AMENDMENTS TO TAXATION OF NON-RESIDENT TRUSTS

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BIOGRAPHIES

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A. INTRODUCTION

Cautionary Note

This paper analyses draft legislation upon which comments have been requested. It is possible that further changes could be made to this legislation before it is passed into law.

Scope and Organization of Paper

The topic of non-resident trusts is a very extensive one, and this paper could easily have been divided up into as many as four separate papers. We have made an attempt to cover the entire subject, and therefore have divided the paper into segments.

In developing the format of the paper and its contents, we determined that it would not be appropriate to analyze the proposed draft legislation without first commenting on the existing rules. An understanding of the existing rules, and their possible deficiencies, will give the reader a much better understanding of the proposed legislation. In addition, it is critically important to determine whether a non-resident trust is subject to the existing rules of section 94, for purposes of certain transitional rules.

In Section B, we give a general background overview of the area. The first main section of the paper is Section C, which looks at the current system of taxing non-resident trusts.

The paper then analyses the proposed draft legislation in detail (Sections D and E).

Once the reader has an understanding of the proposed draft legislation, set against the current rules, it is possible to analyze the impact of the changes on existing structures (Section F). Section G discusses tax planning strategies to be considered in the transition to the new system, and the interaction with international tax treaties.

[*] *This paper is an update of the paper prepared by the authors at the Canadian Tax Foundation's 2000 Annual Conference, September 24-27, 2000, Toronto*.

Finally, the paper summarizes problems with the proposed draft legislation and the difficulties likely to be encountered by practitioners (Section H).

How to read this paper

This paper will not be a quick and easy read. The reader should have at hand a current copy of the Income Tax Act and the August 2, 2001 proposed draft legislation, and have a sense of purpose and determination.

The table of contents to the paper is quite self-explanatory. The draft amendments have been analyzed in what we believe to be a logical progression, starting with the main charging provision of proposed subsection 94(3), which immediately leads to an extensive analysis of defined terms and special rules. Some of these can be skipped on a first read and we mention this throughout the paper to save the reader valuable time. One can return to the more technical and esoteric sections later. For example, one can omit the discussion of *Exempt Foreign Trusts*,[1] and Extended Meaning of Transfer, which are not necessary for purposes of understanding the main thrust of the new amendments.

We do strongly recommend that the section on the current rules be read, as it will greatly assist in gaining an overall perspective of the proposed legislation.

B. SOME BACKGROUND COMMENTS

There are some persons who would say that non-resident trusts serve little purpose in a Canadian context other than to enable Canadians to reduce tax. What follows from this would be the unspoken conclusion that such arrangements should not be allowed to exist.

But to conclude that this is "bad" pre-supposes that the reduction of Canadian tax is bad. And this would be a fair conclusion if the Canadian government didn't constantly meddle with the tax system to achieve social, economic and political goals. As this article will demonstrate repeatedly, the reduction of Canadian tax through what the government determines is appropriate tax planning is not only permitted under the Income Tax Act (sometimes called the "Act"),[2] but is encouraged. It is specifically sanctioned through the use of non-resident trusts. It will be clearly demonstrated that the proposed draft amendments which are the main subject of this paper actually promote even more extensive use of non-resident trusts for certain permitted tax planning purposes. There are to be more

[1] For ease of reference, all defined terms in the proposed legislation are in italics throughout the paper.
[2] R.S.C. 1985 5th Supplement, as amended.

circumstances under which non-resident trusts can be used in tax planning than ever before, and they can be used with greater ease.[3]

Accordingly, it can be concluded that if the original objective of the February 1999 Budget proposals was to eliminate the tax advantages of non-resident trusts, it was misguided and there has been a substantial change of heart. Moreover, the February 1999 proposals themselves contained an extraordinary selection of new tax planning opportunities for using non-resident trusts which almost defy explanation.[4]

For ease of reference, a non-resident trust deemed resident under section 94 is referred to hereafter as a section 94 deemed resident trust.

A non-resident trust is a tool for tax, financial and estate planning. This tool must be used within the context of the rules governing its usage. Far from being a blunt instrument, it is a very precise tool in the hands of a skilled craftsman. There is no reason to discourage or eliminate it, but there are reasons to regulate its usage. The crafters and administrators of the Income Tax Act would do well not to rely on blunt instruments such as GAAR,[5] or on transfer pricing legislation[6] to combat inappropriate tax planning with offshore trusts. Instead, clear and precise rules are required, so that tax planners can understand what is appropriate tax planning and what is clearly not. The rules should be sufficiently precise that the issue of tax avoidance is not up for debate. In other words, the rules should be sufficiently clear to allow a person to readily determine that an international structure achieved through a non-resident trust is either permitted within the rules or is not.[7] There

[3] See, for example, the proposed rules for *exempt foreign trusts* which can be used to create structures using non-resident trusts which are exempt of Canadian tax, and also the amendment to subsection 75(3) which will simplify the creation of trust structures designed to benefit new immigrants to Canada. (Unless otherwise stated, all section references refer to the Income Tax Act. The draft amendments to section 94 and related provisions released on August 2, 2001 are generally referred to as "proposed" section 94 etc.)
[4] See, for example, the proposal to exempt U.S. resident trusts from Canadian taxation contained in the original February 1999 proposals. This will be commented upon in more detail later.
[5] Section 245.
[6] Section 247.
[7] It should not be forgotten that most tax planning structures involving non-resident trusts seek to bring the non-resident trust outside of the Canadian tax system, in order to avoid Canadian taxation. The Canada Customs and Revenue Agency (from hereon referred to as the CCRA), on the other hand, has the task to show that the arrangement falls within the Canadian tax system by virtue of a charging section making the arrangement subject to Canadian tax. Although the principle has been somewhat eroded over the last 10 years, there is still generally a presumption that taxability must be clearly shown, or else the taxpayer is not subject to tax. See, for example, Inland Revenue Commissioners v. Duke of Westminster (1935), [1936] A.C. 1, H.L.; Stubart Investments v. The Queen (1984), [1984] C.T.C. 294, S.C.C.; Corporation Notre-Dame de Bon-Secours v. Quebec (1995), [1995] 1 C.T.C. 241, S.C.C.; Antosko v. The Queen (1994), [1994] 2 C.T.C. 25, S.C.C. However, the decisions of Corporation Notre-Dame de Bon-Secours and Antosko have led to the adoption of another approach to interpretation, being

must not be scope to misunderstand the statute. This is particularly relevant in the international area where one might go so far as to say that the government has a duty to protect the public from overly aggressive tax planners, especially those based offshore who may have less regard for right and wrong than their on shore colleagues.

Whether or not the existing law is imprecise and subject to interpretation is still something of a matter for debate, and it is not at all clear that existing section 94 contains the number of loopholes and deficiencies that certain tax planners might fancy. These issues have never been tested in court. More would be said about this later. However, while the law may have lacked some clarity in certain places, it is probably fair to say that existing section 94 did what it was supposed to do for the most part. It is likely that the greatest part of the problem in the past has been lax enforcement.

The Auditor General has commented on numerous occasions on the CCRA's handling of various matters in the international area.[8] In response to these comments, the CCRA has made great progress by expanding the International Tax Directorate, formalizing its mandate, developing a comprehensive strategy, and establishing an external advisory committee, the International Tax Advisory Committee. There has also been widespread promotion of the concept of "world income". Non-resident trust are now specifically flagged on tax return forms[9]. Yet the CCRA has fallen behind badly in its support of practitioners (accountants and lawyers) by not developing practice aids, commentary and forms concerning such matters as foreign accrual property income (FAPI), foreign affiliates, what constitutes a transfer of property to a trust, financial assistance as contemplated under existing subsection 94(6) etc. How are taxpayers at large supposed to calculate FAPI, for example, with no guidance? There is no form, no bulletin, and no advice of any kind to assist in this highly technical and complex area. The pace of legislative change in recent years has far exceeded the resources available in both the International Tax Directorate and the Rulings Directorate,

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the plain meaning approach, which basically states that regard should be had to the overall scheme of the legislation in determining situations of ambiguity.

[8] See Auditor General's reports, December 1998, paragraphs 24.44 and 24.46 where it was stated "Our review of the International Tax Directorate's management of human resources identified problems that limit its ability to discharge its responsibilities and to manage the inherent risk to Canada's tax base caused by international transactions. Despite having recognized these problems for a number of years, the Directorate is still developing a comprehensive human resource plan and strategies linked to its business plan for the next few years." and "In our view, failure to take urgent action on these matters will severely limit Revenue Canada's ability to manage the risks to Canada's tax base that international transactions represent."

[9] See the 2000 version of the T-3 Trust and Information Return which asks if the trust is an "offshore trust".

resulting in out of date or non-existent interpretation bulletins, forms and information circulars[10].

It can be hinted from the design of the foreign reporting forms themselves that the CCRA needs to be more focused. Consider the importance given to the protector and to letters of wishes on form T-1141, leading certain practitioners to conclude that the CCRA may challenge non-resident trust structures merely because they have Canadian protectors. Yet a recent case held that a person with the power to replace trustees (typically a protector power) did not control the trust in question[11].

The noose has been tightened year by year on arrangements involving non-resident trusts. Consider, for example, the foreign reporting rules, the amendments to the definition of beneficially interested[12], changes to how foreign accrual property income is calculated for a non-resident trust, the expanded definition of taxable Canadian property, changes to section 116 and the tightening of the clearance certificate procedures. Accordingly, it has been our experience that many structures which were put in place several years ago, and were then possibly outside of the ambit of section 94, have crept ever closer to it. As the legislation has been refined and refined, such structures may well have stepped over the line, such that they are currently caught under existing section 94. However, given the imprecise nature of certain aspects of existing section 94, there may be good arguments to support the proposition that certain structures are not currently "off side", notwithstanding that a contrary view is probably the better part of the argument.

The new legislation will almost certainly require disclosure of all structures in which a Canadian has been involved, due to yet further expanded foreign reporting rules. Given this, a harder look must be taken at existing structures under existing rules, since the requirement to disclose such structures will raise the probability of detection to almost a certainty, and will greatly increase the risk of a challenge of the structure by the tax authorities.

A sobering thought is that if a non-resident trust is potentially deemed resident under section 94 (existing or proposed), there is no statute of limitations governing the period of assessment, unless the trust has filed a Canadian tax return. Accordingly, it would seem that the CCRA may assess years as far back as the inception of the trust (whenever that

[10] The authors have received assurances from CCRA that practice aids are now being prepared.
[11] Campbell v. R., 1999 Carswell Nat 186, 99 DTC 1073, T.C.C.
[12] Subsection 248(25).

may be). Penalties and interest may also be levied on the assessed and unpaid tax. Clearly the stakes are very high.

February 1999 Budget Proposals

The changes to non-resident trusts were first announced in the February 1999 Budget Proposals, and revolved around three main principles, being:

i) that non-resident trusts to which Canadians have transferred or loaned property, directly or indirectly, should be subject to Canadian taxation, but with certain exceptions;[13]

ii) that all distributions to Canadian beneficiaries should be subject to tax, except to the extent that tax has previously been paid on the income of a non-resident trust, in which case some form of a credit or deduction would be given;

iii) that any Canadian who has transferred or loaned property to the trust should be jointly and severally liability for the trust's tax liability, in order to provide a means to enforce collection of the tax.

While the first objective above may be viewed as further tinkering of section 94, which has been the subject of frequent amendments in the past (many of these amendments will be discussed later), the second and third aspects of the proposals were new, quite radical, and have proven highly problematic. More will be said about these later, but suffice to say for now that the proposal to tax distributions from non-resident trusts will not be implemented,[14] and that the joint and several liability issue has been modified slightly but nowhere near far enough.

It is useful to discuss each of the main aspects of the February 1999 proposal, since this gives some additional insight into the rationale behind the proposed legislation.

While it is debatable as to whether existing section 94 was deficient in the past, clearly a great number of tax planners believed it to be so, and the CCRA's lack of pronouncements on the subject and seemingly lax enforcement reinforced this view. Given this, the most

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[13] Note, in particular, the exemption for U.S. trusts, as well as the 60-month immigrant trust. No mention was made of trusts established by non-residents.

[14] See November 30, 1999 Press Release – Update on Proposals for the Taxation of Non-Resident Trusts and Foreign Investment Funds, and no changes from this position are proposed in the August 2, 2001 amendments. Note that distributions out of current income of trusts to Canadian beneficiaries are taxable under subsection 104(13).

important objective in amending section 94 must surely have been to clarify the circumstances under which a non-resident trust would be subject to Canadian taxation. The preferred way to do this was by rewriting the section in a way that eliminated the uncertainties and ambiguities, while perhaps not admitting to the fact that there might be deficiencies in the first place and certainly never hinting at what they might be. This objective has generally been achieved in the proposed draft legislation, with a complete re-writing of the rules and by eliminating the requirement that there must be a Canadian resident beneficiary before a non-resident trust is subject to Canadian taxation. In addition, what constituted a transfer of property was not totally clear in the past, and skilled international tax planners could easily exploit ambiguity in this area. Consequently, the proposed legislation has gone to considerable lengths to define the circumstances under which a transfer or loan of property (or using the terminology in the proposed legislation, a *contribution*) will be said to occur.

Taxing of Trust Distributions

Now let us assume that the February 1999 Budget proposals were intended to clearly define the circumstances under which a non-resident trust will be subject to Canadian taxation. Thus all non-resident trusts that should be taxed by Canada are taxed, and those which are not to be taxed, are exempted intentionally. This sounds simple enough and quite reasonable. But if so, why the original proposal to tax distributions from non-resident trusts, to the extent that the income has not been subject to taxation (foreign or Canadian). How can this be reconciled? The only possible justification would be that this proposal represents a fundamental shift in policy, whereby trust income that is intentionally exempt of Canadian tax would now be considered tax-deferred, not tax-free. The taxing of trust distributions changes a tax exemption into merely a tax deferral. But how was this policy change to be reconciled with the five-year tax exemption clearly emphasized as being applicable to new immigrants?[15] Furthermore, what grandfathering was to be granted to existing situations not currently subject to tax?

In addition, the task of actually drafting the appropriate legislation, and the compliance that would be required to perform the calculations, particularly given transitional rules, was surely daunting. It would give rise to enormous complexities, both for taxpayers and for the CCRA. Remember that the CCRA has yet to develop even a simple form for the calculation of mere current year FAPI, despite its place in the Act for over 25 years. How would the CCRA cope with the detailed calculations for thousands of taxpayers who receive distributions from non-resident trusts each year? Who would audit the tax calculations?

In addition, it is very unlikely that the taxing of capital distributions from non-resident trusts would raise any significant tax revenue. In fact, there was a clear danger of achieving the opposite result. Immigrants who relied on the 60-month immigrant trust exemption would clearly feel that the exemption had been all but repealed. They would feel cheated, and at a time when Canada is still trying to recover from the hostility created by the foreign reporting rules. This would put the Department of Finance at loggerheads once again with various immigrant groups, the same ones who had made a very considerable fuss over the introduction of the foreign reporting forms. There had been various views expressed on the foreign reporting forms, most notably being that this was part of a very calculated, intricate and longer range strategic plan (which some have called a plot) which would ultimately conclude with taxation by citizenship, akin to the U.S. model. The first phase was to compile as much information as possible on the holdings of Canadians, particularly holdings overseas. Some would surely see this as the next step in the process.

While immigrants to Canada may establish a non-resident trust, which may benefit from a 60 month exemption from Canadian tax, non-residents of Canada, or persons who had not been resident in the past 18 months, have always been able to establish non-resident trusts with more far reaching exemptions. These trusts are not subject to Canadian taxation at all, unless the person who has contributed property to the trust becomes a resident of Canada for an aggregate period of 60 months. The logic of this is that a trust fund is akin to a gift. The non-resident settlor could retain the funds and give gifts which would be non-taxable.

A number of inter-vivos and testamentary trusts have been set up by non-residents for the benefit of Canadians. If one were to exempt the 60 month immigrant trust, what then of these inbound trusts? Should capital distributions from these trusts nevertheless be taxable? Moreover, since these trusts generally have the ability to accumulate capital, it would not take a great deal of imagination to see that the proposed change would lead to substantial incentive to do so. Canadians might later become non-resident and then receive distributions.

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[15] This exemption was preserved in the February 1999 Budget Proposals and specific exemption has been provided within the definition of *Resident Contributor* and *Connected Contributor* under proposed section 94.

All in all, this proposal had the makings of bad economic policy, a high level of complexity, problematic administration and the prospect of recovering very little in tax revenue.

Accordingly, it was doubtless highly appropriate that the Department of Finance listened to these concerns, expressed by many, and determined that this proposal be scrapped.

Exemption For U.S. Trusts

The February 1999 Budget Proposals contained an exemption for U.S. trusts. The theory seemed to be that the U.S. tax system was sufficiently "tight" so that a U.S. resident trust could not be used by Canadians for tax avoidance. Well think again!

But what sovereign nation abdicates its right to tax in favour of adopting the rules of another nation?

Suppose a Canadian establishes a U.S. resident trust for the benefit of his Canadian resident children and places investments in it. This trust would normally be subject to section 94, which would deem it to be a Canadian resident trust taxable on its investment income. However, under the February 1999 Budget Proposals, this U.S. resident trust would not be subject to Canadian taxation, because it would instead be subject to U.S. taxation. This would allow Canadians a choice of the jurisdiction to which they could pay tax on their investment income. They could either retain the income in the trust and pay U.S. tax on it, or pay out the income, pay U.S. withholding tax, and pay Canadian personal tax at the beneficiary level. To the extent that tax rates are lower in the U.S. than in Canada (which they generally are), there would be an advantage in setting up the arrangement. It would be easy to establish a trust in a manner that would not give rise to a U.S. state tax liability, and therefore considering only federal tax, the tax rate on investment income in general would be 39.6% at a maximum, and the tax rate on long term capital gains, a mere 20%. Moreover, certain types of investment income, especially municipal bond interest, is exempt of federal taxation, in order to provide a tax incentive for U.S. municipal development. Such income could be earned tax-free. And this is just the beginning of the tax planning. It would have been a tax avoidance bonanza.

If it could nevertheless be rationalized to allow such a U.S. resident trust to escape Canadian taxation, what about trusts established in other jurisdictions, and especially other treaty jurisdictions? Why would the exemption be limited to the U.S.? What of the U.K., for example, or Australia? Many of Canada's treaty partners have a host of exemptions for investment income, and especially capital gains. Some treaty countries believe capital gains should not be taxed at all. Canada would effectively be importing these exemptions into its own taxation system.

Enough said! When this proposal was scrapped in November 1999, nobody seemed particularly surprised.

So having taken a very thorough look at the entire non-resident trust area, and appropriately refocused the conceptual framework of the original proposals, the Department of Finance then set about the task of drafting detailed legislation. Because of the time which had elapsed by November 1999, the implementation date was delayed for all situations to 2001.[16] But time slipped by, and the draft amendments based on the November 1999 press release did not appear until June 22, 2000.

The proposed draft legislation immediately ran into serious difficulty, because of the foreign investment entity rules contained as part of the package. This led to the announcement on September 7, 2000 that the legislation on non-resident trusts would be effective January 1, 2002 in all situations.

