposed exception for commercial trusts in the Budget proposals requires that the terms of the trust cannot be varied without the consent of all the beneficiaries or, in the case or a widely-held trust, a majority of the beneficiaries.

The terms of many bona fide commercial trusts typically provide that they may be varied without the consent of the beneficiaries to address errors in drafting or non-material regulatory, administrative or tax changes. For example, a typical commercial trust will permit the trustee to amend, modify, alter or add to the provisions of the trust that do not materially prejudice the interests of the then existing unitholders, that are necessary to comply with fiscal, statutory or other legal or quasi-legal requirements, or to correct manifest errors.

Recommendation

We recommend that the above types of changes to the terms of a trust should be permitted.

It should be clarified that the reference to "beneficiaries" under this provision refers only to the actual beneficiaries (unitholders) of the trust and not to the persons that could be included in the broader definition of "beneficiaries" in the Former Proposals.

(e) Non-Permitted Variance

The Budget proposals state that, if a trust is varied in a non-permitted way, it will cease to be an exempt commercial trust and be taxable on its accumulated income together with an interest amount. While we recognize the Department of Finance's concern about the use of the commercial trust exemption in tax-avoidance situations, we are concerned about the reference to "non-permitted" variance. We assume that this refers only to variances which are not permitted under the rule discussed under the previous heading.

The retroactive application of the NRT provisions as a result of a non-permitted variance of a trust does not take into account the commercial reality that bona fide commercial trusts, particularly those whose units are listed, are acquired from time to time, including as part of a privatization, and the trust terms may be varied in a very legitimate manner that does not justify the application of this proposed anti-avoidance provision.

Recommendation

A non-permitted variance should give rise to retroactive tax only where there is an anti-avoidance motive for making the change.

7. Tax Exempt Contributors and Beneficiaries

The Budget proposes that there will be an exemption from resident contributor and resident beneficiary status for all persons exempt from tax under section 149. We agree that it is appropriate to include all tax exempts in this exemption.

We note, however, that the Department of Finance comfort letters that were issued in April 2008 also contemplate an exemption being provided in respect of "certain Canadian intermediaries" that were referred to as corporations and trusts (including segregated fund trusts) in which qualifying pension entities are the only beneficiaries and holders of participating debt. The Budget does not refer to this category of exemption. If this exemption is not included in the final legislation in a manner that such intermediaries (or their investors) are adversely affected, it would be unfair to those who relied on the comfort letters.

We also note that the Budget proposes that an anti-avoidance measure will be included to ensure that a tax-exempt entity is not used as a "conduit to allow a resident of Canada to make an indirect contribution to a non-resident trust." While we understand that the Department of Finance may be concerned about the abuse of the exemption for tax exempts, we would be concerned if the anti-avoidance provision is framed in a way that results in potential liability for the trustee of the trust or a potential detrimental economic affect on the other investors to the trust. If the trustee or such other investors could be detrimentally affected, it could affect the ability of a Canadian tax exempt to invest in the trust – the administrator of the trust may not permit the investment if it cannot be satisfied that the trust and its other investors will not be affected by having a Canadian tax exempt investor.

Recommendation

The final legislation should not impose tax liability on Canadian intermediaries (including segregated fund trusts) or their investors referred to in the issued comfort letters.

The proposed anti-avoidance rule should not impose potential liability on the trustee of a commercial trust or detrimentally affect the trust's other investors.

8. Restricted Property

The Budget proposes to narrow the definition of "restricted property" so that it is limited to shares or rights (or property that derives its value from such shares or rights) acquired, held, loaned or transferred by a taxpayer as part of a series of transactions or events in which "specified shares" of a closely-held corporation were issued at a tax cost less than their fair market value. We understand that this definition is targeted at "international estate freezes." We assume that the reference to "tax cost" refers to Canadian tax cost and that the definition is targeted at transactions which involve a Canadian tax rollover. We note however that section 86 provides for a rollover where shares of a non-resident corporation are disposed of as part of a reorganization of capital. This could create issues where there is no international estate freeze, but a foreign corporation undergoes a reorganization at the same time as an investment is made by a non-resident trust.