C. CURRENT SYSTEM OF TAXING NON-RESIDENT TRUSTS

Basic Framework of Existing Section 94

Section 94 as currently in force,[17] and to be in force until December 31, 2001, is generally applicable to deem a non-resident trust to be a Canadian resident trust for certain purposes, if two conditions are met. The first condition is that the non-resident trust must have a Canadian resident beneficiary at some time in the year.[18] In this context, the year refers to the taxation year of the trust, which, in most cases, will be the calendar year, but may be something different for a testamentary trust.[19]

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[16] Originally, non-resident trusts which received contributions of property on or after February 16, 1999 would be subject to the new rules in 2000.

[17] Referred to hereafter as existing section 94 or simply section 94.

[18] Paragraph 94(1)(a). The actual test in this paragraph has three components and extends to certain more complex structures where the trust has as a beneficiary a trust or a foreign affiliate.

[19] There have been two unsettled questions with respect to the taxation year of a non-resident trust. The first is whether an inter-vivos non-resident trust must have a calendar year for Canadian tax purposes, and the second is whether the taxation year of a trust ends when the trust ceases to exist.
The first issue is settled by new section 250.1, applicable after December 17, 1999, which provides that non-resident persons are to have taxation year-ends as per Canadian rules.
On the second issue, see 9406256 – First and last taxation year of a testamentary trust, September 7, 1994 where CCRA (then Revenue Canada) acknowledged that there are no specific provisions in the Act which cause the fiscal period or taxation year of a testamentary trust to cease when it is wound up. In

The second condition for the application of existing section 94 is that there must be a Canadian resident person from whom the trust has acquired property (hereafter called a "transferor") and who is related to the beneficiary or is an uncle, aunt, niece or nephew of a Canadian resident beneficiary.[20] However a Canadian resident transferor who has not been resident in Canada for a total of 60 months, or who has not been resident at any time in the past 18 months, is exempted.[21]

It should be noted that the Canadian resident beneficiary condition is a year-by-year test. The trust could be taxable in one year and not taxable in another year because beneficiaries became non-resident, died, or were deleted as beneficiaries under the trust. The transferor condition is applicable at any time in or before the taxation year of the trust, meaning that this test, once met, is applicable forever. Both conditions must be met at some time in a taxation year of the trust, for taxability to result.

The tax planning opportunities of existing section 94 mostly relate to failing to meet one or both of the conditions above.

Deficiencies in Existing Section 94 and Past Amendments

No Canadian resident beneficiary

A straightforward and obvious way to avoid the application of section 94 was to not have a Canadian resident beneficiary at any time in a taxation year. It became popular to structure trusts with no Canadian resident beneficiaries, but which allowed the trustee to add beneficiaries at their discretion. In some cases, the trust agreement would only allow for non-resident beneficiaries to be added.

Section 94 makes specific reference to the term beneficially interested, which is defined in subsection 248(25). Prior to the amendment introduced for 1998 and subsequent years, the definition read:

CCRA's opinion, the final taxation year of a testamentary trust will end on the date of final distribution of its assets and not at its normal taxation year-end. It is unclear whether this position also extends to an inter-vivos trust. The CCRA have repeatedly taken the position that an inter-vivos trust that ceases to exist does <u>not</u> have a year-end at that time. This can be critically important in determining taxability under section 94. See technical interpretations 9508525, October 23, 1995, and 9714685, February 20, 1998. Note that subsection 250(6.1) may seem relevant to this discussion, but on a closer read is not.

[20] Paragraph 94(1)(b).

[21] Sub-clauses 94(1)(b)(i)(A)(II) and (III).

> For the purposes of this Act, a person or partnership beneficially interested in a particular trust includes any person or partnership that has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretionary power by any person or persons) as a beneficiary under a trust to receive any of the income or capital of the particular trust either directly from the particular trust or indirectly through one or more other trusts.

As can be seen from this definition, it is broad and far reaching. For example, it is clear that a person named a beneficiary of the trust is beneficially interested in the trust, even if their entitlement is subject to the fulfillment of certain conditions. Suppose father sets up a non-resident trust for the benefit of son, who lives in Canada, and his brother who lives overseas. The trust document provides that son may only be a beneficiary under the trust if son becomes a non-resident of Canada. Son is most definitely beneficially interested in the trust, even though his entitlement is contingent upon certain future events. However, if son were not named in the trust document, and merely might be added as a beneficiary at the discretion of the trustee, then it is most probable that son would not be considered to be beneficially interested in the trust under this definition. Even if a letter of wishes from the settlor to the trustee requested son to be added as a beneficiary, this would still most probably not make son beneficially interested until so added. This being the case, the trust would not be deemed resident under section 94 until such time as son actually became a beneficiary. If son was added only after becoming a non-resident, the trust would never be taxable under section 94.

Given the relative ease with which such structures could be created, it was not surprising that they became popular. A number of variations of this plan emerged; purpose trusts where the trust had a purpose and no named beneficiaries, and charitable trusts where the trust had a charity as a beneficiary and no other named beneficiaries, and trusts with only non-resident beneficiaries. The power to add beneficiaries was usually contained in the trust document itself and was critical to the plan. In some cases, the trust document might have no specific power to add beneficiaries, but the trustees had the power to amend the trust deed, such that they could add this power later and then use the power to add beneficiaries.

There was initially some controversy as to whether purpose trusts were in fact valid trusts. Furthermore, there were mutterings about whether charitable trusts with respect to which it was fairly apparent that the named charity would receive no more than a nominal contribution were valid trusts or were shams. But before this line of reasoning became too far advanced, certain offshore jurisdictions enacted legislation to confirm that these trusts were valid trusts under the laws of their jurisdiction.[22]

This led to an amendment to the definition of beneficially interested[23] which provided that where a trust arrangement had the ability for beneficiaries to be added, then the transferor and any person who deals at non-arm's length with the transferor shall be deemed to be beneficially interested. The purpose was to bring these trusts within the ambit of section 94 if there are Canadian resident beneficiaries who potentially can be added as beneficiaries of the trust who dealt non-arm's length with the settlor.

After this amendment, one might have expected a flood of voluntary disclosures and tax filings of section 94 deemed resident "purpose" and "charitable" trusts, but it would seem from informal discussions that very few have come forward. It is possible that the CCRA and others have greatly overestimated the number of such arrangements in existence, or alternatively such arrangements were very quickly modified.

It is interesting to consider the situation of a non-resident trust being thus deemed by section 94 to become resident in Canada effective for 1998. The following will be the implications:

i) the trust would most likely be required to file an income tax and information return;[24]

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[22] For example, The Special Trusts (Alternative Regime) Law 1997 ("Star" Law) was introduced in the Cayman Islands and provides for the creation of trusts of any description provided their objects are lawful and not contrary to public policy. Specifically, the Law has these features:

a) The enforcers need not be beneficiaries of the trust but can be appointed by a court order.
a) A Star trust is not rendered void by uncertainty as to its objects or mode of execution. The court can resolve the uncertainty.
a) The court has the power to reform the trust if it is unlawful or contrary to public policy, or if, due to changed circumstances, it is not possible to achieve the general intent of the special trust.
a) The trustees must include at least one duly licensed Cayman Islands trust corporation which is obliged, by law, to retain at its offices a documentary record of certain matters.
a) A trustee must ensure, prior to accepting a settlement of property, that the settlor or person making the settlement understands who will have authority to enforce the trust. Failure to do so results in the trustee being liable to a fine and/or a prison sentence.

[23] The amendment to subsection 248(25) was proposed on December 8, 1997 and implemented by Bill C19 to be applicable after 1997.

[24] Paragraph 150(1)(c), Regulation 204 and 209. See also T3 Guide and Trust Return, Chapter One where it is indicated that a trust return must be filed if income from the trust property is subject to tax, and the trust:

- has tax payable;
- has a taxable capital gain or has disposed of a capital property;
- has provided a benefit of more than $100 to a beneficiary for upkeep, maintenance, or taxes for property maintained for the beneficiary's use (for more information, see Line 43 on page 18); or

ii) if the trust had taxes owing, then it will be subject to the normal rules dealing with taxes payable;

iii) if the trust did not file an income tax return when due, it could be subject to late filing penalties;

iv) if the transferor did not file appropriate foreign reporting forms, then he or she could be subject to penalties. While the trust itself is deemed resident for certain purposes, it is not deemed resident for purposes of certain foreign reporting rules.[25] Therefore, the settlor or other Canadian contributors must file foreign reporting forms to disclose to the CCRA the existence of the non-resident trust;

v) the trust is considered a resident of Canada for purposes of its own foreign reporting obligations to disclose its foreign holdings. Therefore, if it holds over $100,000 of foreign assets, or shares in foreign affiliates or controlled foreign affiliates, then it may also be required to submit its own foreign reporting forms. Note that these are a consequence of the trust being deemed to be resident in Canada;[26]

vi) if the trust has made distributions to beneficiaries, then it is possible, but not totally clear that beneficiaries can be liable for the tax liability of the trust to the extent of the distributions received or receivable and proceeds from a disposition of the trust interest;[27]

vii) if the trustee has made distributions to beneficiaries leaving an unsatisfied tax liability, then the trustee can be personally liable for the tax liability of the trust.[28] Otherwise, the trustee is only liable to the extent of the trust assets.[29]

- receives from the trust property any income, gain, or profit that is allocated to one or more beneficiaries, and the trust has:
  - total income from all sources of more than $500;
  - income of more than $100 allocated to any single beneficiary; or
  - allocated any portion of the income to a non-resident beneficiary.

[25] Subparagraph 94(1)(c)(i) where the trust is deemed for the purposes of Part I, sections 233.3 (foreign property reporting) and 233.4 (foreign affiliate reporting) to be a person resident in Canada. The trust is not deemed to be a person resident in Canada for the purposes of sections 233.2 (foreign trust reporting) and 233.6 (reporting of distributions from foreign trusts).

[26] Ibid

[27] This result is obtained from subsection 94(2), but it is possible that this subsection was drafted in error so that in reality nobody will be liable. Interested readers may study this and reach their own conclusions.

[28] Subsections 227(5) and 227(5.1)

[29] Without the provision of subsection 227(5), which makes the trustee jointly and severally liable, the tax liability remains that of the trust and hence may only be recovered from the assets of the trust.

This amendment should have put a stop to this type of planning, except it might have been possible to still achieve this result by less direct means. For example, the trust document could allow for the addition of beneficiaries, but provide that none of these beneficiaries could be a natural individual. The idea might be to add a trust as a beneficiary, which would, in turn, have the power to add beneficiaries at a later date. The first trust would accumulate income, which would then become capital. Subsequently, this capital would be transferred to the second trust, which would then add Canadian resident beneficiaries. The first trust would not be taxable on the basis that it had no Canadian resident beneficiaries, nor was there a power to add such persons, and the second trust would not be taxable on the basis that it had no income.

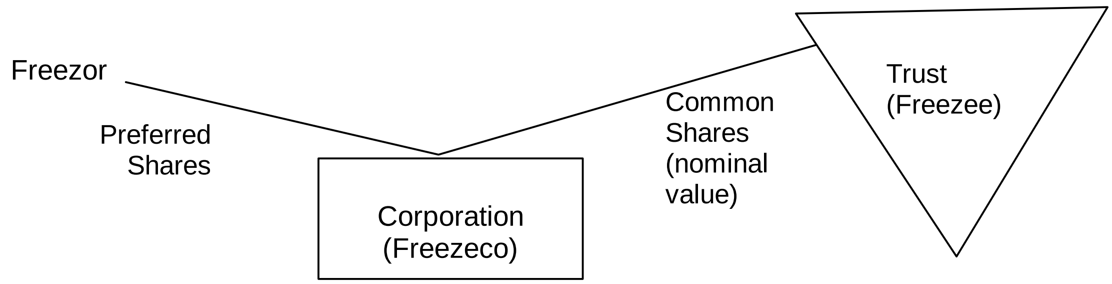
Other similar arrangements might have involved the ability to create a trust which had no ability to add beneficiaries, and to subsequently amend the terms of the trust to add beneficiaries at a later date.

This type of arrangement led to the first major thrust of the amendments, being the deletion of the Canadian resident beneficiary test (discussed in more detail later).

No Canadian Resident Transferor

The second planning alternative focused on not having a Canadian resident transferor. This planning essentially exploited ambiguity or deficiencies in what constituted a direct or indirect transfer. In policy terms, it was well established that if a non-resident constituted a trust for the benefit of Canadians, this trust would not be subject to section 94, unless the contributor became a resident of Canada for a period or periods aggregating 60 months.

Various indirect transfer techniques have been contemplated, to make sure that no Canadian contributor related to a beneficiary has transferred property to a trust. Of these techniques, the most popular was the international estate freeze, whereby a Canadian corporation (herein called Freezeco) would be frozen in value, utilizing a traditional kind of an estate freeze, and then common shares would be issued to a non-resident for nominal value. The non-resident would, then, in turn, contribute these shares as a settlement to a non-resident trust for the benefit of Canadian resident beneficiaries. Assuming that the Canadian resident (the "Freezor") who initially owned Freezeco did not contribute anything to the trust, or give the trust financial assistance by means of paying trustees fees etc., this structure might not fall within the normal ambit of section 94. In other words, a transfer of the future growth in value of Freezeco by allowing a common share subscription for nominal value but albeit fair market value would not in all likelihood constitute the direct or indirect transfer of property by Freezeco or the Freezor to the trust (the "Freezee").[30]



It should be noted, however, that section 94 contains, and has always contained, a section dealing with financial assistance, being subsection 94(6) which states:

> For the purposes of paragraph (1)(b), a trust or a non-resident corporation shall be deemed to have acquired property from any person who has given a guarantee on its behalf or from whom it has received any other financial assistance whatever.

Despite being asked on several occasions, the CCRA has never given a view as to what constitutes financial assistance.

In determining whether an estate freeze type transaction constitutes financial assistance, assume that it does not constitute a direct or indirect transfer of property by the "freezor" to the "freezee". Therefore, absent the financial assistance provision deeming a contribution to have occurred, the trust would be exempt of Canadian taxation.

The term "financial assistance" appears in proposed paragraph 94(2)(e) and existing subsection 94(6). The term also appears in the definition of "beneficially interested" in subsection 248(25)[31] and in paragraph 56(1)(r). However, there is nothing authoritative in the Act on what constitutes financial assistance.

The Income Tax Act contains various phrases, all of which are designed to convey the idea of somebody contributing something to someone else (be it the derivation of a benefit, a gift, a transfer of property etc.). For example, subsection 15(1) speaks of a conferral of a benefit. Subsection 15(2) will seek to invoke taxation where a shareholder has borrowed money or

[30] Note that subparagraph 94(1)(b)(i) may also apply where a Canadian resident person has made a transfer to a controlled foreign affiliate of the trust.
[31] "…has given a guarantee on behalf of the particular trust or provided any other financial assistance whatever to the particular trust"

become indebted to a corporation. Various rollover provisions in the Act will consider a capital gain to arise where it is reasonable to conclude that a benefit has been conferred. However, subsection 94(6) uses the words “financial assistance”, and hence one would conclude that this must be something different to conferral of a benefit, a gift, or suchlike.

The ordinary meaning rule of statutory interpretation provides that clear and unambiguous words used in a statute are to be assigned their ordinary, everyday meaning unless the words are specifically assigned different definitions.[32] There are four steps to establishing the ordinary meaning:[33]

i. Judicial Notice

If facts are indisputable, the court can take judicial notice. In essence, the court assumes the fact to be true, and evidence is not needed to prove the fact. However, given the debate over the precise meaning of financial assistance, it would not seem appropriate for a court to take judicial notice of this fact.

ii. Dictionary Meaning

One consults dictionaries to determine the meaning of a word or term. Financial assistance does not appear to be defined in any dictionary.[34]

iii. Immediate Context

The context of how the term financial assistance occurs is: “a guarantee on its behalf or from whom it has received any other financial assistance whatsoever”. An argument can be made in the absence of anything else that financial assistance must be similar to a guarantee. Otherwise, the drafters could have said “any financial assistance, including without limiting the generality of the foregoing, a guarantee”. Since they did not, it may be a reasonable proposition that “financial assistance” was meant to capture transactions which were similar to guarantees.

iv. Expert testimony and other evidence

[32] Fundamentals of Income Taxation, Krishna 5th ed at p. 51.
[33] Driedger on the Construction of Statutes, Sullivan 3rd ed.
[34] Black’s and two other legal dictionaries were searched, as well as Meriam-Webster and the Concise Oxford Dictionary.

> Other evidence is typically not allowed, however, if all else fails, it may be acceptable.

The term financial assistance does occur in other Canadian statutes. Financial assistance has been defined in the Canada Student Financial Assistance Regulations. Subsection 2(1) of the regulations provides that "financial assistance" means any form of financial aid provided under the Act, including student loans.

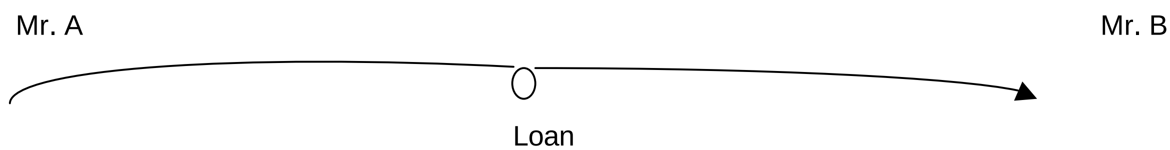
The term financial assistance also appears in the Canada Business Corporations Act ("CBCA"). Although the term is undefined, the context is consistent and helpful to understand the meaning, but broader than the Income Tax Act. Subsection 44(1) of the CBCA states, inter alia, that "a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise".

The Employment Insurance Act also refers to "financial assistance". This Act provides, inter alia, that for the purpose of implementing employment benefits and support measures, the Commission may provide financial assistance in the form of (a) grants or contributions; (b) loans or loan guarantees; (c) payments for any service provided at the request of the Commission; and (d) vouchers to be exchanged for services and payments for the provision of the services.

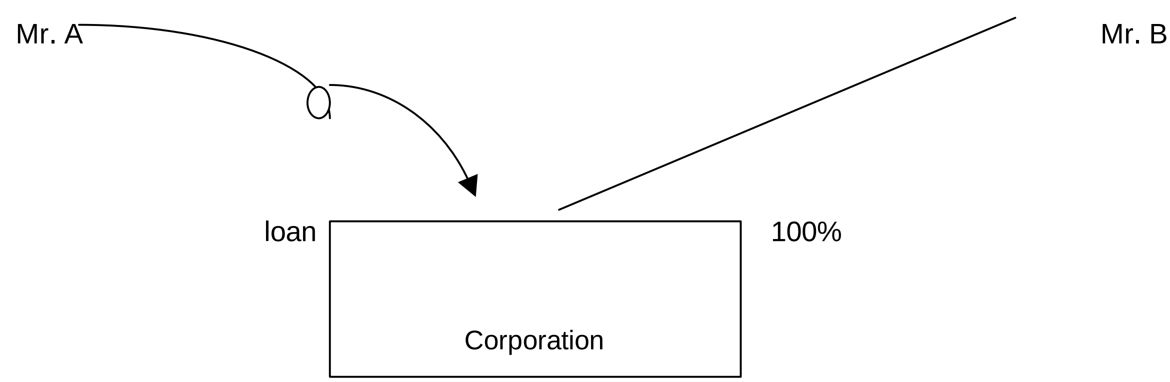
The purposive meaning of statutory interpretation is used where statutory language is obscure or ambiguous. Although "financial assistance" may be obscure or ambiguous, unfortunately so is the purpose of the term. The technical notes to the draft legislation released on June 22, 2000 and August 2, 2001 provide no guidance as to the purpose of proposed paragraph 94(2)(e). Likewise, no information on existing subsection 94(6) could be found in old technical notes. It would appear likely, that the best source of determining the purpose of the drafters is simply to view the context and hypothesize about how the provisions could be drafted differently. This takes us back to the position that financial assistance is either merely a concept meant to capture transactions similar to guarantees or encompasses loans because of its use in this fashion in other statutes and the fact that loans are financial in nature.