Recommendation

We submit that the reference to shares "issued at a tax cost less than their fair market value" in the revised definition of "restricted property" should not apply to shares of a non-resident corporation issued under a section 86 rollover outside the context of an international estate freeze.

C. PARAGRAPH 94(1)(d) TRUSTS

1. Estates, Testamentary Trusts and Other Personal Trusts

The Budget proposes that existing paragraph 94(1)(d) of the Act will apply to a non-resident trust that is not otherwise deemed resident in Canada. In this regard, the Budget proposes that the rules will be broadened to apply to any resident beneficiary who, together with any person not dealing at arm's length with the beneficiary, holds 10% or more of the value of all interests in the trust.

We are concerned that this provision could apply to a small non-discretionary interest in a non-resident estate, testamentary trust, or other personal trust. For example, a Canadian resident individual could have a small percentage (say less than 1%) of a non-discretionary interest in a non-resident estate, testamentary trust or other personal trust. If other beneficiaries of the trust are related to the Canadian individual (which is likely the case in a family situation), the Canadian individual could be subject to the modified FAPI provisions in paragraph 94(1)(d) in respect of his/her less than 1% interest. This would be the case if the Canadian individual, together with non-arm's length persons, have a greater than 10% interest in the trust.

Recommendation

We recommend that paragraph 94(1)(d) should not apply to an interest in an estate, testamentary trust, or personal trust that was not acquired for consideration.

2. Foreign Affiliate Treatment of Paragraph 94(1)(d) Trusts

The Budget proposes to expand the application of paragraph 94(1)(d) to non-discretionary trusts which deems those trusts to be corporations for certain provisions of the foreign affiliate and foreign accrual property income rules. The current enacted version of paragraph 94(1)(d) does not deem the trust to be a foreign affiliate for all purposes of the foreign affiliate system (such as surplus computation etc). It would seem appropriate for these trusts to be subject to the entire foreign affiliate system and not just certain rules within that system. This approach would seem to be consistent with the recommendations of the Minister of Finance's Advisory Panel on Canada's System of International Taxation with respect to the treatment of offshore entities that are not corporations.

Recommendation

It is recommended that trusts that are subject to paragraph 94(1)(d) be deemed to be foreign affiliates and be subject to all the foreign affiliate rules and not just certain rules within that system.

D. OIF RULES

1. Application of the OIF Rules to Widely-Held Trusts

If a widely-held trust has previously included in its income an amount under the former proposed FIE rules in the Former Proposals, it can either file amended returns for those previous years to back-out the income or take a deduction in its 2010 taxation year for the net over-reported amount.

For a trust with many unitholders, the reassessment of prior years option is impractical, as it would require the reissuing of T3 slips for several years to potentially thousands of taxpayers (many of whom may no longer hold units in the fund). It will also place a heavy burden on Canada Revenue Agency to process all of these amended returns and then input that information to allow for the funds to be accurately assessed for current taxation years (for example: situations where in previous years the FIE income under the Former Proposals was offset by losses of the fund. An amended return will result in the reinstatement of those losses to possibly be used in current years).

As well, there may be a trapped loss issue if a fund does not otherwise have any income - that is, its only income for tax purposes over the past years has been FIE income and otherwise it generally earns capital gains. The deduction in 2010 is of limited utility as it will merely generate a large non-capital loss that may never be used.

Recommendation

We recommend that a single information return should be permitted to be issued to each affected unitholder that would show the unitholder's cumulative FIE income inclusion amount over the relevant years, and that the unitholder be permitted to deduct the cumulative amount in 2010. In addition, should the deduction exceed the unitholder's Division B income without reference to the deduction, the definition of a non-capital loss in section 111 should be amended as needed to ensure that the excess deduction is treated as a non-capital loss.

2. 60 Month Immigration Exemption

The former FIE rules included an exception for individuals (other than trusts) who, before the end of the tax year, were resident in Canada for a period that, or periods the total time of which, did not exceed 60 months.

The Budget made no reference or comment as to whether this exception would be continued. If immigrants are to continue to be excepted from the application of the NRT rules under the Budget (by virtue of not qualifying as a resident contributor) then it follows that they should similarly be excepted from the OIF rules.