Because this provision involves a charging section, there is an argument that ambiguity should be construed in favour of the taxpayer. If it is not clearly demonstrated that a person is to be taxed, he is not taxed.

If one were to survey a group of people at large,[35] to ask what constituted financial assistance, virtually everyone would say that an interest-free loan constitutes the conferral of financial assistance. This would be the case especially if the loan had no particular terms of repayment. Therefore, if Mr. A makes an interest-free loan to Mr. B, and the loan is of a long term or indefinite duration, and contains no requirement for Mr. B to compensate Mr. A beyond the eventual repayment of the principal sum of the indebtedness, it would be fairly clear that Mr. A has given Mr. B financial assistance. Most likely though, Mr. A has not conferred a benefit on Mr. B.[36]

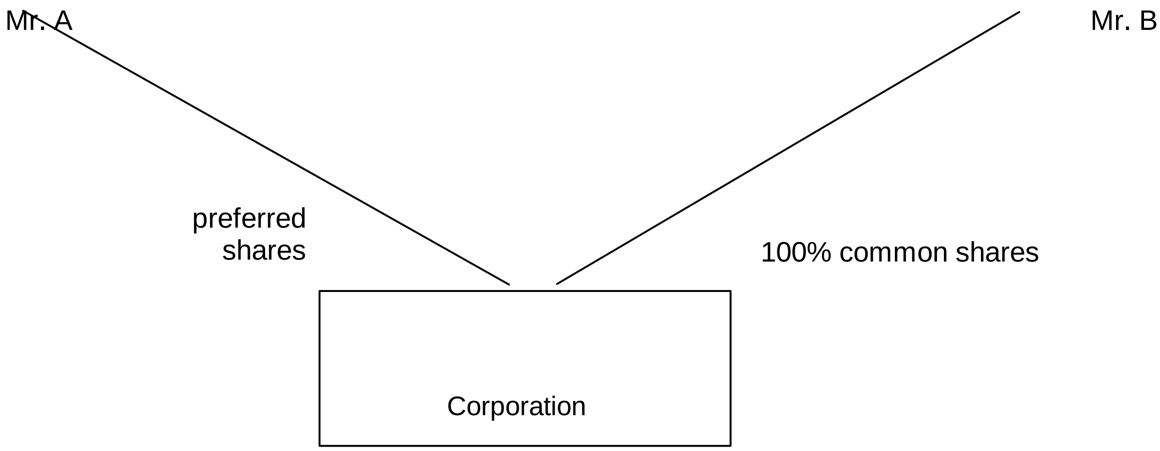


Suppose now that Mr. A does not make the loan to Mr. B, but instead makes the loan to a corporation wholly owned and controlled by Mr. B. The corporation may invest the proceeds, and earn a return, which Mr. B, as sole shareholder, can exploit. The situation can continue indefinitely until the loan is required to be repaid. In this circumstance, it would seem difficult to distinguish the arrangement from the interest free loan arrangement, except in so far as to say that financial assistance was given to the corporation, and not directly (or possibly indirectly) to Mr. B.

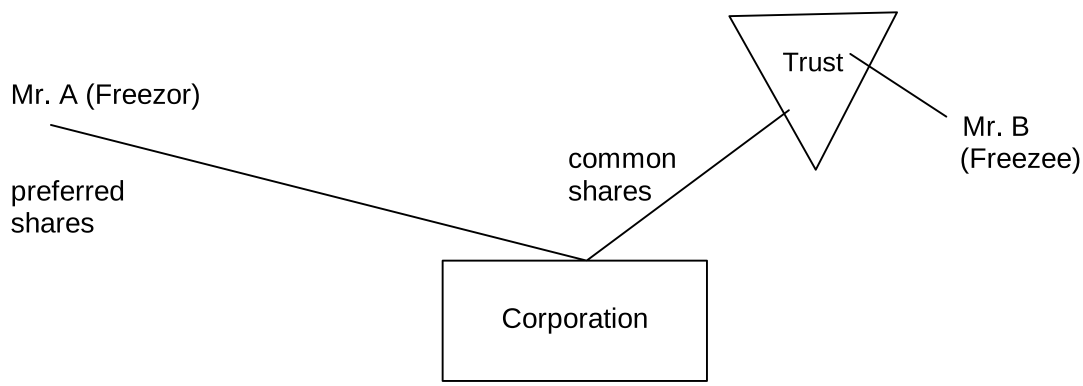


35 The man on the Clapham Omni Bus approach, Bower v MNR [1949] DTC 554 (Can. Ex. Ct.) at p. 557.
36 Support for the fact that no benefit has been conferred may be found by examining the taxable benefit rules applicable to interest-free and low interest loans contained in section 80.4. If an interest free loan were a benefit, then these rules would not be necessary as the benefit would be taxable under paragraph 6(1)(a). Therefore, under the scheme of the Income Tax Act, in general terms an interest-free loan does not result in the conferral of a benefit.

Assume now that Mr. A makes an investment in preferred shares of the corporation, where Mr. B owns the common shares (see diagram below). Assume that the preferred shares do not pay a dividend commensurate with market rates of return. In this circumstance, it would seem again that Mr. A has given financial assistance to the corporation since this achieves the same result in substance as the previous example. Again, whether this extends to Mr. B. is debatable.



If this example is compared to an international estate freeze, it seems very clear that the basic set up is similar. Based on this, one would have to consider the possibility that an international estate freeze structure could cause a non-resident trust to fall within section 94 by virtue of the Freezor giving financial assistance to the Freezee. (See diagram below).



This issue is not only critical to determine whether certain existing trust arrangements may be taxable, but also for purposes of transitional rules in moving to the new system of proposed section 94.

Gap in Section 94

Existing subsection 94(1) deems the trust to be resident in Canada for purposes of Part I of the Income Tax Act, and certain other limited purposes,[37] and deems it to have taxable income, which consists of certain things which are specifically enumerated. The subsection was proposed to be amended in 1998 to expand its scope.[38] It seems that prior to this amendment, an argument could be made that dividends received by a non-resident trust from foreign affiliates and capital gains from the disposition of excluded property would not fall within the ambit of the charging provision. This is because the charging provision originally only included income which would be considered foreign accrual property income of a foreign affiliate. Dividends from foreign affiliates, and capital gains from disposition of excluded property are not considered to be FAPI.[39]

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[37] Sections 233.3 and 233.4.

[38] Under proposed sub-clause 94(1)(c)(i)(B)(II), "the description of A in the definition 'foreign accrual property income' in subsection 95(1) were, in respect of dividends received after 1998, read without reference to paragraph (b) thereof," and under proposed sub-clause 94(1)(c)(i)(B)(III) "the descriptions of B and E in that definition were, in respect of dispositions that occur after 1998, read without reference to 'other than dispositions of excluded property to which none of paragraphs (2)(c), (d) and (e) apply'". These amendments are to be applicable to 1999 and subsequent years.

[39] It seems that the CCRA concurred with this view in a technical interpretation issued April 17, 1984. Thus incredibly CCRA were aware of this deficiency for 15 years before the loophole was finally closed.

Tax Treatment of Section 94 Deemed Resident Trust

Section 94 gives two alternate tax treatments to a trust that was deemed to come within its ambit. The first applies if the trust is a discretionary trust, into which category the vast majority of trusts would fall. The second applies if the trust is a non-discretionary trust. If the trust was a non-discretionary trust, then presumably the interest of each particular beneficiary can be ascertained with certainty. As a result, the income of the trust is specifically imputed to the beneficiary or beneficiaries in accordance with their proportionate interests.

In the vast majority of cases, a typical non-resident trust will be a discretionary trust.

A trust deemed to fall within section 94 may obtain a deduction for payments on account of income to beneficiaries. Obviously, for Canadian beneficiaries, they would be taxable in respect of this income, but non-residents would not be taxable. However, it is not totally clear that a deduction can be taken by the trust for distributions to non-residents of the trust's taxable income earned in Canada.[40]

Other Relevant Sections

While potentially all of the rules of Part I of the Income Tax Act are relevant to a section 94 deemed resident trust, there are a number of sections which play a very key role. These merit analysis individually and will be relevant for subsequent discussion.

Firstly, while not totally clear, it is the CCRA's position that a trust to which section 94 applies is not subject to section 94.1 in general. Therefore, such a trust will not be considered to be a non-resident entity subject to section 94.1, although it could hold property (shares of a corporation or units in a trust), which itself could be considered a non-resident entity.

The trust will be subject to the normal rules contained in sections 104 through 108 because the trust is deemed to be Canadian resident for purposes of Part I. Moreover, a trust which is subject to section 94, is deemed to be subject to section 94 throughout its taxation year,

[40] For a discretionary trust, existing paragraph 94(1)(c) provides that the taxable income of the trust is the total of its taxable income earned in Canada for that year, its FAPI for that year and the net income inclusion under section 91. A deduction is provided under existing subsection 94(3), but only for the FAPI income and net section 91 income. The trust's taxable income earned in Canada is the trust's income computed under subsection 115(1). This will include taxable capital gains from the disposition of taxable Canadian property. Thus it would appear at first blush that such income cannot be distributed to a beneficiary. However, subsection 104(6) arguably provides for a deduction for such income in any event.

meaning that the trust cannot be a part year resident, which simplifies some of the analysis contained in these sections.

A section 94 deemed resident trust will be a resident for purposes of section 116. Accordingly where the trust sells taxable Canadian property, there should be no requirement for such a trust to obtain a clearance certificate. This somewhat undermines the ability of the section 116 clearance certificate procedure to aid as an audit tool for non-resident trusts.

For purposes of Part XIII tax, the trust will be considered a non-resident thereby meaning that it will be subject to withholding tax upon receiving amounts from Canadian residents, but will not be subject to withholding tax upon making distributions to Canadian residents or non-residents.

For purposes of Part XII.2 tax, the trust will be considered a non-resident trust, and not a Canadian resident trust. Therefore, the trust will not be subject to Part XII.2 tax upon making distributions to non-residents.

The trust will pay tax federally, but should not be subject to provincial tax, unless a particular province somehow deems it to be so taxable. With various provinces developing their own personal income tax systems, this issue is becoming more relevant. If the trust is not subject to tax in a province, then one would presume that it would be subject to the additional federal surtax.[41]

It would seem that a section 94 deemed resident trust would be able to obtain a dividend tax credit, and other tax credits in the normal fashion.[42] There are, however, special rules for claiming a foreign tax credit as follows:

As provided under subparagraph 94(1)(c)(ii), for the purposes of section 126,

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[41] Under subsection 120(1), additional federal surtax is applicable to tax otherwise payable that the individual's income for the year, other than the individual's income earned in the year in a province bears to the individual's income for the year. The individual's income for the year is defined under subsection 120(3) where paragraph (a) applies to a part-year resident and paragraph (b) applies to a non-resident. Thus for a deemed full year resident, the term is undefined. CCRA (then Revenue Canada) seems to have a different view. Paragraph 16 of IT-434R states that rental income, subject to a section 216 election, and which is not computed under subsection 115(1), is considered to not be "income earned in a province". It was stated that the individual is liable for the additional tax under subsection 120(1) upon the rental income.
CCRA's theoretical argument is that although the terms are undefined, this results in a ratio of nil over nil, which equals one.

[42] The CCRA has stated that a section 94 deemed resident trust may claim a dividend tax credit in a technical interpretation dated February 5, 1980.

(A) the amounts referred to in clauses 94(1)(c)(i)(B) [FAPI income] and 94(1)(c)(i)(C) [section 91 income] shall be deemed to be income of the trust from sources in the country other than Canada in which the trust would, but for subparagraph 94(1)(c)(i), be resident, and

(B) such part of any income or profits tax paid by the trust for the year (other than any tax paid by virtue of this section) that may reasonably be regarded as having been paid in respect of that income shall be deemed to be non-business income tax paid by the trust to the government of that country.

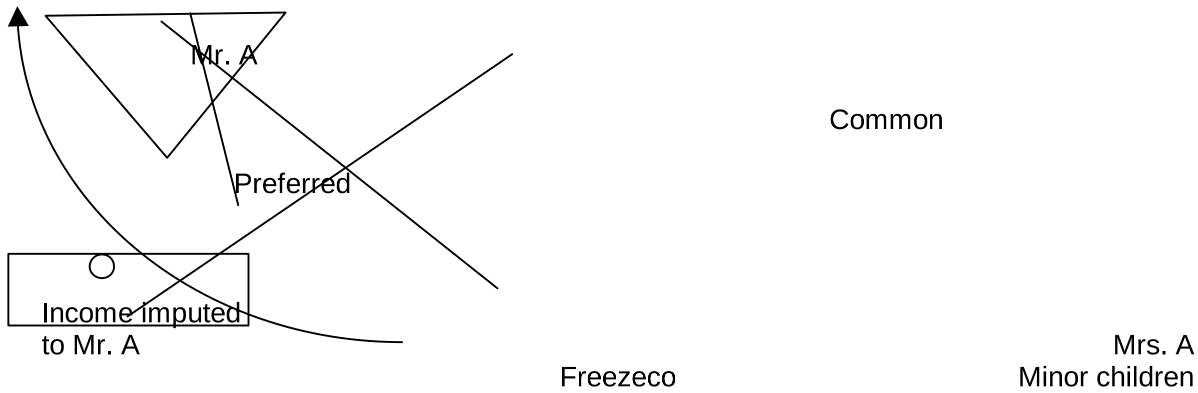
Subsection 56(4.1) deals with interest free or low interest loans that are made to non-arm's length persons. Where this section is applicable, the income earned from the proceeds of the loan, but not capital gains from the disposition of property, will be imputed to the lender. The rule applies whether the loan is made to a resident or a non-resident, and therefore could be applicable to non-resident trust structures.

From a careful analysis of this subsection, if a loan is made to a non-resident trust, and the proceeds of the loan are retained in the trust to earn income, and that income is itself retained in the trust, then the section will have no application. The section will normally only apply to a natural individual who receives income from the loan proceeds. However, the section is most definitely problematic for payments of income from trusts to beneficiaries, resident or non-resident, where the trust has been funded from a non-arm's length person[43] via an interest-free or low interest rate loan.[44] As will be discussed later, one of the possible planning alternatives under the new rules is to make income distributions to non-resident beneficiaries. If so, non-resident trusts structured through loan arrangements, rather than outright settlements or loans to corporations as intermediaries, could trigger application of this rule. The result would be that the income paid out to the non-resident beneficiary would be imputed to the person who has funded the trust through a loan. More will be said about this provision later. It is recommended that this subsection be amended so that it is not applicable to a section 94 deemed resident trust.

Section 74.4 can apply where a person resident in Canada has transferred property directly or indirectly for the benefit of a spouse or a minor child through a corporation. Theoretically,

[43] Note the amendment to subsection 251(1) which codifies when a trust and its settlor, trustees, and beneficiaries deal at non-arm's length with the trust. This is discussed later.
[44] This interpretation is in accordance with the CCRA's views in a technical interpretation dated September 1991, and in question 58 of the November 1992 Roundtable, Canadian Tax Foundation.

this section can apply in an estate freeze type structure, or where assets are transferred to a trust utilizing an intermediary corporation. Where the section is applicable, it can have extremely adverse results, by imputing an interest charge to the person who is deemed to have transferred the property.



Subsection 75(2) is applicable where property is held by a trust on condition that:

i) The property or a substituted property may revert to the person from whom the property was received.

ii) The property or a substituted property may pass to persons to be determined by the person from whom the property was received.

iii) During the lifetime of the person from whom the property was received, the property shall not be disposed of except with the person's consent or in accordance with the person's direction.

Where it is applicable to a trust, whether resident, non-resident, or section 94 deemed resident, the income or loss from the property and any taxable capital gain or allowable capital loss from the disposition of the property are attributable to the person from whom the property was received, but only while this person is resident in Canada.[45]

Very little of an authoritative nature has been written on subsection 75(2) and most practitioners simply stay well clear of it if they can.

Subsection 104(13) will subject the beneficiary to tax upon receiving an income distribution from a trust. Therefore, if Canadian taxation is to be avoided, distributions from non-resident trusts to Canadian resident beneficiaries must clearly be paid out of capital of the trust.

[45] The CCRA believes subsection 75(2) can be applicable in the context of a non-resident trust and has commented in numerous technical interpretations. See Memo – 2000 – 0000217 dated April 20, 2000.

Whether a payment from a trust is income or capital is a question of fact. CCRA seems to take the position that a trust's current year's income, when paid in the year to a beneficiary, is an income distribution. It is not clear that this is correct.

If a trust is a non-resident and not deemed by section 94 to be Canadian resident, then it will be considered a non-resident for purposes of the Income Tax Act (both Part I and Part XIII). Within this context, it should be noted that most of the rules described above are still applicable. The trust is still potentially subject to Part I tax, as a non-resident, computing its taxable income in accordance with section 115. Such would be the case if it disposed of taxable Canadian property for example.

Foreign Reporting

A Canadian transferor who contributes property to a non-resident trust may be subject to foreign reporting in accordance with section 233.2. This has been the subject of other papers, so the basic foreign reporting rules will not be repeated here.[46] It should be noted, however, that in order for the foreign reporting rules to be applicable, the trust must first of all be a non-resident <u>trust</u>. In some cases, entities have been used which may arguably not be trusts, and are perhaps difficult to classify. Foundations have been used for tax planning purposes most notably constituted under the laws of Lichtenstein or the Netherlands Antilles. This could give a filing position, as a minimum, that foreign reporting is not necessary in such circumstances. The only alternative under the foreign reporting rules as currently written, would be if the arrangement constituted holding shares of a foreign affiliate.

Without the foreign reporting, it is difficult for the CCRA to examine the situation and reach a conclusion as to whether or not the arrangement should be subject to Canadian tax.

The other point to note concerning the existing foreign reporting rules is that a number of conditions must be met before the rules are applicable. In general, there must be a relationship between the person establishing the trust and the beneficiary of the trust (referred to as a non-arm's length indicator). If this is not present, then there may not be a requirement to complete foreign reporting forms.

Arm's Length/Non-Arm's Length

Until certain recent amendments, there has been some controversy as to whether a trust deals at arm's length or non-arm's length with its settlor, and its beneficiaries. To eliminate

[46] See "New Foreign Reporting Requirements: Individual and Trusts", 1996 Canadian Tax Foundation Conference Report, Volume Two, 41.

this uncertainty, paragraph 251(1)(b), applicable after December 23, 1998 provides that a trust shall be deemed to deal at non-arm's length with a person who is beneficially interested in the trust and any person who deals at non-arm's length with this person. This has quite extensive consequences in analyzing certain aspects of non-resident trusts. For example, shares of a Canadian public company can be deemed to be taxable Canadian property to a person, if the person, together with anyone who deals at non-arm's length with the person, owned 25% or more of any class of shares in the past five years. If a trust is considered to deal at non-arm's length with persons, then the shareholdings of all such persons are added to the trust's ownership to determine whether the trust owns taxable Canadian property. This has significance under existing rules, and an even greater significance under the proposed legislation.

This rule also has application to paragraph 94(1)(a), which extends the beneficiary test, for example, to trusts which have as a beneficiary a trust with which a person resident in Canada does not deal at arm's length.