Recommendation

It is recommended that an exception from the OIF rules include individuals (other than trusts) who, before the end of the tax year, were resident in Canada for a period that, or periods the total time of which, did not exceed 60 months.

The Joint Committee on Taxation of
The Canadian Bar Association
and
The Canadian Institute of Chartered Accountants
The Canadian Institute of Chartered Accountants 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

January 7, 2009

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, Ontario

Dear Minister,

Re: Non-Resident Trusts and Foreign Investment Entities

We are writing to urge you to accept the recommendation of the Advisory Panel on Canada's System of International Taxation to reconsider the proposed "non-resident trust" (NRT) and "foreign investment entity" (FIE) rules that were contained in Bill C-10.

The Advisory Panel believes that the proposed NRT and FIE rules should be reconsidered to ensure that their need and scope are consistent with the Advisory Panel's recommendations in its Final Report and the principles enunciated in that report regarding the international taxation of outbound investments.

In our submission to the Advisory Panel, the Joint Committee on Taxation made the following recommendations with respect to these provisions:

> The NRT rules should be rewritten to deal only with the type of tax planning which is intended to be prevented – i.e., the use of foreign trusts to accumulate income offshore without tax for the benefit of an ultimate Canadian beneficiary.
>
> The NRT, FIE and FAPI [foreign accrual property income] rules should be coordinated. The NRT rules should be limited to anti-avoidance situations as discussed above. Taxpayers should be able to elect to have the FAPI rules apply to trusts and to non-controlled entities (both corporations and trusts) where sufficient information is available to enable the determination of the amounts included in income. The FIE rules should be rewritten to apply only where the FAPI rules do not apply <u>and</u> it is reasonable to consider that one of the main reasons for making the investment in the foreign entity is to earn a profit or

> return attributable to underlying activities of the foreign entity that would generate FAPI if the foreign entity were a [controlled foreign affiliate] of the Canadian investor. There should also be an exemption from the FIE rules where the underlying FAPI of the foreign entity is subject to a significant level of foreign tax – i.e., a rate that is not significantly more favourable than the Canadian rates.

In our view, our recommendations are consistent with the Advisory Panel's conclusions and, in particular, their recommendation that consideration be given to

1. moving to a broader exemption system for taxing active business income of foreign affiliates,
2. taxing passive income of a foreign affiliate under the FAPI regime, and
3. expanding the definition of "foreign affiliate" to include non-corporate entities or associations, such as trusts.

As you will recall, members of the Joint Committee on Taxation were part of the group of four tax lawyers and accountants that met with you in June to discuss our concerns with these provisions. After that meeting, the Joint Committee had additional discussions with your officials to provide them with examples of concerns that arise in practice under these proposals. Attached for your information are the notes that we provided to your officials.

One of the principles enunciated in the Advisory Panel's Final Report is the need for straightforward tax rules. The proposed NRT and FIE rules are anything but straightforward. In many cases it is virtually impossible for taxpayers to determine whether the proposed NRT and FIE rules apply. The Final Report also emphasizes the need for "...anti-avoidance rules that target the problem directly without affecting a wider range of taxpayers than absolutely necessary." The attached materials provide examples of how the proposed NRT and FIE rules affect a much wider range of taxpayers than is necessary to address the Department of Finance's tax policy concerns.

We urge you to accept the Advisory Panel's recommendation to review the proposed NRT and FIE rules. Bill C-10 provided that these rules would be applicable to taxation years that begin after 2006. We recommend that you defer the implementation of the rules until that review is completed.

While the focus of this letter is on the NRT and FIE rules, we would like to comment on two other matters that were discussed in the Final Report:

1. We urge you to accept the Advisory Panel's recommendation to repeal section 18.2 of the *Income Tax Act*. In our view, section 18.2 does not effectively address any of the issues discussed by the Advisory Panel relating either to the use of debt by foreign-owned

corporations or the deductibility of domestic costs relating to foreign investment. Further, the provision impairs the competitiveness, efficiency and fairness of Canada's system of international taxation. In the current economic environment it is critical to ensure that Canada's tax system promotes (rather than hinders) the competitiveness of Canadian firms.