D. <u>SCHEME OF PROPOSED SECTION 94</u>

Main Features

The easiest way to describe the main features of proposed section 94 is to consider the areas where there are significant changes from its predecessor version.

For most purposes, the requirement to have a Canadian resident beneficiary under the trust before the section is applicable has been dropped.[47] All that is required is to have a Canadian *resident contributor*. This simplifies matters to some degree.

Any person who has contributed property to the trust and is resident in Canada may be severally liable for the trust's tax. There are, however, certain limitations to the amount that may be recovered.[48]

The trust is deemed resident in Canada for purposes of determining its taxable income, and consequently its taxes payable under Part I of the Act, but there is a certain element of

[47] Retained in the concept of *Resident Beneficiary*, but not *Resident Contributor*. Either will trigger proposed subsection 94(3).
[48] Proposed subparagraph 94(3)(d)(i) and subsection 94(7).

"cherry picking" such that the trust is not considered resident for all purposes. For example, the trust is not considered resident for purposes of section 116.[49]

There is an expanded list of circumstances under which a non-resident trust may be exempt of section 94. For the most part, these involve trusts that are set up to benefit non-residents. This allows the trust to accumulate income rather than being forced to pay out the income to avoid Canadian taxation.[50]

There are exemptions for *arm's length transfer* where such transfers or loans of property are not considered to be a *contribution* of property for purposes of proposed section 94.[51]

There are limitations on the deductibility of income distributions paid from section 94 deemed resident trusts to non-resident beneficiaries. This can result in the trust having income for tax purposes, even though all the income has in fact been paid out to the beneficiaries.[52]

While the trust is considered a resident for purposes of determining the tax under Part XIII, on amounts paid or credited to the trust, Canadian payors must nevertheless withhold Part XIII tax on payments to the trust. The trust may then reclaim the tax withheld by filing a Canadian income tax return.[53] The trust is, however, still considered to be a non-resident for purposes of determining the tax under Part XIII for payments by the trust itself to beneficiaries. Such payments will not be subject to tax under Part XIII.

When the trust ceases to have a Canadian *resident contributor* or a *resident beneficiary* (either because the *contributor* has died, or because the *contributor* has become a non-resident),[54] the trust is deemed to have a year end immediately prior thereto, and to sell all of its property at fair market value.[55]

There are also many similarities between proposed section 94 and existing section 94. These include:

[49] See proposed paragraph 94(3)(a). Section 116 is not one of the sections for the purposes of which the trust is deemed to be resident in Canada.
[50] See proposed subsection 94(3) and definition of *exempt foreign trust*, in proposed subsection 94(1).
[51] Subsection 94(1).
[52] Proposed subsection 104(7.01). The scope of this is extended beyond the existing subsection 94(3) limitations.
[53] Proposed subparagraph 94(3)(a)(v) and paragraph 94(4)(b).
[54] Specifically neither a *Resident Contributor* or a *Resident Beneficiary*, both defined terms of much precision and complexity, see proposed subsection 94(1).
[55] Proposed subsection 94(5) will deem the trust to have ceased to be resident in Canada at the time which is the earliest time at which there is neither a *Resident Contributor* nor a *Resident Beneficiary*. In such case, subsection 128.1(4) will be applicable. See also proposed subsection 94(5.1).

- It is fundamentally, first and foremost the trust which is the taxable entity.

- Liability for tax flows only if the trust itself is first liable.

- The trust is non-resident for Part XIII purposes in respect of payments made by the trust to beneficiaries.

- Certain of the indirect transfer rules of existing section 94 have been retained.[56]

Under the existing as well as the proposed rules, the trust is deemed to be a person resident in Canada such that it must file Canadian tax returns and pay Canadian tax.

Cost base adjustments will arise upon residency or deemed residency of the trust.[57]

New Charging Provision of Proposed Subsection 94(3)

Proposed subsection 94(3) is the main operating component of proposed section 94. However, before being able to analyze it in detail, it is necessary to review painstakingly a large number of definitions (contained in proposed subsection 94(1)), and special rules (contained in proposed subsection 94(2)).

Proposed subsection 94(3) will apply where there is a trust (other than an *exempt foreign trust*) that is non-resident at the end of a taxation year of the trust, and at that time there is a *resident contributor* to the trust or a *resident beneficiary* under the trust. The terms *resident contributor* and *resident beneficiary*, and *exempt foreign trust* are defined terms. The consequence is that the non-resident trust is deemed resident for purposes of Part I, except in a few aspects. It is taxable accordingly.

It is interesting to note that the draft legislation uses the term “non-resident” in a novel way, not generally found in other parts of the Income Tax Act. Normally, the Income Tax Act would refer to a “non-resident trust”, and not to a trust that is “non-resident”. The same use of the term “non-resident” can be found in the language in proposed section 94.1. Compare this to the use of the phrase “non-resident trust” used in other parts of the Act.[58] It is not clear as to whether there is significance to this new drafting style.

[56] Subsection 94(6), financial assistance, appears as proposed paragraph 94(2)(e). Also proposed paragraph 94(2)(n), trust to trust transfers is essentially the rule contained in existing clause 94(1)(b)(i)(B).
[57] Section 128.1 will be applicable, by virtue of proposed paragraph 94(3)(c).
[58] See draft subsection 107(2.001) for example.

Definitions

The flow of the legislation immediately leads into an analysis of the definitions contained in proposed subsection 94(1).

Resident Contributor

A *resident contributor* to a trust at any time is an *entity* who is, at that time, both resident in Canada and a *contributor* to the trust. However, it does not include an individual (other than a trust) who has not, at that time, been resident in Canada for more than 60 months.

By retaining within the definition a reference to time, it is clearly apparent that there can be a *resident contributor* at a particular time, while at a later time there may not be. If the person who would be a *resident contributor* becomes a non-resident of Canada, or ceases to exist, then that person would at that subsequent time cease to be a *resident contributor*. This is important to note, particularly for purposes of analyzing the special rule contained in proposed subsections 94(5) and 94 (5.1) whereby a trust is deemed to have ceased to be resident in Canada. This will be discussed in detail later.

It should also be noted that the definition of *resident contributor* contains within it the 60-month exemption for immigrants to Canada, and also the exemption for inbound inter-vivos and testamentary trusts. (More will be said about this in analyzing the definition of *resident beneficiary*, which contains a similar provision). Provided the person contributing property to the trust has not been resident in Canada for more than 60 months during his or her lifetime, then the *resident beneficiary* definition is generally not applicable. As there is no *resident contributor* or *resident beneficiary*, proposed subsection 94(3) is simply not applicable.

A *resident contributor* does not include an individual who contributed to an inter vivos trust prior to 1960 while a non-resident. [59]

It should also be noted that the test of applicability in proposed subsection 94(3) is determined at the end of the taxation year of the trust. For an inter-vivos trust, this will be the calendar year. For 60-month immigrant trusts, this preserves the original methodology of existing subsection 94(1). If the person contributing property to the trust has in that calendar year exceeded the 60-month residency period, then the trust will be deemed resident as a consequence throughout that year.

[59] Paragraph (b) of the *resident contributor* definition maintains the same grandfathering rules as in existing section 94, but only for inter-vivos trusts.

Entity

The term *entity* is defined to include an association, a corporation, a fund, an individual, a joint venture, an organization, a partnership, a syndicate and a trust.

Contributor

In further analyzing the *resident contributor* definition, one must then look to the meaning of the word *contributor* since this is also a defined term. A *contributor* to a trust at any time means an *entity* that <u>at or before that time</u> has made a *contribution* to the trust. Note that the definition of *resident contributor* requires the person to be both resident in Canada and a *contributor* to the trust at a particular time, but the definition of *contributor* is a person who at or before that time has made a *contribution*. Therefore, if a person makes a *contribution* while a non-resident, and subsequently becomes resident, he or she will at that later time become a *resident contributor* (absent the exemption for a person who has not been resident 60 months in total during the person's lifetime). A *contributor* includes an *entity* which has ceased to exist.

Contribution

The definition of *contributor* contains a defined term being the word *contribution*. This is probably one of the most difficult aspects of the legislation, as will clearly be seen from the discussion which follows.

A *contribution* at any time to a trust by a particular *entity* means a transfer or loan at that time of property to the trust by the particular *entity* (other than an *arm's length transfer*).[60] Note the extension of the concept of *contribution* to include a loan,[61] and deletion of references to "directly or indirectly" as found now in existing subsection 94(1).

Meaning of Transfer

On a first read, certain persons may wish to skip this section of the paper and return to it later. Proceed to the Resident Beneficiary discussion.

Since the concept of a transfer is so critical and fundamental to the taxation or non-taxation of a non-resident trust, we analyze below the available sources on what constitutes a

[60] Definition of *contribution* in proposed subsection 94(1) in paragraph (a).
[61] It should also be noted that under the case Dunkelman v. MNR, [1959] C.T.C. 375, 59 DTC 1242, Exch Court of Canada, a loan was held not to constitute a transfer of property.

transfer. The word “transfer” is not defined in the proposed legislation, although certain transactions are deemed to be transfers.[62]

The following extracts from Canadian cases show that the word “transfer” has a very broad meaning:

(a) “There is a transfer if there is impoverishment of the transferor, whether the transfer is made directly or indirectly, and corresponding enrichment of the transferee.”[63]

(b) “The *Shorter Oxford English Dictionary On Historical Principles* defines the word ‘*transfer*’ as follows:

1. To convey or take from one place, person, to another; to transmit, transport; to give or hand over from one to another.

2. To convey or make over (title, right or property) by deed or legal process.

The ‘transfer’ of any property is the physical handing-over of it from one person to another whether or not it is accompanied by consideration, as in the case of a sale or by way of gift.…

When a corporation pays a dividend to its shareholders the corporation gives or hands over property to its shareholders. Property is taken from the patrimony of a corporation and placed in the patrimony of a shareholder. When the dividend is declared, the corporation becomes indebted to the shareholder. When the dividend is paid, the corporation divests itself of ownership of the money (or other property) used to pay the dividend.…

…The payment of a dividend in money or other property is a ‘*transfer*’ of property within the meaning of subsection 160(1) of the Act. The corporation is impoverished and its shareholders are enriched. I fail to see the reason why a dividend is not a ‘transfer’ of property.…”[64]

(c) “In the present case, the broad meaning which is ascribed to the word transfer could encompass the transaction through which Adriana acquired shares. I have found that the defendant divested himself of an economic interest in the company and which was vested in his wife. Effectively there was an indirect transfer of Mr. Kieboom’s economic interest in the company of his wife.”[65]

(d) “Was there then a transfer of property within the meaning of subsection 56(2)? It has been held in Warren Champ v. The Queen, [1983] C.T.C. 1 at 3; 83 D.T.C. 5029 at 5031, relying in turn on Estate of D. Fasken v. M.N.R., [1948] C.T.C. 265; 49 D.T.C. 491 (Ex. Ct.) that the word “transfer” should not

[62] See discussion on Extended Meaning of Transfer and proposed subsection 94(2) later.
[63] Hamel v. M.N.R., [1966] 2 C.T.C. 2046 at 2053, T.C.C.
[64] Algoa Trust v. Canada, [1993] 1 C.T.C. 2294, 93 D.T.C. 405 at 2303-2304, 411-412, T.C.C.
[65] Kieboom (A.) v. M.N.R., [1991] 2 C.T.C. 106, 91 D.T.C. 5478 at 116, 5487, F.C.T.D.

be confined to a technical meaning normally associated with the change of ownership of property. It was held in the Champ case that a transfer was effected by the taxpayer to his wife by means of him having the company he controlled pay an amount of dividends to her far in excess of what would be her entitlement based on her shareholding. In the present case the taxpayer contends that there was no 'transfer' because he did not convey the property nor did his company: instead, title issued in his former wife's name by virtue of a court order. It seems to me that the property was nevertheless transferred. Subsection 56(2) does not specify that the previous owner of the property must have willingly and actively conveyed title to the property."[66]

(e) "I accept the contention of counsel for the plaintiff that the word transfer as used in subsection 56(2) and the word 'transferred' as used in subsection 74(1) are not used in a technical sense and in its ordinary dictionary meaning it is to give or hand over property from one person to another."[67]

(f) "The word 'transfer' is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property as to divest himself of it and vest it in his wife, that is to say, pass the property from himself to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer."[68]

(g) "A loan cannot legally be a transfer of property as required by the provisions of 56(2), still less a payment, and the courts have clearly confirmed this interpretation. What the Act means by a 'transfer of property' is not simply a physical transfer but a transfer of the right of ownership attached to the property."[69]

(h) "If the word transfer is taken in its primary sense, a person makes a transfer of property to another person if he does the act or executes the instrument which divests him of the property and at the same time vests it in that other person."

'The expression "has transferred" in section 22(1) has, in my opinion, a similar meaning. All that is necessary is that the taxpayer shall have so dealt with property belonging to him as to divest himself of it and vest it in a person under 19 years of age. The means adopted in any particular case to transfer property are of no importance, as it seems clear that the intention of the subsection is to hold the transferor liable for tax on income from property transferred or on property substituted therefore, no matter what means may have been adopted to accomplish the transfer. Nor is scope of the provision affected or qualified by expressions such as 'as if the transfer had not been made', which appeared in the corresponding section of the Income War Tax Act…

[66] Boardman v. The Queen, [1986] 1 C.T.C. 103, 85 D.T.C. 5628 at 106, 5631, F.C.T.D.
[67] Murphy v. The Queen, [1980] C.T.C. 386, 80 D.T.C. 6314 at 392, 6320, F.C.T.D.
[68] Fasken Estate v. M.N.R., [1948] C.T.C. 265, 49 D.T.C. 491, [1948] Ex. C.R. 580 at 278-83, 496-99, 591-92, Ex. Ct.
[69] Beliveau (P.) v. M.N.R., [1991] 1 C.T.C. 2683, 91 D.T.C. 669, per Couture, at 2690, 675, T.C.C.

> I do not think it can be denied that, by loaning money to the trustees, the appellant, in the technical sense, transferred money to them, even though he acquired in return a right to repayment of a like sum with interest and a mortgage on the Butterfield Block a security, or even though he has since then been repaid with interest. But, in my opinion, it requires an unusual and unnatural use of the words 'has transferred property' to include the making of this loan. For who, having borrowed money and knowing he must repay it, would use such an expression to describe what the lender has done? Or what lender thinks or speaks of having transferred his property, when what he has done is to lend it? Or again, what capital observer would say that the lender, by lending, 'has transferred property'? And, more particularly, who would so describe the lending where, as in this case, the transaction is such that the only purpose to which the money loaned could be turned was in acquiring a property to be immediately mortgaged to the lender? I venture to think, in the terms used by Lord Simonds, that no one, be he lawyer, business man, or man in the street, uses such language to describe such an act. I also think that, if Parliament had intended to include a loan transaction such as the present one, the words necessary to make that intention clear would have been added, and it would not have been left to an expression which, in its usual and natural meaning, does not clearly include such a transaction. To apply the test used by Lord Simonds, I do not think this transaction was one which the language of the subsection, according to its natural meaning, 'fairly' or 'squarely' hits. I am, accordingly, of the opinion that the making of the loan in question was not a transaction within the meaning of the expression "has transferred property" and that section 22(1) does not apply.'[70]

It seems clear that a transfer will include a gift as well as a sale for consideration. All that is required for a transfer of property to occur is for property that previously belonged to one person to become vested in another person. However, based on the Dunkelman decision (see (h) above), a loan is not a transfer. As a result, in order to make sure that loans are also included, the legislation has specifically used the expression "a transfer or loan at the time of property". This is in stark contrast to the language of existing subparagraph 94(1)(b)(i) which speaks of the trust having acquired property directly or indirectly in any matter whatever.

Sequential Transfers

Where a particular transfer or loan of property is made by an *entity* as part of a series of transactions or events that includes another transfer or loan of property to the trust by another entity, that other transfer or loan is also considered to be a *contribution* made to the trust by the particular person (the original person) to the extent that it can reasonably be considered to have been enabled by the particular transfer or loan (the original transfer or

[70] Dunkelman v. M.N.R., [1959] C.T.C. 375, 59 D.T.C. 1242, [1960] Ex. C.R. 73, per Thurlow, at 380-84, 1244, 78, Ex. Ct.

loan).[71] This is intended to deal with back to back arrangements where a person, Mr. A, makes a loan or transfer to another person, say Mr. B, who may or may not be Canadian resident, who then makes a *contribution* to a trust all as part of a series of transactions or events. The rule applies if the first loan or transfer can reasonably be considered to have enabled the second loan or transfer. It would also seem that this could apply sequentially to any number of intermediate persons who are involved in the series of transactions or events. It is interesting to note that not only does the second loan or transfer have to be part of the same series of transactions or events as the first loan or transfer, but also the second loan or transfer must have been enabled by the first.

The third aspect of the definition of *contribution* involves even more indirect arrangements. Where a particular *entity* becomes obligated to make a particular transfer or loan as part of a series of transactions or events that includes a transfer or loan of property that is made by another *entity*, this will be considered to be a *contribution* made by the particular *entity* (the original person) to the extent that the transfer or loan can reasonably be considered to have been enabled by that obligation.[72]

It should also be noted that under the special provisions of proposed subsection 94(2) discussed later, there are at least 12 further rules which will deem a person to have transferred property in certain circumstances. Clearly the intent of the legislation is to address every conceivable situation under which property can be transferred from a Canadian resident person to a non-resident trust.

Whether after analyzing all of these rules, one can conclude that pathways still remain to transfer property outside the ambit of these rules will be debatable. Furthermore, if such pathways do still remain, it will likely be only a matter of time before they are closed.

Resident Beneficiary

A non-resident trust will be liable to tax under proposed subsection 94(3) if at the end of the year of the trust there is a *resident beneficiary*.

The term *resident beneficiary* is even more complicated to understand conceptually than *resident contributor*. Under existing subsection 94(1), an individual who has been resident in Canada for 60 months or more may nevertheless set up a non-resident trust provided he or she has not been a resident of Canada at any time within the previous 18 months. It was

[71] Definition of *contribution*, proposed subsection 94(1) in paragraph (b).
[72] Definition of *contribution*, proposed subsection 94(1) in paragraph (c).

considered appropriate to continue to allow some form of an exemption in these types of circumstances. However, the 18-month period was considered to be too short, and has been extended to a 60-month period, which looks to both the past and to the future. However, the rule is only applicable if there is also a Canadian resident beneficiary.

A *resident beneficiary* at any time of or under a particular trust means an *entity* that is a Canadian resident beneficiary of or under the trust where, at that time, there is a *connected contributor* to the trust.

The word *beneficiary* as used here is also a defined term in subsection 94(1). The definition extends the meaning of *beneficiary* to include a person beneficially interested and a person who may receive income or capital of the trust indirectly through other *entities*.[73]

Simply put, a *resident beneficiary* is defined to mean a person resident in Canada where at that time there is a *connected contributor* to the trust and Canadian resident beneficiary other than a *testamentary beneficiary*.[74]

Connected Contributor

The *resident beneficiary* test is a two-part test in that there must be both a *connected contributor* and a beneficiary resident in Canada (other than a *testamentary beneficiary*). It is now necessary to examine the definition of *connected contributor*.

A *connected contributor* to a trust means an *entity* (including a person who has ceased to exist) who is a *contributor* to the trust, other than an individual (other than a trust) who was before the particular time not resident in Canada for a total of 60 months. It also does not include a person who would not be a *contributor* to the trust if *contributions* made to the trust at a "*non-resident time*" were ignored.

Non Resident-Time

A "non-resident time" means a particular time at which the person is non-resident (or not in existence) throughout the period that begins 60 months before the contribution time and ends 60 months after the contribution time. For transfers before June 23, 2000, the period of non-residency before the *contribution* is 18 months[75]. Where the trust arose as a consequence of the death of a person, the period of non-residency is also shortened to 18 months before the contribution.

[73] Subsection 248(25). It is not clear that paragraph (b) of the definition of beneficiary in proposed subsection 94(l) adds everything to the meaning.
[74] See definition of *testamentary beneficiary* in proposed subsection 94(1).

Testamentary Beneficiary

A *testamentary beneficiary* who is resident in Canada is not considered a *beneficiary* for purposes of the *resident beneficiary* definition.

A *testamentary beneficiary* is a *beneficiary* whose right to receive income or capital is solely dependent on the death of an individual who is alive and who is a *contributor* to the trust or on the death of a person related to that *contributor*.

This rule will exempt a non-resident trust from taxation in limited circumstances where there is no *resident contributor* but there is a *connected contributor*. Note that the *testamentary beneficiary* definition can apply to both an inter-vivos and a testamentary trust.

While not totally clear, it seems likely that a person can be a *testamentary beneficiary* at certain times and not at other times. A person may cease to be a *testamentary beneficiary* say after the death of the person upon which the interest is contingent.

Summary of Resident Beneficiary

To recap, a non-resident trust will fall within proposed subsection 94(3) if there is either a *resident contributor* to the trust or a *resident beneficiary* under the trust. In order to have a *resident beneficiary* under the trust, there must be a Canadian resident beneficiary under the trust and a *connected contributor*. Any person who has transferred property to the trust, including a person who has ceased to exist, will be a *connected contributor* to the trust unless exempted. Two circumstances are exempted. The first is an individual who has not been resident in Canada for more than 60 months. In this way, the definition is very similar to the *resident contributor* test, in that the same exemption is found there.

The second possible exception applies to persons who had been resident for more than 60 months during their lifetime, but who make transfers to the trust while non-resident. In these circumstances, transfers and loans made to the trust will be excluded from being *contributions* if made at a “non-resident time”. This will be so if the person has not been resident for 60 months prior to the time of the transfer or loan, and does not become resident for at least 60 months after the particular time. This effectively puts a ten-year time line around any transfer of property to a trust. (As stated above, the timeframe where residency is permitted preceding the transfer is shortened to 18 months in the event of death or *contributions* before June 23, 2000.)

[75] See Enacting Provision 10(2), paragraph (d).

The ten-year time line will ensure that only non-residents who have left Canada long-term and who intend to remain outside of Canada may set up a non-resident trust for the benefit of Canadian residents. If the non-resident *contributor* decides to return to Canada within 5 years making of the *contribution* to the non-resident trust, the trust would be deemed resident under proposed subsection 94(3) from inception, and not merely upon the return of the non-resident *contributor*.

Suppose a non-resident *contributor* (Mr. NR) who was previously a long-term resident sets up a non-resident trust for Canadian residents. If Mr. NR has been non-resident for 5 years prior to establishing the trust, then the trust will not have a *resident beneficiary*. The *contributions* will have been made at a non-resident time. If Mr. NR returns to Canada within 4 years of establishing the trust, it will be deemed resident from inception. If instead he returns after 6 years, the trust will be deemed resident commencing in the year of his arrival. There will never be a *resident beneficiary*, but Mr. NR will be a *resident contributor* on arrival.

It should be noted that in the case of testamentary trusts, provided the individual has been a non-resident of Canada for 18 months preceding the establishment of the trust (which is presumably the date of death), the forward window is not needed because the individual can never subsequently become a resident of Canada once deceased.

Exempt Foreign Trust

The legislation exempts from the ambit of proposed subsection 94(3) an *exempt foreign trust*. There are a total of nine circumstances under which a non-resident trust can be considered an *exempt foreign trust*. Among these, the majority are not likely to be encountered even occasionally. Of the remainder, the requirements are very stringent, so as to basically make tax planning through the use of *exempt foreign trusts* uninteresting except in very limited circumstances. Where applicable, the benefit to having an *exempt foreign trust* is the ability to accumulate income in a non-resident trust free of Canadian tax mainly for the benefit of non-resident beneficiaries.

The *exempt foreign trust* is a trust which is granted this status at a particular time. It can thus cease to be an *exempt foreign trust* after that particular time. Note that the *exempt foreign trust* rules achieve the same result as the *arm's length transfer* rules as long as this status is maintained. However, rather than the *contribution* being ignored (as occurs under the *arm's length transfer* rules), it will cause the trust to be taxable under proposed subsection 94(3) when the conditions for exempt status cease to be met. A year-end is deemed to occur on transition.[76]

The consequence of being an *exempt foreign trust* is that the trust is exempt of the ambit of proposed subsection 94(3). It would seem then that the trust would not then be subject to Canadian taxation on its world income. Instead, the trust would be subject to taxation under section 115, and to non-resident withholding tax, in the normal manner applicable to non-residents.

On a first read, certain persons may wish to skip this section of the paper from here on, and return to it later. Proceed to Detailed Mechanics of Subsection 94(3).

Infirm Beneficiary

The first exemption is concerned with infirm beneficiaries. It is a four-part test.[77]

Firstly, under this rule, each beneficiary who can currently benefit under the non-resident trust must be an individual who at the time the trust was created was, because of mental or physical infirmity, dependent on an individual who is a *contributor* to the trust or an individual related to the *contributor*. No other person may be entitled to receive or otherwise obtain use of the trust's income or capital until after the "particular time". The construction of the rule is to disqualify the trust from being an *exempt foreign trust* after the particular time. The "particular time" can be thought of as the time at which the trust ceases to be an *exempt foreign trust*, and only after this may non-infirm beneficiaries benefit under the trust (e.g., on death of the infirm beneficiary).

There are three further conditions.

At least one infirm beneficiary must suffer at the particular time from a mental or physical infirmity which causes the beneficiary to be dependent on any person (and not necessarily the *contributor* to the trust or an individual related to such *contributor*). This rule will allow for persons in addition to the initial infirm beneficiary, who subsequent to the trust's creation become infirm, to benefit under the trust, while preserving the *exempt foreign trust* status. It also takes into account that over time the person upon whom the infirm beneficiary is dependent could change.

[76] Proposed subsection 94(6).
[77] Definition of *Exempt foreign trust* in proposed subsection 94(1) in paragraph (a).

Each infirm beneficiary must be non-resident at some time in the trust's taxation year that includes the particular time. This allows for an infirm beneficiary who is a resident of Canada to become a non-resident in the year that the trust is established. The idea clearly though is to benefit non-residents, not Canadian residents.

Lastly, each *contribution* to the trust made at or before the particular time must reasonably be considered to have been, at the time the *contribution* was made, to provide for the maintenance of an infirm beneficiary during the expected period of the beneficiary's infirmity.

To recap, the following conditions are required:

i) the non-resident trust must be established in order to provide for the maintenance of an infirm beneficiary, with the amount of the *contributions* being reasonable for this purpose;

ii) the infirm beneficiary must be a non-resident at some time during the trust's taxation year;

iii) the infirm beneficiary must be dependent upon some person (who is not necessarily the *contributor* to the trust or a person related to the *contributor*); and

iv) at the time the trust is created, each beneficiary must be either an individual who is dependent on the *contributor* or a person related to the *contributor* because of infirmity, or be a person who is only entitled to benefit under the trust at some time in the future (whereupon the trust will cease to be an exempt foreign trust).

Marital Breakdown

The next situation of an *exempt foreign trust* concerns marital breakdown. This is a five-part test with even greater complexity and more stringent requirements.[78] The tests are:

i) The trust must have been created after the breakdown of the marriage or common law partnership of two individuals and the purpose of the trust must be to provide for the maintenance of a beneficiary under the trust who is a child of one of those individuals (the child beneficiary).

ii) Each beneficiary under the trust at the particular time must be a child beneficiary under the age of 21, a child beneficiary under age 31 who is enrolled at any time in the

[78] Definition of *Exempt foreign trust* in proposed subsection 94(1) in paragraph (b).

trust's taxation year at an educational institution as described below, or a person who is entitled to benefit under the trust only after the particular time.[79]

iii) Each beneficiary must be non-resident at some time in the trust's current year.

iv) Each *contributor* to the trust must be either one of the individuals involved in the marriage breakdown, or a person related to one of those individuals. (This means that well meaning grandparents could contribute to the trust).

v) Each *contribution* to the trust at the time the *contribution* was made must have been to provide for the maintenance of a child beneficiary while under the age of 21, or if under the age of 31, then enrolled at an educational institution located outside Canada. The educational institution must be a university, college or other educational institution that provides courses at a post-secondary school level or an educational institution that provides courses that furnish a person with skills for, or improve a person's skills in, an occupation.

This will allow Canadians who are party to a marital breakdown or suchlike to establish non-resident trusts for a child who becomes a non-resident, which will provide for maintenance and education. A lump sum amount could be placed in the non-resident trust, and the income derived from this lump sum could be accumulated in the trust without Canadian tax. The amount that may be contributed is limited to what is required to achieve the purpose of the trust. It could be a reasonably large lump sum if it were to fund, for example, seven years of university education in the U.S. Still, the opportunity for tax planning is limited.

Charitable and Other Trusts

The other types of *exempt foreign trusts* are less interesting, and will be described here more briefly.[80]

Trusts that are charitable in nature are exempt. The third and fourth set of exceptions deals with them. These exceptions were necessary because otherwise if a Canadian contributes property to any non-resident trust (other than via an *arm's length transfer*), the trust itself will be subject to Canadian tax on its world income. Accordingly, a strange and embarrassing result could occur where Canadians made *contributions* to trusts that are non-resident, and have only non-resident beneficiaries (possibly bona fide charities or even government agencies), and basically have no connections to Canada other than the fact that they

[79] Same basic construction as the infirm beneficiary rule (see above)

accepted a donation from a Canadian resident person. In such circumstances, the trust could be subject to Canadian tax on its worldwide income, and would be required under Canadian law to file Canadian income tax returns etc. One can imagine a scenario where donations to an international charity would not be accepted from Canadians.

A trust that is an agency of the United Nations is specifically and unconditionally an *exempt foreign trust*. Likewise, a trust which owns and administers a university outside Canada that is prescribed to be a university the student body of which ordinarily includes students from Canada will be exempt.[81] Also exempt is a trust which has in that year or the preceding year received a gift from Her Majesty in right of Canada. Accordingly, if one could lure the government into making a token gift to one's own non-resident trust, this would be a sure way to obtain exempt status, at least for two years.

In general, a trust established for charitable purposes is an *exempt foreign trust*, provided it meets five basic conditions. These are:

i) The trust must be non-resident (and at all times would not be deemed resident under subsection 94(1) as it read before 2002).

ii) The trust must be created and must have been operated throughout the period that began when it was created and ended at the particular time exclusively for charitable purposes.

iii) At all times beyond 24 months after the trust is created, there must be a group of at least 20 persons (other than trusts) who are *contributors* to the trust and who all deal at arm's length with each other.

iv) The income of the trust would, if not for the exemption for charitable purposes, be subject to an income or profits tax in the country in which it is resident other than Canada.

v) The laws of the particular country where the trust is resident must exempt the trust from the payment of income or profits tax in recognition of the charitable purposes for which the trust is operated.

[80] Definition of *Exempt foreign trust* in proposed subsection 94(1) in paragraphs (c) to (i).
[81] Paragraph (f) of the definition of total charitable gifts in subsection 118.1(1).

The requirement to have at least 20 arm's length individuals who have contributed to the trust, together with the other stringent requirements concerning the purpose for which the trust is established, the fact that it must be operated exclusively for charitable purposes, and that the foreign country must recognize it as being tax exempt due to its charitable nature, make this rule extremely resilient to abuse. It would be very difficult to create any realistic scenario where a foreign charitable trust of this nature could be used for unintended tax planning purposes.

Other Exempt Foreign Trusts

The other situations under which a non-resident trust may be an *exempt foreign trust* concern trusts that are governed by a retirement compensation arrangement, a foreign retirement arrangement, an employees profit sharing plan, an employee benefit plan and a widely held mutual fund trust. The widely held mutual fund trust is a trust which is an exempt trust as defined in paragraph (c) of subsection 233.2(1). This type of trust will potentially be considered a foreign investment entity for purposes of proposed section 94.1.

Trusts may be prescribed to be *exempt foreign trusts*. Thus in a situation where a non-resident trust was unwittingly and inappropriately caught under proposed subsection 94(3), it could be exempted by regulation. It is quite likely that such situations will arise.[82] Whether they are ever brought to light will be another matter.

Arm's Length Transfer

This section may be skipped on first read. Proceed to Detailed Mechanics of Subsection 94(3).

Throughout proposed section 94, there are references to an *arm's length transfer*. The main definition of *contribution* and the extended transfer rules exempt from a *contribution* a transfer or loan of property which is an *arm's length transfer*. Therefore, it is necessary to examine closely the definition of an *arm's length transfer*, since such a transaction may be sufficient to exclude the trust from the ambit of proposed subsection 94(3). As might be imagined, the circumstances under which a transaction will be an *arm's length transfer* are very limited. Furthermore, the rule is drafted extremely subjectively, leading to difficulty in

[82] Consider a nominal contribution by a Canadian to a foreign charitable trust or government fund which did not specifically fit the exempting requirements. There could even be scope for public mischief.

interpreting the rule with any degree of precision. Therefore, reliance on this rule will be difficult.

The *arm's length transfer* rule in the August 2, 2001 draft legislation is more liberal than that of the June 22, 2000 draft legislation.

There are five possible *arm's length transfer* exemptions.

The first exemption applies to transfer that involves a payment of interest, a dividend, rent, a royalty, or any other similar return on investment if the fair market value of the property transferred does not exceed the fair market value of property that the transferor would have been willing to transfer if the parties had dealt at arm's length.[83] In other words, the rate of return must be reasonable in relation to the value of the asset held. Also, the transfer cannot be a transfer described in paragraph 94(2)(g). These include such things as the issuance of shares by a corporation and the issuance of debt. This will be discussed later in detail.

The second type of transaction is a transfer that is a reduction in the paid up capital of a corporation's stock. Again, the payment cannot be a transfer described in paragraph 94(2)(g).

The third situation is a transfer or loan made in the ordinary course of the business of the transferor. This might apply, for example, to a commercial lending institution who makes a loan to a non-resident trust.

The fourth transaction is a refund of a gift made to a *specified charity* of the recipient.[84]

The fifth type of transaction is much more general. It is a transaction where it is reasonable to conclude that none of the reasons for the particular transfer or loan was to permit or facilitate the conferral at any time of a benefit in respect of the transferor, a descendant of the transferor, or any person with whom the transferor or a descendant does not deal at arm's length. It must also be a transaction that an arm's length person would be willing to do. The exact text of the legislation should be consulted for more details.

It should be noted that for purposes of the foreign reporting rules,[85] the *arm's length transfer* exemption is a basis upon which an exemption can be claimed from the reporting

[83] Note that this wording presumes that the payment of interest, dividends etc. is itself a transfer. This may be derived from the comments in Algoa Trust v. Canada (Supra, Footnote 65).
[84] Specified charity is defined in proposed subsection 94(1).

requirements, except for the fifth type of transaction (paragraph (e)). Therefore, in the general case (paragraph (e)) whether a transfer is an *arm's length transfer* or not, the foreign reporting requirements will still apply, so that the CCRA can examine the transaction with full disclosure.

It is not uncommon for non-residents to make investments in Canadian businesses and Canadian real estate through non-resident trusts. These trusts may have no connection to Canada, other than the investment. However, if a Canadian resident person (whether related or not, and whether or not a beneficiary of the trust) transfers property to the trust, then the trust will be deemed to be Canadian resident by virtue of having a *resident contributor*. This result is avoided via the *arm's length transfer* rule. Whether this exemption is still too narrowly defined remains to be seen.

Note that a transaction which is arm's length, is not necessarily an *arm's length transfer*. Conversely, a non-arm's length transaction could be an *arm's length transfer*. This choice of wording, *arm's length transfer,* is unfortunate because it is potentially misleading.

Extended Meaning Of Transfer

This section may be skipped on a first read. Proceed to Detailed Mechanics of Subsection 94(3).

As if the rules were not complex enough, proposed subsection 94(2) has been added to define at least 12 situations where a transfer is specifically deemed to occur. It has two main purposes, namely to extend the circumstances under which a transfer will be considered to have taken place by adding these deeming rules, and to quantify the value of property that is transferred for purposes of the joint and several liability for tax rule which is discussed later.

Proposed paragraphs 94(2)(a), (c), (e), (f), (g), (h), (j), (k), (l), (m), (n) and (o) contain the extended transfer rules. Each of these will be analyzed individually.

Proposed Paragraph 94(2)(a) - Inadequate Consideration

Proposed paragraph 94(2)(a) applies unless proposed paragraph 94(2)(c) applies. It deals with transfers to another *entity* where as a consequence, the value of property held by a trust

[85] Amended subsection 233.2(2).

increases or a liability of the trust decreases at the time of the transfer. Specifically, property is deemed to be transferred by an *entity* to a trust where, because of the transfer or loan, the value of one or more properties held by the trust increases, or a liability or potential liability of the trust decreases at the time of the transfer.

The explanatory notes give two examples of proposed paragraph 94(2)(a). They both involve transactions for clearly inadequate consideration, which, as a consequence, result in the conferral of a benefit. In the first example, a Canadian resident purchases property and pays more than fair market value. This property is held by a corporation, and a non-resident trust holds shares in the corporation. These shares increase in value as a result of the transaction occurring at an inflated price. The second example is merely a variation of the first example, and which also illustrates proposed paragraph 94(2)(m).

It should be noted that this rule will only apply where property held by the trust increases in value as a result of the transaction <u>at the time</u> of the transfer or loan. Therefore, this rule cannot apply to an estate freeze type of transaction, where at the time of the freeze, fair market value consideration has been received.

Proposed Paragraph 94(2)(c) - Inadequate Consideration

This paragraph deals again with indirect transfers, but is more complex to interpret than proposed paragraph 94(2)(a). It will apply to transfers or loans to another *entity* (referred to as the "recipient") where the following conditions are met, being:

i) a trust must hold property at or after the time of the transfer the fair market value of which is derived, in whole or in part, directly or indirectly, from properties held by the recipient, and

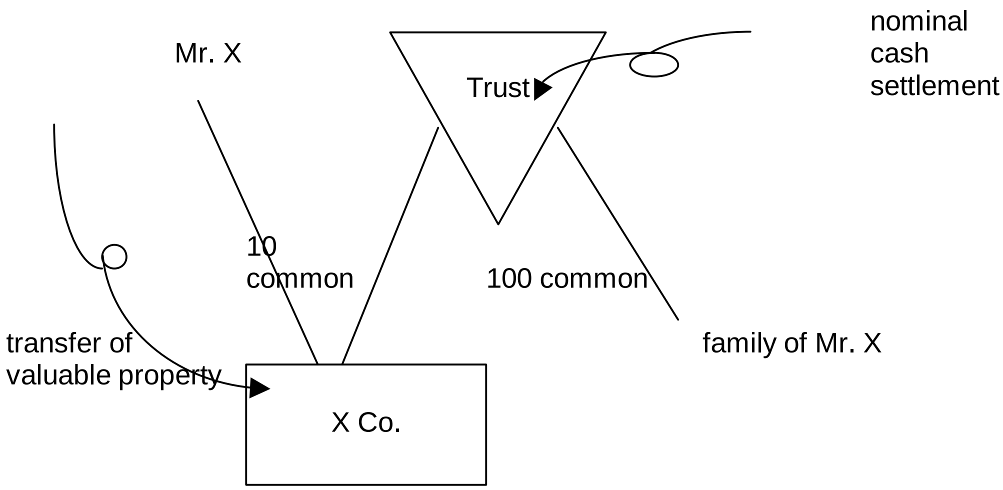
ii) it is reasonable to conclude that one of the reasons for the transfer or loan to the recipient was to permit or facilitate directly or indirectly, the conferral at any time of a benefit on the transferor, a descendant of the transferor or an *entity* with whom the transferor or descendant does not deal at arm's length.