The application of section 18.2 is deferred until periods beginning after 2011 in order to give taxpayers time to reorganize their affairs to avoid the effect of the section. We recommend that you announce your intention to repeal section 18.2 as soon as possible, so that affected taxpayers will not have to incur unnecessary time and expense to restructure their affairs to comply with the provision.

2. The Advisory Panel has recommended that a measure be introduced to deal with tax-motivated "debt-dumping" transactions within related corporate groups. While we understand the policy reasons for such a provision, in our view it is important to ensure that any implementing legislation is drafted in accordance with the principles enunciated by the Advisory Panel that tax rules should be straightforward and should target the problem directly without being overreaching. We think it is also important to provide a generous grandfathering exemption for indebtedness (and any refinancing of that indebtedness) that was in place or committed to prior to the announcement of any new rules.

Finally, we agree with the Advisory Panel that any proposal should be subject to full consultation with interested stakeholders before proceeding with the release of draft legislation. The Joint Committee on Taxation would be pleased to be part of that process.

Yours truly,

John Van Ogtrop
Chair, Income Tax Committee
Canadian Institute of Chartered Accountants

Paul Tamaki
Chair, National Tax Section
Canadian Bar Association

cc: Brian Ernewein, Director General, Tax Policy Branch, Finance Canada
Gérard Lalonde, Director, Tax Legislation Division, Tax Policy Branch, Finance Canada

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November 19, 2008

CBA – CICA Joint Committee on Taxation

Non-Resident Trust (NRT) and Foreign Investment Entity (NRT) Provisions

Points to Discuss

The Joint Committee's views and recommendations on the proposed NRT and FIE provisions are set out in our July 15, 2008 submission to the Advisory Panel on Canada's System of International Taxation.

The following are examples of concerns that arise in practice under the existing proposals.[1] These comments are not intended to be exhaustive.

A. Non Resident Trusts (NRT)

1. Paragraph 94(2)(c) is unnecessarily broad and catches arrangements where there is no anti-avoidance motive.

    Example

    A foreign trust with no Canadian contributor or Canadian beneficiary acquires a portfolio investment in publicly-listed shares of Can Pubco, a widely held Canadian public company. Can Pubco transfers an asset to a subsidiary of Can Pubco, for an interest-free promissory note. This transfer would not have occurred on the same terms if the transferor and the transferee dealt with each other at arm's length.

    The transaction would not satisfy the requirements of being an "arm's length transfer" as defined in subsection 94(1). Paragraph 94(2)(c) would deem Can Pubco to have transferred property to the foreign trust, resulting in potential Canadian tax liability for both Can Pubco, the foreign trust and its beneficiaries. This would also appear to be the case even where the transaction was completed before the foreign trust owned any shares of Can Pubco.

   There would be the same result if the transfer is from one controlled foreign affiliate of Can Pubco to a second entity in which Can Pubco has a direct or indirect interest. Under paragraph 94(2)(l), Can Pubco would be deemed to have jointly made the transfer to the second entity if the transfer is made at the direction of or with the acquiescence of Can Pubco. If Can Pubco controls the transferor, it may be difficult to conclude that Can Pubco did not acquiesce in the transfer.

   There also would be the same result in the case of an intercompany loan (paragraph 94(2)(c)), guarantee (paragraph 94(2)(e)) or provision of services (paragraph 94(2)(f)) by Can Pubco (or any Canadian subsidiary or controlled foreign affiliate of Can Pubco) in favour of any other entity in which Can Pubco has a direct or indirect interest, if the terms are not arm's -length.

2. Paragraph 94(2)(f) applies with respect to services rendered directly or indirectly to a trust. In order for a service to a trust to not be deemed to be a transfer to the trust

[1] References to provisions of the Income Tax Act (the "Act") are to the provisions of the Act as proposed to be amended by Bill C-10.

under the NRT rules, the service must be an exempt service or an arm's length transfer. To be an exempt service or arm's length transfer, it must be reasonable to conclude, having regard *only* to the service provided to the trust, that the provider would have been willing to provide the service if the provider had been dealing at arm's length with the trust, and the terms, conditions and circumstances under which the service was provided would have been acceptable to the service provider if the service provider dealt at arm's length with the trust.