It should be noted that both proposed paragraphs 94(2)(a) and 94(2)(c) contain specific exclusions for *arm's length transfers*, although an exclusion for *arm's length transfers* has been included in the definition of "contribution" and should apply to all transfers in any case.

Note that the provision applies where the trust derives value from the transactions <u>at or after the time</u> of the transfer or loan.

This rule is probably best understood by reference to an example. It is unfortunate that the explanatory notes do not give such an example.

In our example, a trust is established for the benefit of the family of Mr. X. The trust is settled with a nominal contribution of capital. The trust then uses the funds to subscribe to 100 common shares of X Co., a non-resident corporation. Mr. X then transfers valuable property to X Co. and takes back no consideration or consideration of less than fair market value, such as 10 common shares of X Co.[86] By doing this, a substantial amount of value is immediately transferred to the trust. Clearly the reason for the transfer to XCo at below fair market value is to permit the conferral of a benefit on the beneficiaries of the trust, who do not deal at arm's length with Mr. X.



The result of this is that Mr. X is deemed to have transferred property to the trust.

Proposed Paragraph 94(2)(e) - Guarantees, Financial Assistance

Proposed paragraph 94(2)(e) is virtually identical to its predecessor in subsection 94(6) of the existing legislation. It provides that where at any time an *entity* has given a guarantee on behalf of, or has provided any other financial assistance to, another *entity*, the *entity* is deemed to have transferred, at that time, property to that other *entity*. However, there is no further clarification on what constitutes "any other financial assistance". Therefore, it is difficult to determine where this provision could apply, and in particular whether it applies to an estate freeze.

[86] Mr. X will trigger any accrued gains on hand in the property he transfers. The purpose though is to plan for future gains, not current gains.

See the previous discussion on financial assistance.

Proposed Paragraph 94(2)(f) - Services

This paragraph applies for transactions occurring only after June 22, 2000. It should be noted that for the majority of rules governing transfers of property, there is no grandfathering. This is an exception.

The rules in proposed paragraph 94(2)(f) apply to the rendering of services by an *entity* (referred to as a “service provider”) to, for or on behalf of another *entity* (referred to as a “recipient”). In such circumstances, the service provider rendering any service (other than an exempt service) is deemed to have transferred property at that time to the recipient of the service. The following are exempt services:

i) services provided to a trust in relation to the administration of the trust;

ii) services rendered in the capacity as an employee, or as an agent, where in exchange for the service, the recipient transfers or loans property or becomes so obligated and the exchange is made under arm’s length terms and conditions and would have been acceptable to the service provider if the service provider had dealt at arm’s length with the recipient.

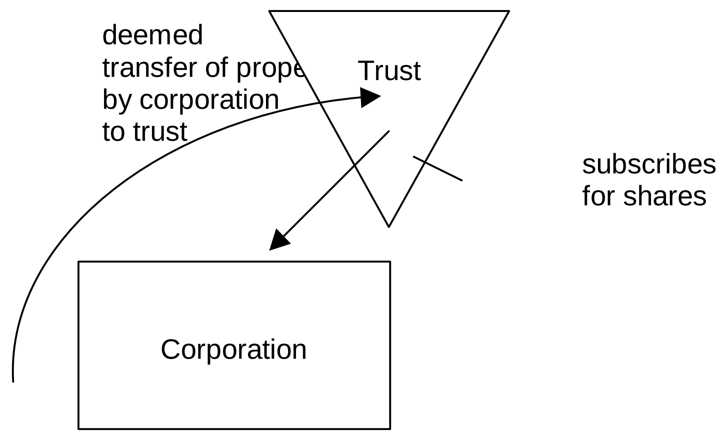
Thus any Canadian corporation, partnership with a Canadian partner, Canadian trust or long term Canadian resident individual that renders a service to a foreign trust, in the capacity as an employee or agent of the foreign trust, will be a *resident contributor* unless the arm’s length conditions are met. In the world at large, there are many commercial trusts that carry on business or hold investments. If a Canadian renders a service to such a trust (for example gives a legal opinion as to the trust’s Canadian tax liability or prepares a tax return), that act should surely not cause the trust to become deemed a Canadian resident provided there has been arm’s length consideration. Hopefully this rule will be applied rationally by the CCRA.

Proposed Paragraph 94(2)(g) - Share Subscriptions etc.

This paragraph applies in four circumstances, all of which involve the acquisition of property[87].

[87] There is no longer any grandfathering provision to this rule. This rule will apply to acquisitions even if made before June 22, 2000. The previous version of the legislation had an exemption for transactions before this date.

Where a particular *entity* acquires a share of the capital stock of a corporation from the corporation, the corporation is deemed to have transferred, at that time, the share to the particular *entity*. This rule, the first of the four rules in paragraph 94(2)(g), is likely to be the one most commonly encountered in international trust structures. This would apply to an acquisition of shares by a non-resident trust in an estate freeze type transaction, where the non-resident trust subscribes to common shares of a Canadian corporation. In such circumstances, the corporation, a Canadian resident, will be considered a *resident contributor*.



Where an *entity* acquires a beneficial interest in a trust, other than as a consequence of the disposition of the interest by a beneficiary under the trust, then the trust is deemed to have transferred at that time the interest to the particular *entity*. This is not going to be a commonly encountered transaction except in commercial situations, since generally persons do not subscribe to beneficial interests in trusts.

A similar rule applies to the acquisition of an interest in a partnership, otherwise than as a consequence of a disposition of the interest by a member of the partnership. This will constitute a transfer by the partnership to the acquirer.[88]

Lastly, where the entity acquires indebtedness owing by a corporation, trust or partnership from the corporation, trust or partnership, then the corporation, trust or partnership is deemed to have transferred the debt to the particular entity.

[88] Other persons may also be *resident contributors* per proposed paragraph 94(2)(o) discussed later.

Proposed Paragraph 94(2)(h) - Grant of a Right

Where after June 22, 2000, a particular *entity* grants to another *entity* the right to acquire or be loaned property, the particular *entity* is deemed to have transferred property at that time to that other *entity*.

Proposed Paragraph 94(2)(j) - Obligation to Transfer

Where at any time a particular *entity* becomes obligated to do an act that would constitute the transfer of a property to another *entity* if the act occurred, the particular *entity* is deemed to have become obligated at that time to transfer property to that other *entity*. This rule is particularly relevant for purposes of the definition of *contribution* in proposed paragraph 94(1)(c). This is obviously intended to address more indirect transfers of property or elaborate sequences of transactions that involve a series of steps.

Proposed Paragraph 94(2)(k) - Death

Where a property is acquired at any time by an entity as a consequence of the death of an individual, the individual is deemed to have transferred the property to the entity immediately before the individual's death.

As the transfer occurs immediately before death, the deceased will be a *resident contributor* until death if he or she is resident in Canada prior to death. At death, the deceased will cease to be a *resident contributor*.

The rule also has application to the *resident beneficiary* test.[89] The deceased would be considered a *connected contributor* to the trust. Note that the preamble to this definition states, "a person (including a person who has ceased to exist)". If the deceased was resident in Canada at any time in the 18 months preceding death, then this would also make the deceased a *connected contributor*. The issue then comes down to whether there is a Canadian resident beneficiary. If so, a non-resident trust created on death in this circumstance would be a proposed subsection 94(3) deemed resident trust. Otherwise it seems it would not.

Therefore, if a Canadian resident individual dies, and as a consequence of death establishes a non-resident testamentary trust, the trust will be subject to the rules of proposed section 94 until death. This will merely be a moment in time. Whether the trust will continue to be

[89] Recall that this definition requires a *connected contributor* <u>and</u> a beneficiary resident in Canada.

subject to the rules of proposed section 94 by meeting the *resident beneficiary* test will depend upon the residency of the beneficiaries and the nature of their interests.

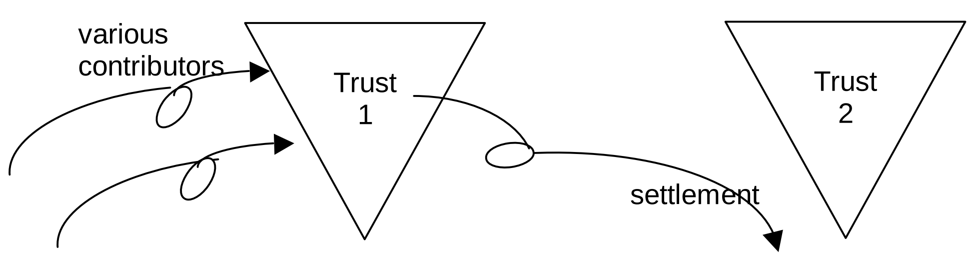
Proposed Paragraphs 94(2)(l) and (m) – Transfers Involving Others

These paragraphs apply where an *entity* makes a *contribution* to another *entity* at the direction or with the concurrence of a third party and it is reasonable to conclude that one of the reasons was to enable the third party to avoid joint and several liability. The *contribution* is deemed to be made jointly by the third party. For example, suppose that under an estate freeze, a corporation issues common shares to a non-resident trust. This is deemed to be a *contribution* of property by the corporation to the trust.[90] In turn, proposed paragraph 94(2)(l) will deem the person who "orchestrated" the freeze to be jointly liable with the corporation unless none of the reasons for the series of transactions is to avoid the joint and several liability doctrine. Proposed paragraph 94(2)(m) is applicable where the transferring *entity* is a controlled foreign affiliate of the third party or if the transfer is made in contemplation of the transferring *entity* becoming a controlled foreign affiliate of the third party.

It should be emphasized that in order for there to be joint and several liability for tax, there must first be a tax liability of the trust. If it is genuinely believed that there will be no such liability, proposed paragraph 94(l) or (m) may be inapplicable.

Proposed Paragraph 94(2)(n) – Trust to Trust Contribution

This rule is similar to the existing rule in subsection 94(1).[91] It applies where a particular trust makes a *contribution* to another trust, to deem the *contribution* to be made jointly by the particular trust and each *entity* that, at that particular time, is a *contributor* to the particular trust. Therefore, if a non-resident trust transfers property to another non-resident trust, that second non-resident trust will take on the same characteristics for purposes of proposed section 94 as the first trust.



[90] Proposed paragraph 94(2)(g).
[91] See existing clause 94(1)(b)(i)(B).

Proposed Paragraph 94(2)(o) – Partnership to Trust Contribution

This rule applies where a partnership makes a contribution to a trust. In such circumstances, the contribution is deemed to be made jointly by the partnership and each person or partnership that is a member of the particular partnership. However, it does not apply to any member of the partnership where, by operation of any law governing the partnership arrangement, the liability of the member as a member of the particular partnership is limited. This means that if a limited partnership transfers property to a non-resident trust, for example, then the transfer will be considered to have been made by the general partner (whose liability for indebtedness of the partnership is not limited), and the partnership itself.

It is perhaps interesting to consider whether a partnership could be a *resident beneficiary* or a *resident contributor*. In both cases, the definition applies only to "an *entity*… resident in Canada". Can a partnership be resident in Canada? If not, it would seem that a partnership cannot be a *resident contributor* or a *resident beneficiary*. Therefore, in the unusual event that a partnership transfers property to a non-resident trust, it may be possible to argue that this falls outside of the ambit of proposed section 94, except as proposed paragraph 94(2)(m) would deem the contributions to be made by the partners.

Joint and Several Liability

Under proposed paragraph 94(3)(d), each person who at any time in the year is a *resident contributor* to the trust or a *resident beneficiary* under the trust shall have, jointly and severally with the trust and with each other such entity, the rights and obligations of the trust in respect of the year under Division I and J and subsection 180.1(4), and each entity shall be subject to the provisions of Part XV in respect of those rights and obligations. This rule was believed to be necessary to enforce the legislation because, without having a Canadian resident responsible for the tax of the non-resident trust, enforcement could be difficult. This rule extends the widest possible net of joint and several liability, to assist enforcement action and serve as a deterrent for persons seeking to establish non-resident trust arrangements.

More will be said about this rule later, but it should be noted that this rule is by far the most far reaching provision ever proposed in Canada for joint and several liability under which a person can be liable for another's taxes. The closest provision at present is for non-arm's length transfers under section 160. In these circumstances, the amount of liability is normally limited to the value of the transfer.

The purpose of introducing this topic at this stage in the paper is merely to comment on proposed paragraphs 94(2)(b), (d), (i), (p), (q) and (r). These deal with either the quantification of the amount of a transfer, for purposes of a limitation on recovery rule in proposed subsection 94(7) (discussed later), or the scope of the joint and several liability.

Proposed Paragraph 94(2)(b) and (d) – Value of Contribution

Proposed paragraph 94(2)(b) is a rule to determine the fair market value of property transferred in circumstances where proposed paragraph 94(2)(a) applies. The fair market value of property transferred is the amount by which the fair market value of the property of the trust increases or a liability or potential liability of the trust decreases as a result of the transaction. This should generally be fairly straightforward to determine.

Proposed paragraph 94(2)(d) is a rule to determine the fair market value of property transferred in circumstances where proposed paragraph 94(2)(c) applies. This is deemed to be the fair market value of the property actually transferred.

Proposed Paragraph 94(2)(i) – Value of Assistance, Service, Right

This rule applies for purposes of proposed paragraphs 94(2)(e), (f), and (h). Here the fair market value of the property transferred is the fair market value at the time of transfer of the assistance, service or right to which the property relates. This will be difficult to quantify in many cases. Also, the fair market value of such assistance at the time of the transfer may be nil or a nominal amount in that the value may accrue over time in the future.

Proposed Paragraph 94(2)(p) – Value of Contribution

In general, and subject to proposed subsection 94(9), the fair market value of a *contribution* to a trust will be deemed to be the fair market value at the time of the *contribution* of the property that was the subject of the *contribution*.

Proposed paragraph 94(2)(q) and (r) - Treasury Interest of Trust

Proposed paragraph 94(2)(q) applies to deem an *entity* to have made a *contribution* to the trust if the *entity* acquires a treasury interest from the trust. The *contribution* is deemed to be equal to the fair market value at that time of the treasury interest. Proposed paragraph 94(2)(r) provides for an exception to proposed paragraph 94(2)(q) where the transaction was carried out on an arm’s length basis.

Concluding Comments on Proposed Subsection 94(2)

The deeming rules in proposed subsection 94(2) apply only for purposes of proposed section 94, and not elsewhere in the Act in and of themselves.

The rules in proposed subsection 94(2) can be applied sequentially, meaning several can apply to a transaction or arrangement.

The rules do not apply for greater certainty; rather they deem a result to occur which would otherwise not occur.

Unlike the June 22, 2000 version of the rules, concerning which we commented that "many of the rules are vague and difficult to interpret", this version of the rules shows broad drafting and a considered and well reasoned approach.

These deeming rules do not preclude the application of other rules in the Income Tax Act that may be relevant to proposed section 94. For example, the fact that a particular transfer is not listed in proposed subsection 94(2) does not mean that it is not a transfer.

In most cases, the rules apply to transactions at any time (even many years ago)[92]. Therefore all existing situations must be analyzed in accordance with these new rules. Certainly some unusual and unintended results will arise along with unhappy and surprised taxpayers and professional advisors.

A Few Words About "Time"

It is interesting to consider the various ways in which time is important to the application of the rules which govern proposed subsection 94(3). This will become clear from the discussion below.

Firstly, proposed subsection 94(3) applies where a trust is non-resident <u>at the end of a taxation year of the trust</u> and, <u>at that time</u>, there is a *resident contributor* to the trust or a *resident beneficiary* under the trust. Accordingly, what is relevant first of all is the state of events at the end of the taxation year of the trust.

The *resident contributor* test will apply <u>at any time</u> where a person is <u>at that time</u> both resident in Canada and a *contributor* to the trust. A person is a *contributor* to the trust at any

[92] Proposed paragraph 94(2)(f) and (h) are exceptions.

time where the person has <u>at or before that time</u> made a *contribution* to the trust. A *contribution*, in turn, is defined <u>at any time</u> to be a transfer or loan <u>at that time</u> of property to the trust. This means, in summary, that a *resident contributor* is a person who is both resident in Canada at the relevant time, which is the end of the taxation year of the trust, and also a *contributor* to the trust at that time or at any time before that time. Therefore, past *contributions* to trusts will be relevant, regardless of how long ago they were made.[93]

The extended transfer rules in proposed subsection 94(2) generally apply to transfers, loans, transactions or events occurring at any time. Transactions which occurred prior to the introduction of these rules will nevertheless be relevant now for purposes of most of these rules.

The *resident beneficiary* test is relevant <u>only at the end of the taxation year of the trust</u>. A person will be a *resident beneficiary* <u>at any time</u> where <u>at that time</u> there is both a *connected contributor* to the trust and a beneficiary under the trust who is resident in Canada <u>at that time</u>. It is therefore possible to have a *resident beneficiary* at certain times and to not have a *resident beneficiary* at other times. This can occur because beneficiaries become non-resident, are deleted from benefiting under the trust, or die.

Where there ceases to be a *resident contributor* or a *resident beneficiary*, special rules apply to subject the trust to departure tax. This is discussed in detail later.

E. <u>DETAILED MECHANICS OF SUBSECTION 94(3)</u>

Proposed subsection 94(3) is the main charging section of proposed section 94 in that it outlines the manner in which the trust is taxed. It must be read in conjunction with proposed subsection 94(4) because paragraph (a) of proposed subsection 94(3) states that it is specifically so subject. The trust is deemed to be resident in Canada throughout the year for purposes of an extensive list of items. The trust is not in general a resident of Canada, so remember that it is only resident for the purposes specifically stated.

The trust is resident firstly for purposes of applying section 2.[94] Section 2 is the main charging provision of Part I of the Income Tax Act. The trust will compute its income and its taxable income under subsection 2(1), and then compute taxes payable.

[93] There is an exception for certain inter-vivos trusts created before 1960.
[94] Proposed subparagraph 94(3)(a)(ii)

It is curious to consider why the draft legislation added subparagraph 94(3)(a)(i) which says that the trust is resident for purposes of "computing the trust's income for the year"[95]. Surely subsection 2(1) achieves this.

The trust is also considered resident for purposes of applying proposed subsections 94(5) and (5.1), clause 53(2)(h)(i.1)(B), the definition of non-resident entity in proposed subsection 94.1(1), subsections 104(13.1) to (29), and 107(5), sections 115, 233.3 and 233.4. Each of these is discussed below.

[95] Proposed subparagraph 94(3)(a)(i)

Proposed Subsections 94(5) and (5.1) – Ceasing to be Deemed Resident

The special rule in proposed subsection 94(5) applies to deem the trust to have ceased[96] to be resident in Canada at any time where there is neither a *resident contributor* nor a *resident beneficiary.* The rule works mechanically as follows:

i) It must be possible to identify a particular time in a period that would be a taxation year of a trust that follows a taxation year of the trust throughout which the trust is resident in Canada. The trust was resident due to proposed subsection 94(3).

ii) The trust was non-resident at the end of the particular period. This means that proposed subsection 94(3) would not be applicable at the end of the particular period, because of not having a *resident contributor* or a *resident beneficiary*.

iii) There was a *resident contributor* to the trust or a *resident beneficiary* under the trust at the beginning of the particular period. This is necessary in order for proposed subsection 94(3) to apply in the first instance for the preceding taxation year.

iv) The time is the earliest time in the particular period at which there is neither a *resident contributor* to the trust nor a *resident beneficiary* under the trust. A deemed year-end occurs immediately before this time.

This is best illustrated by an example. Suppose that John Smith is a *resident contributor*. He is a long term resident of Canada and a *contributor* to the Smith Trust, which is a non-resident trust. For simplicity, it is assumed here that the Smith Trust has no beneficiary who is resident in Canada. Suppose that the trust would normally have a calendar year end, being an inter-vivos trust, and that John Smith dies on July 1, 2002.

The period that would be the taxation year of the trust is calendar 2002. At the end of the period, the trust is non-resident, because proposed subsection 94(3) would not be applicable at December 31, 2002. Proposed subsection 94(3) applies only where there is a *resident contributor* or a *resident beneficiary* at the end of the taxation year of the trust. This would

[96] Note here that the trust is deemed to have ceased to be resident. This is consistent with the wording of subsection 128.1(4). It should be noted that where a trust ceases to be a resident in Canada, it is deemed

not be the case since John Smith, the only *resident contributor*, is deceased. However, there was a *resident contributor* to the trust at the beginning of the particular period, which commenced January 1, 2002. The earliest time in the particular period at which there is neither a *resident contributor* to the trust nor a *resident beneficiary* under the trust is John Smith's date of death of July 1, 2002. This now brings the analysis back to proposed paragraph 94(5)(a). There is a time, July 1, 2002, that is in a particular period, the 2002 calendar year, that but for this subsection and subsection 128.1(4) would be a taxation year of the trust (the 2002 taxation year), that immediately follows the taxation year of the trust throughout which the trust was resident in Canada because of the application of proposed subsection 94(3). Accordingly, the four conditions of proposed subsection 94(5) would be met, deeming the trust to cease to be resident in Canada at the earliest time that there is neither a *resident contributor* to the trust nor a *resident beneficiary* under the trust, being July 1, 2002.

It should be noted that the rule in proposed subsection 94(5) only applies where there is no longer a *resident contributor* <u>or</u> a *resident beneficiary*.

This rule has the effect of extending the deemed disposition rule on death or on leaving Canada in an extraordinary way. Let us return to the example of John Smith discussed above. In this situation, suppose that he established a trust for his non-resident children many years before his death. It is quite possible that he has had very little contact with the trust since the time that it was established, because as settlor, and not trustee, it is not necessary for him to have an ongoing relationship with the trust. Under this rule, the Smith Trust will be subject to Canadian taxation from a deemed disposition of its assets, due solely to John's death. Whether or not income created as a result of the deemed disposition of assets within the trust can be paid out to beneficiaries, so as not to subject such income to tax in the trust, is unclear. Some persons believe that so-called "phantom income" cannot be distributed to a beneficiary because there would not be an <u>amount of income</u> that become payable in the year to a beneficiary[97].

One significant change from the June 22, 2000 draft amendments to the August 2, 2001 version is the addition of proposed subsection 94(5.1). It applies where a trust to which

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to have a taxation year immediately prior to ceasing to be resident, with all of the ensuring consequences of subsection 128.1(4).

[97] Paragraph 104(6)(b) allows a deduction for income for the year as became payable to a beneficiary. If income is not actually realized, can it become payable?

proposed subsection 94(3) applied no longer has a *resident contributor*. Thus the deemed disposition rule will apply even if the trust still has a *resident beneficiary.*

Potentially a trust can have two deemed dispositions, once under proposed subsection 94(5.1) when there ceases to be a *resident contributor*, and again under proposed subsection 94(5) when later there ceases to be a *resident beneficiary*.

Suppose the Jim Jones Trust is established by Jim, a long term Canadian resident, for the Jones children who live in Canada. Jim becomes a non-resident some time later. The Jim Jones Trust ceases to have a *resident contributor*, so proposed subsection 94(5.1) applies to result in a deemed disposition. Some time later, the last of the Jones children living in Canada either leaves Canada or dies. The Jim Jones Trust now ceases to have a *resident beneficiary*, and thus has a deemed disposition under proposed subsection 94(5).

Because of the deemed disposition problems with non-resident trusts, that would not result from resident trusts, care must be taken before deciding to use a non-resident trust for Canadian estate planning.

Note however that these issues can be avoided if the non-resident trust becomes Canadian resident or is wound up before these events occur.

Clause 53(2)(h)(i.1)(B) – Cost Base Calculation

The trust would be resident for purposes of clause 53(2)(h)(i.1)(B), which deals with determination of the adjusted cost base of the trust interest. This makes the calculation of the adjusted cost base of a beneficiary's interest in the trust in accordance with Canadian rules.

Non-resident Entity

The trust is considered resident for purposes of applying the non-resident entity definition in proposed subsection 94.1(1). The purpose of this is to exclude a trust which is taxable under proposed subsection 94(3) from being a non-resident entity because the latter rule applies only to a trust that is non-resident.[98]

Subsections 104(13.1) to 29 and 107(5), Sections 115, 233.3 and 233.4

A section 94 deemed resident trust is considered resident for purposes of Part I of the Act and Part I.1 (the federal surtax) solely because it is deemed to be so[99]. It is necessary to

[98] See definition in proposed subsection 94.1(1) in paragraph (a).
[99] Proposed subparagraph 94(3)(a)(i) and (ii).

specifically deem the trust to be resident for every other purpose for which this result is desired.

The rules in subsections 104(13.1) to (29) in many cases apply only to a trust resident in Canada. They are not necessary for the purpose of computing the trust's income, and so the trust is not deemed resident for this purpose due to section 2. Therefore, a specific rule is necessary for these flow-through rules to apply to a section 94 deemed resident trust.

The trust is resident for purposes of subsection 107(5), which refers to subsection 107(2.1). This provides for any accrued gains on hand to be realized on a distribution of trust property to a non-resident beneficiary.

The trust is considered resident for purposes of section 115, which presumably makes this section inapplicable to the trust. Otherwise, there might be the potential to count income twice, once under normal rules of computing income for a Canadian resident, and once under section 115 for the trust as a non-resident.

The trust is also considered Canadian resident for purposes of Sections 233.3 and 233.4. The result of this is that the trust is required to file certain foreign reporting forms. Section 233.3 deals with foreign reporting for holdings of foreign property with a cost of over $100,000. Section 233.4 deals with filing information returns for shareholdings of foreign affiliates.

It is interesting to note at this point that the trust is not considered to be a resident of Canada for purposes of section 116, dealing with clearance certificates. It is also not considered resident for purposes of sections 233.2 and 233.6 which deal with foreign reporting requirements for Canadian residents who establish non-resident trusts, and Canadian resident beneficiaries who receive distributions from foreign trusts respectively. Accordingly, these reporting requirements are still applicable as if the trust were non-resident.

Computation of Tax

It is not explicitly stated either in the legislation or in the explanatory notes how the tax liability of the trust is to be actually calculated. One would assume that it is calculated in the normal manner applicable to Canadian resident individuals, but it is not completely obvious. Firstly, one would assume that the tax rates are those applicable to trusts under general principles, being the top tax rate for most inter-vivos trusts, and graduated tax rates for testamentary trusts. The trust does not obtain personal tax credits, but can obtain credits for such things as charitable donations, the dividend tax credit, the investment tax credit, and the foreign tax credit (modified by a special rule as described later).

The next question is whether the trust pays tax to a province, or instead pays additional federal tax. Nothing in the legislation addresses this, and therefore one would look to the traditional analysis of determining whether or not the trust had income subject to tax in a province. Most likely the trust is non-resident for purposes of Regulation 2602, and thus subsection 120(1), the additional federal tax, will be applicable (now 48% of tax otherwise payable).

Withholding Tax

The trust is considered a resident of Canada for purposes of determining the liability of the trust for tax under Part XIII on amounts paid or credited to the trust.[100] This means that payments from Canadian residents to the trust will not be subject, ultimately, to non-resident withholding tax. Because the trust is considered resident only for purposes of determining the liability for Part XIII tax on amounts paid or credited to the trust, the trust is not considered Canadian resident for purposes of levying withholding tax on distributions by the trust to beneficiaries, either Canadian or non-resident.

This rule must be read together with proposed paragraph 94(4)(b) which states that proposed paragraph 94(3)(a) does not apply for purposes of determining the liability of a person that arises because of the application of section 215, except as the Minister otherwise permits in writing. Proposed paragraph 94(3)(a) deems the trust to be resident in Canada only for certain purposes. Absent this, a person making a payment to the trust must consider the trust to be a non-resident. The payment would accordingly be subject to non-resident withholding tax. Therefore, even though the trust is not itself liable to tax under Part XIII, a person making a payment to the trust must nevertheless withhold tax under Part XIII. The explanatory notes indicate that the trust is expected to file an income tax return and to claim a refund of the withholding tax.

Since the CCRA is likely to contend that the trust is not a treaty resident of another country, it can be expected that reduced treaty withholding rates will not be available.

[100] Proposed subparagraph 94(3)(a)(v).

Special Rules For Foreign Tax Credit

Paragraph 94(3)(b) deals with the situation where the trust pays tax to a foreign jurisdiction. To take into consideration this possibility, the rules provide for certain special deeming provisions applicable to section 126.

First of all, the trust's income, other than what would be its taxable income earned in Canada, is deemed to be income of the trust from sources in the country where the trust would, but for proposed subsection 94(3), be resident.

The trust's taxable income earned in Canada is a defined term which is essentially its income computed under section 115. As a result, only certain Canadian source income would be included within this, and other Canadian source income may be considered to be income from sources in the country where the trust would otherwise be resident. For example, interest, dividends, rental income and capital gains from other than taxable Canadian property would all be considered to be income which is not taxable income earned in Canada. Thus, these income components are foreign source income for this purpose.

Where the trust has paid an income or profits tax (including Canadian tax but other than any tax payable due to proposed subsection 94(3)), this tax is deemed to be non-business income tax paid by the trust to the government of the country where the trust would, but for proposed subsection 94(3), be considered resident.

The provision contemplates that the trust could be resident in another country were it not for subsection 94(3).[101] However, in the case of a non-resident trust, the trust will invariably be a resident of a foreign jurisdiction in the normal course. Where the trust is a resident under treaty in the foreign jurisdiction, then the CCRA believe that subsection 250(5) will automatically apply to state that the trust is resident only in the foreign country.[102] The very fact that the legislation contemplates that the trust might be resident in another country were it not deemed resident in Canada by virtue of proposed subsection 94(3), presumes that there will never be a circumstance under which subsection 250(5) would deem the trust to be a non-resident of Canada. Put another way, the construction of the wording presumes that proposed subsection 94(3) will always override any finding of non-residency status and that there will never be a determination of non-residency status under subsection 250(5) deduced from a treaty considering the trust to be non-resident. It presumes that the trust will not even

[101] Proposed subparagraph 94(3)(b)(i).
[102] See Technical Interpretation 2000-0047355.

be a dual resident, because application of proposed subsection 94(3) will somehow preclude this.

It is not clear that the CCRA's position on whether subsection 250(5) applies to a section 94 deemed resident trust is correct. Subsection 250(5) applies to a person who would otherwise be resident for purposes of the Act. A section 94 deemed resident trust is resident only for certain purposes, of all purposes of the Act. The question comes down to an interpretation of what exactly is meant by "for purposes of the Act".

Proposed paragraph 94(3)(b) has a number of purposes which are for the most part relieving. Firstly, it sources all of the income into one place, being the foreign country where the trust would otherwise be considered resident. It then sources the tax paid by the trust for the year, including certain Canadian income tax[103], to that particular country as well, regardless of the country or countries to which tax is actually paid. This is beneficial because it allows income to be blended and taxes to be averaged.

For purposes of applying section 126, it is not clear that the foreign tax credit calculation will be straightforward.

While all of the income of the trust is considered to arise in the foreign jurisdiction where the trust is resident (or should we say otherwise resident), the provision does not state the nature of the income. Absent a deeming provision, one would assume that the income retains its normal characterization. Therefore, the income will be considered either business or non-business income. Since the taxes are all deemed to be non-business income taxes, there may be limitations in claiming the foreign tax credit in some circumstances. It is difficult to imagine that this was the result intended and seems to be derived from existing section 94. Presumably all of the income should simply be deemed to be foreign non-business income. However, it is not so deemed, so trusts that have foreign business income will have difficulty obtaining a foreign tax credit.

One must decide under which credit mechanism in section 126 the trust falls.

The trust is arguably resident in Canada for purposes of section 126, and has only non-business income tax. Thus, the credit mechanism must surely be subsection 126(1).

[103] It is difficult to imagine what this Canadian tax will be, because tax created by proposed subsection 94(3) is not includable, and Part XIII tax should be refunded to the trust.

The sourcing rules for the income and the tax (Canadian and foreign) are designed to harmonize with the rules of section 126 and especially subsection 126(6). However, on a close reading, the sourcing rules of proposed paragraph 94(3)(b) will harmonize with paragraph 126(6)(b) but not necessarily paragraph 126(6)(c). The latter applies to tax-exempt income where a foreign tax treaty applies to exempt income from tax in that treaty country[104]. Potentially such income must be segregated from other income under this rule, before a credit is calculated under subsection 126(1).

Because the tax is deemed to be non-business income tax, it cannot be carried forward or backward. If it cannot be credited in full, it can be deducted.

One would assume that for purposes of applying subsections 20(11), the trust's income will be viewed as sourced under normal rules. Canadian source income will not be deemed foreign, and the nature of the income (e.g., business vs. property) will be preserved. If the income is foreign property income other than from real property, subsection 20(11) will restrict the tax credit to 15% of that net foreign property income, allowing (effectively forcing) a deduction for the excess non-business income tax.

Where a full foreign tax credit is unavailable, subsection 20(12) will allow a deduction for the uncredited tax. Since the non-business income tax as referenced in subsection 20(12) ties directly to the definition in subsection 126(7), this mechanism should work to allow a full deduction for uncredited non-business income tax[105].

In many cases, the non-resident trust will not be subject to any appreciable amount of tax. It would be unusual for the trust to have business income. However, where the tax is sizeable, say with a U.S. trust settled by a Canadian for U.S. estate tax purposes, the foreign tax credit and subsection 20(11) limitation could be highly problematic.

The explanatory notes do not shed any further light on this special foreign tax credit calculation.

Proposed Paragraph 94(3)(c) – Becoming Deemed Resident

It should be noted that under proposed subsection 94(3), the trust is deemed to be resident in Canada, but it is not clear that the trust is being so deemed actually becomes resident in Canada. Subsection 128.1(1) applies to deem a year-end of the trust to occur and give a

[104] See definitions in subsection 126(7).
[105] It is possible that further anomalies will be encountered. For example, if the source of the income is a capital gain, can a deduction be taken for uncredited foreign non-business income tax?

step up in cost base, where a non-resident trust becomes resident in Canada. For purposes of resolving this uncertainty, proposed paragraph 94(3)(c) states that where a trust was non-resident throughout the preceding taxation year, for purposes of computing its income for that preceding year, then for the purpose of subsection 128.1(1) the trust is deemed to have become resident in Canada immediately after the end of that preceding year. Accordingly, this brings the trust squarely within the framework of subsection 128.1(1), which allows for a step-up in the basis of property where the rule is otherwise applicable.[106]

The CCRA's position on trusts which were non-resident trusts and are subsequently deemed under existing section 94 be resident in Canada is that they have become resident in Canada for purposes of subsection 128.1(1). In other words, the CCRA is of the view that where a trust is deemed to be resident in Canada, it has thus "become" resident in Canada.[107] There is some doubt as to whether this position is correct, because being deemed to be resident is the attaining of a particular status not a transition of status. When one becomes resident, this implies a transition of status. Compare this to the analogy of being alive or being dead versus becoming dead (i.e., dying) which is the transition.[108]

Purposes for Which Not Resident

Now let us consider for what purposes the trust is not considered to be resident.

Under existing section 94, the trust is considered resident for purposes of Part I, which includes section 116. Therefore a section 94 deemed resident trust that disposes of taxable Canadian property has no reason to comply with clearance certificate requirements.

Under proposed subsection 94(3), the trust is not considered resident for purposes of section 116, because section 116 is not specifically listed in proposed paragraph 94(3)(a), nor is it

[106] See paragraph 128.1(1)(b).
[107] See technical interpretation 950825 – 60 month non-resident trusts which stated that "Since such a trust would be deemed to become resident on January 1 of the applicable year in which the 60 month period referred to in subclause 94(1)(b)(i)(A)(III) ends, the trust will also have a deemed year end immediately before that time and would be deemed to begin a new taxation year at the time the trust becomes resident, that is, January 1, pursuant to paragraph 128.1(1)(a) of the Act. Pursuant to paragraphs 128.1(1)(b) and (c) of the Act, the trust would be deemed to have disposed of its property, other than property described in subparagraphs 128.1(1)(b)(i) to (v), at fair market value immediately before becoming resident and then to have acquired the property at a cost equal to the same proceeds of disposition. Since the deemed disposition occurs "immediately before the time that is immediately before" the time the trust becomes resident, any gain that accrued on such property before the trust became resident will generally not be taxable under the Act."
[108] The CCRA took the view that the non-resident trust did not become resident in a technical interpretation dated November 23, 1981 commenting on former subsection 48(3) – For unexplained reasons their view changed under section 128.1.

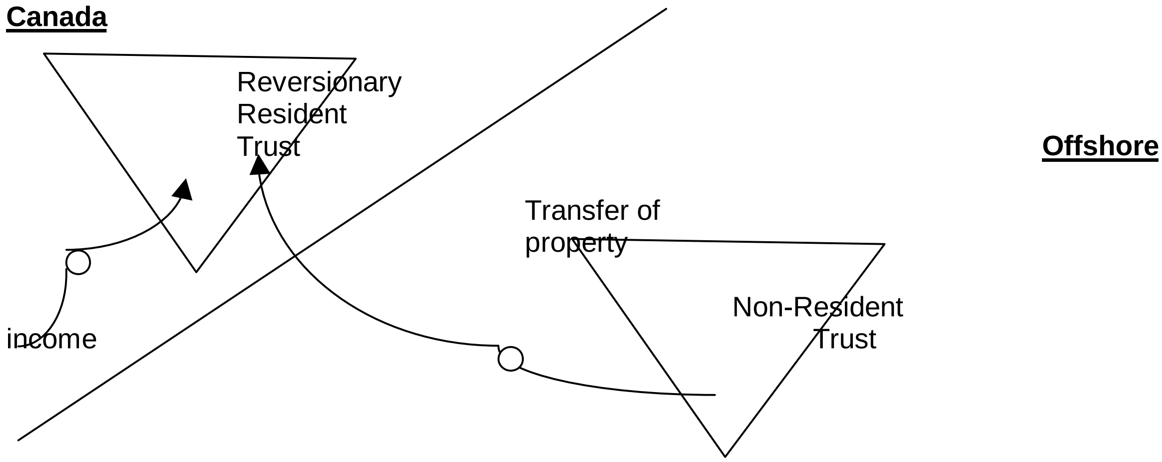
relevant to computing the trust's income. Thus after 2001, such trusts will have to comply with section 116.