Legitimate arrangements may not on arm's length terms, especially if analysed on an unbundled basis.

> Example
>
> A Canadian resident individual with a particular skill or knowledge (such as a lawyer, accountant or investment advisor) provides assistance (other than with respect to trust administration) to a foreign trust simply because of a personal relationship with the beneficiaries or trustees of the trust or for any other non-tax reason. The individual does not charge for the services or charges less than an arm's-length amount.
>
> Paragraph 94(2)(f) would cause the Canadian to have made a contribution to the trust and cause the trust to be deemed resident in Canada.

There would be the same result if the services are provided to a corporation in which the trust had an interest because paragraphs 94(2)(f) and 94(2)(c) would deem the individual to have transferred property to the trust.

> Example
>
> An individual resident in Canada is both a 50% shareholder and director of NRCo, a non-resident private company. The other 50% of the shares of NRCo are held by a foreign trust with unrelated foreign beneficiaries and the settlor of the foreign trust is the other director of NRCo. The two directors act without compensation.
>
> Since both the exempt service and arm's length transfer definitions require that *only* the service and the compensation for the service be considered, the Canadian director would be deemed under paragraph 94(2)(f) to have made a transfer of property to the trust and the trust would be deemed to be resident in Canada thereby creating potential Canadian tax liability for the Canadian director, the trust and its beneficiaries.

3. In determining whether the rules apply, it is irrelevant whether the trust or its beneficiaries are taxable in their own jurisdictions at rates of tax comparable to the Canadian rates. Many Canadians create trusts in other jurisdictions for legitimate family reasons unrelated to tax.

Example

Canadian parents settle a trust for a child who lives outside Canada. For legal and family (non-tax) reasons, they wish to have a relative or family friend in that jurisdiction to act as trustee.

Where it can clearly be demonstrated that there is no tax avoidance motive or possibility of tax avoidance, a foreign trust should not be subject to the NRT rules. This can reasonably be expected to be the case, for example, where all of the income of the trust is taxed in either the trust or a beneficiary at rates comparable to Canadian rates. At the very least, it should be possible to resolve the matter of residence using the competent authority procedures of any applicable tax convention.

4. Foreign tax credits do not deal satisfactorily with double taxation issues, particularly for those trusts that are actually resident in a country that has a sophisticated tax system and a tax rate that is comparable to the Canadian tax rate.

If the trust has Canadian source income then no foreign tax credit can be claimed for Canadian tax purposes for any non-Canadian tax paid on that income. Subsection 20(11) can also limit the amount of the foreign tax credit claim to 15% of any non-Canadian source interest, dividend or similar property income.

The timing of deductions and income inclusions in the country of actual residence may differ from the year in which deductions or income is included for Canadian tax purposes.

For investment income (dividends, interest etc) there is no ability for Canadian tax purposes to carry foreign taxes paid in one year to another year.

The Canadian tax payable by the trust is determined using Canadian dollar values whereas the trust's foreign tax is determined using the relevant foreign currency. Thus the trust's capital gain for foreign tax purposes may be different from the gain as determined for Canadian tax purposes.

The basis for recognizing income in the foreign jurisdiction may be different from the Canadian rules.

Example

A US trust holds shares of a corporation and receives dividends from the corporation.

The US taxation of the dividend depends on whether the corporation is a fiscally transparent entity for US tax purposes, and if it is not fiscally transparent, whether the corporation is considered to have sufficient earning and profits for US tax purposes. These concepts are not applicable for Canadian tax purposes.

The application of the "21 year rule" under subsection 104(4) can also result in Canadian tax liability where there is no liability in the US. '

Double taxation relief may be available under a tax treaty, but this is a very inefficient process if it is necessary for a deemed resident trust to continuously approach the Canadian competent authority (or the competent authority of the country of actual residence) to eliminate double taxation problems.

5. Foreign tax credits may not be sufficient to deal with double taxation issues under the NRT provisions.

   Example

   A US trust is deemed resident in Canada because there is a Canadian resident contributor. Trust income is distributed by the trust to the US beneficiaries and is subject to Canadian withholding tax by virtue of subparagraph 94(3)(a)(ix). From a US perspective that Canadian withholding tax is on US source income and as a result a US foreign tax credit may not be allowed.

   A foreign tax credit would not relieve the trust and the Canadian contributor from liability in respect of Part XIII withholding tax on the distribution.

6. Paragraph 94(2)(n) and the definition of “non-resident time” can provide anomalous results.

   Example

   NRT, a non resident trust with Canadian beneficiaries, was settled by Mr. X, a non-resident individual, and is not subject to section 94 because Mr. X was not a connected contributor to the trust. Mr. X dies and NRT transfers its assets to NRT II, another non-resident trust with Canadian beneficiaries.

   NRT II will be subject to section 94 because paragraph 94(2)(n) deems a contribution to NRT to be a contributed to NRT II *at the time of the subsequent transfer*. Thus Mr. X is deemed to have made a transfer to the NRT II at the time of the subsequent transfer, but as he is dead at that time the time of contribution cannot be at a “non-resident time” because the definition of non-resident time ends at the time of death. Therefore, Mr. X is deemed to have made a transfer at a time other than a non-resident time and thereby becomes a connected contributed to NRT II and NRT II is subject to section 94.

7. The definition of “successor beneficiary” in subsection 94(1) is too narrow. It is not uncommon for nieces and nephews to be included as beneficiaries of an estate or trust particularly if all of the settlor’s or testator’s children are deceased at the time of a distribution.

   It is also not clear from the definition of successor beneficiary that a person would be a successor beneficiary if their entitlement to trust income or capital arises after the death of more than one person.

8. Under the NRT rules, Canadian taxpayers may unknowingly be contributors to a foreign trust and thereby be jointly and severally liable for all of the taxes of the trust.

The limitation in subsection 94(7) may not apply if the Canadian contributor does not file form T1141 on a timely basis. In many cases it is not reasonable to expect that the foreign trust will pay the Canadian tax or that the Canadian contributor can compel payment. Under the "revenue rule," one sovereign state will not enforce the tax laws of another. Furthermore, foreign trustees may be unwilling or unable to provide the Canadian contributor with information to contest a Canadian assessment.

9. The exemption in paragraph (h) of the definition of "exempt foreign trust" in subsection 94(1) is intended to cover investments in genuine commercial trusts, but in practice it is largely unworkable and ineffective because it does not reflect the reality of how investors invest in commercial trusts, or the structure and features of such trusts. In practice, investors and non-resident trusts have found it impossible to obtain the information that is required to determine whether the requirements of the exemption are satisfied. Given the significant liability that may be imposed on a commercial trust and its unitholders, managers of such funds may not permit Canadians to invest if there is any uncertainty whether the NRT rules may apply.

These concerns apply to both taxable and non-taxable investors. The legislative changes described in the April 2008 comfort letters issued by the Department of Finance will provide only limited assistance in excluding legitimate commercial trusts from the application of the NRT rules for a limited group of investors.

Example

Many investment funds are structured as "funds of funds" being an investment fund that itself invests in a wide array of other investment funds some of which may be non-resident trusts or may be corporations or partnerships that, in turn, invest in non-resident trusts. An investor in the top fund may have no idea whether or when that top fund will hold a direct or indirect investment in a non-resident trust. The manager of the top fund may have limited influence over a non-resident trust in which the top fund directly or indirectly invests. Consequently, it may be impossible to determine, for example, whether any Canadian contributor holds more than 10% of any class of the non-resident trust's units, or whether the non-resident trust holds restricted property.

A fund may be a trust, partnership or corporation. A Canadian investor can be caught by the NRT provisions even on an investment in a corporation, if that corporation makes a transfer to a non-exempt foreign trust which is caught by paragraph (b) or (c) of the definition of "contribution."

Example

A foreign corporation issues shares to the public and uses the funds to acquire units in non-resident trust. A Canadian individual subscribes for shares of the foreign corporation under the offering. As a result, there is a series of transactions whereby the individual transfers property to the foreign corporation and there is another transfer of property to the non-resident trust, and the second transfer is in respect of the first transfer.

> The Canadian individual is a “contributor” to the underlying non-resident trust under paragraph (b) of the definition of “contributor” in subsection 94(1). The exemption in that definition in respect of arm’s length transfers is not available if one of the reasons for both transfers is the acquisition by any entity (i.e., the top foreign corporation) of an interest as beneficiary under the non-resident trust (see paragraph (a) of the definition of “arm’s length transfer”). As a result, the non-resident trust is deemed to be resident in Canada.

The exception for commercial trusts in paragraph (h) of the definition of exempt foreign trust applies only were units in the trust are “specified fixed interests.” Paragraph (c) of the definition of “specified fixed interest” provides that the only manner in which any part of an interest in a commercial trust may cease is by way of a “transfer” that is a “disposition.” Commercial trusts may undergo transactions which do not involve a redemption or other form of transfer of units.

> Example
>
> A commercial trust undergoes a merger whereby units of a commercial trust cease to exist and unitholders receive units of a new trust or other securities, without a specific redemption of their units.
>
> Because the definition of “specified fixed interest” provides that the only way that an interest in the trust *may* cease is by way of a transfer, the mere possibility that units may cease to exist under such a transaction (i.e., without a transfer) may be sufficient to disqualify the trust from the outset.

Paragraph (d) of the definition of “specified fixed interest” provides that no amount of the income or capital of the trust that any entity may receive at any time can depend on the exercise of a “discretionary power.” Commercial trust declarations are not drafted with Canadian tax laws in mind and can provide trustees with discretion in respect of a number of matters which could affect the amount or timing or income or capital distributions of the trust. The technical notes indicate that the provision means in very general terms that no entity may hold a power to appoint beneficiaries under the trust, but the legislation itself is clearly much broader and there is significant uncertainty regarding how the courts or the CRA would interpret such language. It may also be impossible for some investors in non-resident trusts to obtain the relevant trust deeds in order to even identify the existence or nature of any discretionary power that might influence the particular amount of income or capital distributed by the trust.

> Example
>
> The declaration of trust for a commercial trust provides for multiple classes of units with different distribution entitlements. The declaration of trust provides that the trustees shall make regular distributions of “distributable cash” on a class by class basis, determined by deducting such reserves or other amounts as the trustees may determine, and may pay special distributions in such amounts and at such times as the trustees may determine in their sole discretion. The amount of distributable cash received by the trust

> also depends on the exercise of discretion by underlying entities of the trust.
>
> Since the trust has multiple classes of units, distributions are not made pro rata to all unitholders of all classes. Thus it is not clear whether CRA administrative practice with respect to the existing provisions applies: see for example CRA document 903515 (January 15, 1991).

Clause (d)(ii)(C) of the definition of “specified contributor” effectively requires units of a commercial trust to be acquired at fair market value whereas many foreign funds provide flexibility for other arrangements.

> Example
>
> A commercial trusts permits distributions to be reinvested at net asset value, which may not be fair market value. The trust also permits additional investments through rights offerings made available to all unitholders.

If a commercial trust cannot qualify under the exemption in respect of commercial funds with more than 150 qualifying investors, it must meet the more restrictive test in clause (h)(ii)(B) under which the trust cannot hold any “restricted property.” We understand that the provision is intended to cover participating shares of a corporation acquired by the trust as part of an international estate freeze, but the wording is much broader than this.

> Example
>
> A foreign commercial trust issues units to the public and uses the funds to acquire redeemable shares of a wholly owned corporate subsidiary of the foreign trust.
>
> The redeemable shares are restricted property because they are specified shares of a closely held corporation acquired by any entity in exchange for any property.

The exemption in clause (h)(ii)(B) also requires a form to be completed and filed with Canada Revenue Agency by or on behalf of the fund. In many cases, it is unreasonable to expect that a fund will file this form or authorize it to be filed on its behalf.

Even where a Canadian taxpayer invests in an exempt foreign trust (and might therefore think that the NRT rules cannot possibly apply), the rules might nevertheless apply as a result of the application of paragraph 95(2)(n), which provides that a contribution made by a particular trust to another trust is deemed to have been made jointly by the particular trust and by each entity that is a contributor to the particular trust. There is a similar concern discussed above under the broad definition of “contribution” in subsection 94(1).

Example

An exempt foreign trust issues units to the public and uses the funds to acquire units of a second non-resident trust.

Canadian unitholders of the exempt foreign trust are deemed to have made a contribution to the second non-resident trust. If the second non-resident trust is not an exempt foreign trust, the NRT provisions apply to the second non-resident trust and to the resident contributors to the exempt foreign trust.

10. Paragraph (f) of the definition of exempt foreign trust does not permit Canadian employees of foreign multinationals to participate in employee share plans even where they make up a very small proportion of the total plan membership.

B. Foreign Investment Entities

1. The major concern with the FIE rules is that it is not practical to expect that investors will be able to make the factual determinations necessary to decide whether the FIE rules apply to an investment or, if the investment is a FIE, to determine the amount of income from the investment which must be reported.

Example

A Canadian has a minority interest in a foreign trust that is not an exempt foreign trust under the NRT rules but is an FIE.

For the purpose of applying the FIE rules to the investment, the Canadian investor's designated cost of the investment is determined under paragraph 94.1(2)(c) based upon the underlying assets of the trust and this determination must be made on a month-by-month basis. This requires information from the trust that may not be available to the beneficiary.

Example

A Canadian has a portfolio investment in shares of a Luxembourg company whose shares are listed on the Luxembourg stock exchange.

The investment would not be an exempt interest unless the Luxembourg company is resident in a country in which there is a designated stock exchange. The Canadian investor would be unlikely to be able to confirm the residence of the company under the common law test of mind and management as this would require information as to the authority of the board of directors and the place where they exercise central management and control.

2. A "specified interest" is any interest of a beneficiary under a trust (other than trust referred to in paragraph (h) of the definition of "exempt foreign trust" in subsection 94(1)), excluding a beneficial interest under which every amount of the income and capital of the trust that the individual may receive depends on the exercise of a discretionary power. This is unnecessarily broad.

Example

A Canadian resident individual is one of a number of residual beneficiaries of a foreign trust. The trustees have discretion to make distributions of income or capital to certain beneficiaries during the term of the trust. According to the terms of the trust, any remaining amount in the estate is to be distributed pro rata to residual beneficiaries on termination of the trust.

Since the Canadian resident's entitlement does not depend on the exercise of a discretionary power, the interest is caught by the FIE provisions. This may be the case even though the Canadian beneficiary may not have been advised of his or her interest in the estate.

3. The tracking interests portion of the FIE rules is difficult to interpret and apply.

Example

A Canadian taxpayer acquires 100% of the outstanding common shares of USco., a United States corporation. USco owns 40% of the outstanding common shares of USco2, and 40% of the outstanding common shares of USco3. USco2 and USco3 each carry on an active business in the United States.

In testing whether the tracking interest rule applies to the shares of USco it is necessary to first determine what are the relevant "tracked properties" in paragraph 94.2(9)(d). Here, it is unclear whether the tracked properties are the shares of USco2, the assets of USco2, the shares of USco3, the assets of USco3, or some combination thereof. It is then necessary to determine whether the "tracked properties" are owned by USco to determine whether it is a "tracking entity" as defined in subsection 94.2(1), which requires the tracked properties to be identified. If the tracked properties are all owned by USco then it is necessary to determine whether the fair market value of those properties is more than 90% of the fair market value of all USco's property, or whether the fair market value of any tracked property that is "investment property" exceeds 50% of the tracked property. Even if it were possible to identify the tracked properties, the relevant fair market values may not be available. If any tracked property is not owned by USco then it is necessary to determine whether USco (or any non-arm's length entity) owns investment property (or substituted property) that may be used to satisfy right to income from the tracked property referred to in paragraph 94.2(9)(d).

4. The definition of "exempt business" should not exclude a business that is carried on by an exempt foreign trust.

Example

A Canadian resident acquires units of a non-resident trust, the units of which are listed and actively traded on a designated stock exchange. The principal purpose of the trust is to derive income from the rental of real estate and, except for the carve out for exempt foreign trusts in the preamble of the exempt business definition, the trust would carry on an exempt business.

The sole fact that the trust is an exempt foreign trust should not preclude it from carrying on an exempt business under the FIE rules.