One would imagine that a section 94 deemed resident trust would not be considered resident for purposes of matters related to control, and determining Canadian-controlled private corporation status.[109] For example, if the non-resident trust controlled a Canadian private corporation, one would imagine that the non-resident nature of the trust would still govern for purposes of determining whether or not the corporation was a Canadian-controlled private corporation. However this is not entirely clear. One might argue on policy grounds that if the trust is resident for purposes of Part I, then it should be afforded any and all benefits that may be derived from such status.

The trust is not considered resident for purposes of applying the definition of *exempt foreign trust.* Thus an *exempt foreign trust* is still considered to be a non-resident trust. The technical notes state that this is for purposes of making sure that there is no circularity with respect to the definition of *exempt foreign trust*. This is quite logical since an *exempt foreign trust* is not supposed to fall within proposed subsection 94(3).[110]

More curiously, the trust is deemed not to be resident for purposes of apply subsection 75(2).[111] This subsection would apply to attribute income or loss from property or any taxable capital gain or allowable capital loss of a trust to a resident of Canada in certain circumstances. This is apparently to deal with the situation where a non-resident trust transfers property to a reversionary trust. Assume that the reversionary trust is Canadian resident. If the non-resident trust is deemed to be a Canadian resident, then income from property and taxable capital gains of the reversionary trust would be attributed back under subsection 75(2) to the deemed resident trust. One would imagine that the Department of Finance became aware of some structure which utilized this for tax planning purposes. Possibly the deemed resident trust would try to claim a treaty exemption.

[109] Subsection 125(7).
[110] Paragraph 94(4)(c).
[111] See proposed amendment to subsection 75(2).



The trust is not deemed resident for certain specific purposes, as stated in proposed subsection 94(4).

Proposed subsection 94(3) will not apply for purposes of subsection 73(1). This means that if the transferee is a spousal trust deemed resident in Canada under proposed subsection 94(3), the trust will not be resident for the spousal trust rollover.

The trust is not considered resident for purposes of paragraph 107.4(1)(c), other than for purposes of subparagraph 107.4(1)(c)(i) and subparagraph (f)(ii) of the definition of "disposition" in subsection 248(1). This is to ensure that the special relieving rules for dispositions of property where there is no change in beneficial ownership do not generally apply to a transfer to a non-resident trust, including one which is deemed to be resident by virtue of proposed subsection 94(3).

The trust is also not considered resident for purposes of paragraph (a) of the definition of mutual fund trust in subsection 132(6). The purpose of this is to make it clear that a non-resident trust deemed resident under proposed subsection 94(3) will not be treated as a mutual fund trust for any purpose.

As mentioned above, the trust is still considered a non-resident for purposes of the withholding tax obligations of a Canadian payor.

Joint and Several Liability

Each person who at any time in the year is a *resident contributor* to the trust or a *resident beneficiary* under the trust shall have joint and several liability with the trust for the taxes of the trust[112]. This joint and several liability extends to all of the rights and obligations of the trust under Divisions (I) and (J), and subsection 180.1(4). Clearly the most important of these rights and obligations deal with liability for tax, interest and penalties. This was thought to be an important component of the new system, since it gives CCRA an additional person or persons from whom tax can be recovered.

Proposed subsection 94(7) limits the liability of a *resident contributor* and a *resident beneficiary* in certain circumstances. Otherwise, the liability is unlimited. This subsection states that the amount which may be recovered under this joint and several liability rule shall not exceed an amount defined to be the "recovery limit" where certain conditions are all met.

The rules for a *resident contributor* and a *resident beneficiary* are different, but are grouped together, making the analysis more complex. First the *resident contributor* recovery limit rule is analyzed.

To apply, three conditions must be met. The first requirement concerns the total of contributions to the trust by an entity and other non-arm's length entities. It must be less than the greater of $10,000 or 10% of all contributions to the trust. Secondly, all information returns required to be filed under section 233.2 (dealing with the obligation to disclose loans or transfers to a non-resident trust) must have been filed on a timely basis (or such later period as is acceptable to the Minister). Lastly, no transaction must have been undertaken to minimize liability for the trust's taxes under this rule.

The Minister has discretion to accept late filed information returns, and presumably will do so where a good faith attempt has been made to comply with the rules, but the filings were late due to inadvertence, or some reasonable "confusion" as to whether or not the forms were required.

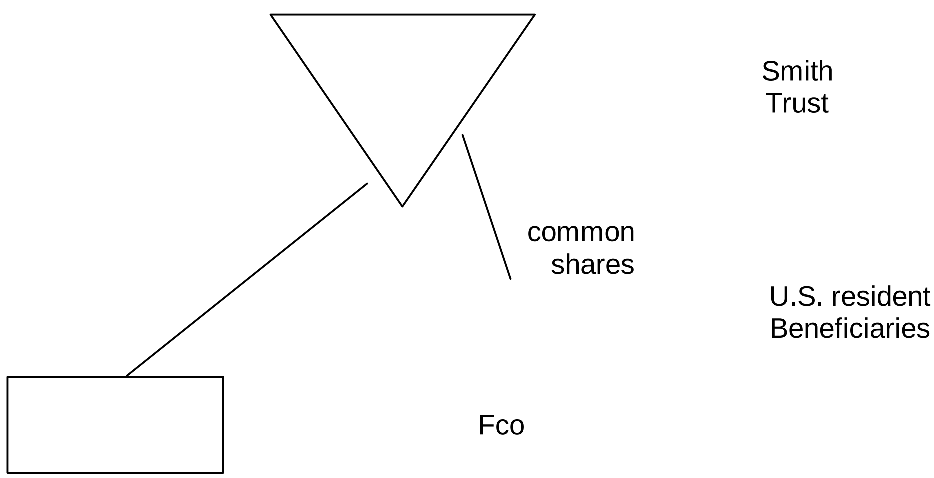
It would seem reasonably easy to avoid the joint and several liability rules, by contributing only a nominal amount to the trust (far less than $10,000).

However for purposes of determining the amount of a *contribution*, where the *contribution* is made directly or through a sequence of transactions, in a share or a right to acquire a share (or other property that derives its value from a share or a right to acquire a share) the fair market value of the *contribution* is deemed to be the greater of the fair market value at the

[112] Proposed paragraph 94(3)(d). Note use of the word "solidarity", which addresses legal issues under the civil law of the province of Quebec.

time of the contribution, and the greatest fair market value of the share at any time up until the end of the third calendar year that ends after the time of the contribution.[113] Accordingly, if a nominal contribution to a non-resident trust finds its way into shares of a corporation, the value of the contribution would be deemed to be the greatest fair market value of those shares at any time until the end of the third calendar year following the year[114].

For illustration, take the case of Mr. Smith, a long-term Canadian resident, who established a non-resident trust (the Smith Trust) for his children living in the U.S. The income is accumulated in the Smith Trust. Mr. Smith contributed $4,000 to the Smith Trust. The Smith Trust invests in shares of a private company ("Fco"). The test would be met initially because Mr. Smith has contributed less than $10,000. However, if the shares of Fco increase in value, beyond $10,000 by the end of the third calendar year, the condition is not satisfied and Mr. Smith has unlimited liability for the taxes of the trust.



It will be recalled in the discussion of proposed subsection 94(2) that a number of rules were provided to determine the fair market value of a *contribution* of property to a trust. It is for purposes of this recovery limit that the quantification of the amount of the *contribution* is relevant. These rules have a second purpose; to expand the number of possible *resident contributors*, so that more people can be potentially liable for unpaid taxes of the trust.

[113] Subsection 94(9).
[114] Paragraph 94(4)(c).

Where the recovery limit rule is applicable to a *resident contributor* (which will probably be rarely), it is necessary to determine the amount of the recovery limit. The recovery limit is calculated under proposed subsection 94(8).

For a *resident contributor*, the recovery limit is the total of all amounts each of which is the fair market value of property contributed to the trust. The recovery limit is reduced by any amounts previously recovered from the person[115].

For a *resident beneficiary* the recovery limit test will usually be met. All that is required is to not enter into transactions to minimize the joint and several liability[116]. If so, the recovery limit is the total of:

i) the amounts that become payable to that person (or to a specified party of the person) as a beneficiary;

ii) an amount received or receivable by a beneficiary or a specified party on a disposition of an interest in the trust;

iii) the fair market value of any benefits received or enjoyed by the person or a specified party under the trust.

In summary, the overall recovery that may be claimed from a *resident beneficiary* is basically the amount received by that beneficiary or closely related persons from the trust in one form or another. The amount that can be recovered from a *resident contributor* is the fair market value of that person's *contributions* to the trust, if the recovery limit rule applies, or else an unlimited amount.

The recovery limit rule for the *resident beneficiary* is a fair and reasonable one. It is similar to existing subsection 94(2). The recovery limit rule for the *resident contributor* is especially punitive, given the lack of grandfathering.

Suppose that the Smith Trust was set up prior to the proposed amendments even being contemplated. Possibly it was established to mitigate exposure to U.S. estate tax, and not for Canadian tax reasons. It was totally within what was permitted by existing subsection 94(1). The trust document may possibly not allow for distribution of income to beneficiaries.

[115] See definition of "specified party" in proposed subsection 94(9).
[116] Specifically, it seems that only paragraph (c) of proposed subsection 94(7) is relevant.

Now, not only is the trust taxable by Canada starting in 2002, but Mr. Smith will be liable for the Smith Trust's taxes as well in an unlimited amount.

Changes to Foreign Reporting Rules

All tax practitioners will readily agree that very few things in the Income Tax Act ever get simplified.[117] When they do get simplified, it is noteworthy. The scoop now is that the foreign reporting rules of section 233.2 have been substantially simplified.

In proposed subsection 233.2(1), the definitions of "specified beneficiary" and "specified foreign trust" have been repealed, because they are no longer necessary, and are being replaced with the concepts in proposed section 94.

Existing subsection 233.2(2) is a complicated section dealing with relationships called non-arm's length indicators. These define the circumstances under which a relationship between a *contributor* of property to a trust and a *beneficiary* under the trust would be sufficiently close as to result in a requirement to provide foreign reporting information. This concept has been scrapped entirely, and replaced by a cross reference extending the rules and definitions of proposed subsections 94(1) and (2) to proposed subsection 233.2(2). This is a sensible result, since the relationship between a *contributor* to a trust and a *beneficiary* under the trust is no longer relevant for purposes of proposed section 94.

Existing subsection 233.2(4), which is the main rule defining the requirement to file a foreign reporting form, has been revised substantially. It is now far simpler than before, and has three basic requirements.

i. There must be a *contribution* made by a person to a particular trust at any time in a taxation year or a preceding year (other than an *exempt foreign trust*, with certain modifications). This is similar to the concept of a *resident contributor*, although slightly modified.

ii. The person must be a resident of Canada at the end of the trust's particular taxation year.

[117] The last major simplification was perhaps the elimination of the cumulative deduction account, section 125, in 1985 which eliminated about 10 pages from the Act.

iii. The trust must be a non-resident of Canada at the end of its taxation year. Note that for purposes of this foreign reporting rule, the trust is not deemed to be a resident of Canada (see discussion above).

Where these conditions are met, the person shall file an information return in prescribed form. The filing requirements are identical to those under the current rule.

There is an interesting addition to the foreign reporting rules, contained in proposed subsection 233.2(4.1). This deals with so called similar arrangements, and is designed to require the reporting of arrangements which may not be trusts, but are arrangements similar to trusts. For example, these rules could apply to a foundation (in a civil law jurisdiction such as Lichtenstein, Switzerland or the Netherlands-Antilles). If the entity is not considered to be a trust, it will most likely be considered to be a non-resident entity under proposed subsection 94.1(1).

This rule applies where five conditions are met.

i. property must be transferred or loaned by a person to be held under an arrangement governed by foreign law or by a non-resident entity (as defined under subsection 94.1(1));

ii. the transfer or loan would not be an *arm's length transfer* (which is defined in proposed subsection 94(1) except that the definition shall be read without reference to paragraph (e) of that definition).[118]

iii. The transfer or loan is not solely for certain types of specified foreign property;

iv. the entity or arrangement is not a trust in respect of which a person would normally be required to file an information return under subsection 233.2(4);

v. the entity or arrangement is not an *exempt foreign trust*, a foreign affiliate in respect of which the person is a reporting entity under subsection 233.4(1), or an exempt trust (as defined under subsection 233.2(1));

Where these conditions are met, then information reporting is required under proposed subsection 233.2(4) as if the *entity* were a trust not resident in Canada.

[118] Subsection 233.2(2). It is very unlikely that tax planning can be engineered using the arm's length transfer rule. The vast majority of planned situations will not involve arm's length transfers.

This is designed to allow the CCRA to examine other arrangements which may not constitute trusts, to determine whether or not they would be taxable under a variety of possible provisions of the Income Tax Act (including proposed section 94, the non-resident entity provisions of proposed sections 94.1, 94.2, and the FAPI rules).

There are other minor changes to components of the foreign reporting rules, under sections 233.3, 233.4 and 233.5. These are not substantive changes, and are consequential on other amendments.

Distributions To Beneficiaries

As a general rule, a trust may deduct such amount as it may claim of its income as became payable to a beneficiary in the year.[119] Certain limitations are placed on the amount that may be deducted, and these limitations relate, for the most part, to issues involving the so-called 21-year deemed disposition rule.[120]

No amount may be deducted by a trust for a payment to a designated beneficiary (basically a non-resident person) where the trust is not resident in Canada throughout the year.[121] This rule was introduced prior to section 128.1 which deems a year-end to occur when a trust becomes resident in Canada and when it ceases to be resident. Existing subsection 94(1) deems a trust to be resident in Canada throughout the year. Accordingly, it is difficult to imagine a situation today where a trust would be a part-year resident. Thus one may conclude that this limitation will only apply to trusts which are non-resident throughout the year. This said, subsection 104(7) should not be applicable to a trust deemed resident under proposed subsection 94(3). Thus one needs to consider only the general rule of subsection 104(6).

A fundamental objective of the Income Tax Act is to make sure that non-residents pay Canadian Part I tax on income from carrying on a business in Canada and from gains from the disposition of taxable Canadian property. To this end, while a deduction may be taken from the income of a trust for income distributions which include these income components, the trust is subject to a special tax under Part XII.2 where these distributions are made to a non-resident.[122] However, this tax does not apply to a non-resident trust.[123] Since a trust that is deemed resident under proposed subsection 94(3) is not resident for most purposes

[119] Paragraph 104(6)(b).
[120] Subsection 104(4) and related provisions.
[121] Subsection 104(7).
[122] Section 210.1.

of the Act other than Part I, such a trust will not be resident for Part XII.2 tax purposes, and hence will not be so subject. Accordingly, without a limitation in subsection 104(6), the trust would be able to distribute all of its income to non-resident beneficiaries, and avoid all Canadian tax. The trust would not be subject to tax under Part I, because the income would be distributed to beneficiaries leaving it with no taxable income, would not be subject to Part XII.2 tax, because it would be a non-resident trust for this purpose and therefore would be exempt, and would not be subject to Part XIII tax on distributions because the trust would be considered a non-resident for purposes of Part XIII. Consequently, it was necessary to revisit the overall formulation and interaction of these provisions, to develop a methodology which would tax Canadian income of the trust in an appropriate manner.

While clearly there were a number of possible ways of tackling this issue, a decision was made to place a limitation on the amount that could be deducted by a trust deemed under proposed subsection 94(3) to be resident in Canada, where the trust had certain Canadian source income. This limitation is placed in proposed subsection 104(7.01).

Where this subsection is applicable, the maximum amount that may be deducted under subsection 104(6) for payments to non-resident beneficiaries is deemed to be reduced by the trust's "designated income" within the meaning assigned by subsection 210.2(2), and 50% of amounts which would, under general principles, be subject to Part XIII tax upon being paid to the non-resident trust.

The designated income of the trust will consist of income from real property situated in Canada, income from timber resource properties, income from Canadian resource properties unless acquired by the trust before 1972, income from businesses carried on in Canada, and taxable capital gains less allowable capital losses from dispositions of taxable Canadian property. Losses in respect of these sources may reduce the income. Components of income subject to Part XIII tax on payment to a non-resident trust would typically include Canadian interest, dividends, rental and royalty income.

The limitation on the deduction is designed to serve as a "proxy" for non-resident withholding tax. If the trust is assumed to have an income tax rate of 50%, then the denial of a deduction for Canadian business income and taxable capital gains places an effective tax rate of 50% and 25% on these sources of income respectively. For components of income that would be subject to Part XIII tax, such as rental income, dividend interest, and royalties, the limitation

[123] Paragraph 210.1(e).

of a 50% deduction results in a 25% tax rate, except on taxable dividends to which a dividend tax credit would be attached. In such circumstances, the tax rate is lower.

The previous drafting of proposed subsection 104(7.01) had a number of deficiencies most of which have been corrected. With respect to the limitations on the amount that may be deducted, as laid out in proposed subparagraphs 104(7.01)(b)(i) and (ii), there is the potential for duplication in that rental income, for example, may be subject to withholding tax under Part XIII[124] and can also comprise designated income within the meaning assigned by subsection 210.1(2).[125] Accordingly, the provision should be amended to eliminate this duplication. This is surely an unintended result.

The limitation does not apply to payments to Canadian resident beneficiaries. The calculation works so as to give the maximum possible deduction, by reducing the deduction by the minimum possible amount. That amount is the lesser of the income and the amount otherwise deductible for payments to non-residents. There will be optimal planning strategies, when dealing with Canadian and non-resident beneficiaries, and with a mixture of income types.

Subsection 75(3) – Exception to Reversion Rule

Subsection 75(3) sets out a number of circumstances under which the reversion rule of subsection 75(2) is not applicable. To the existing list, proposed paragraph 75(3)(c.2) is being added which states that subsection 75(2) will not be applicable to a trust that is non-resident for the purposes of computing its income for the year because an individual (other than a trust) is a *contributor* who has not been resident before the end of the year for more than 60 months. It seems that the so-called immigrant trust will no longer suffer from the problems that subsection 75(2) can create for the unwary or ill-informed. This is welcome news for practitioners. However, beware that a reversionary trust, once resident in Canada, will not be able to make tax-free distributions of property to beneficiaries in many circumstances.[126]

This rule applies for 2001, rather than 2002.[127]

[124] Paragraph 212(1)(d).
[125] Subparagraph 210.2(2)(a)(i)
[126] Subsection 107(2.1) will apply.
[127] See subsection 6(4) of the enabling legislation.

F. IMPACT ON EXISTING STRUCTURES

So far, this paper has discussed the history of the legislation in the non-resident trust area, the policy intent behind the legislation, the mechanics of the proposed legislation itself, and possible deficiencies within the legislation. This next section of the paper will examine commonly used structures, and comment on how the legislation will apply to each of them. The paper will also comment on tax planning ideas for restructuring existing arrangements, and will give examples of inconsistencies, inequities or deficiencies in the legislation where applicable.

Commonly Used Structures

There is no commonly agreed upon classification of trust structures, and therefore we feel at liberty to put forward such a classification, for purposes of efficiently explaining the structures commonly in use. In all of the structures, the trusts are non-resident trusts by virtue of the trustee being a non-resident. The classifications do not consider the impact of protectors or appointers on the residency of the trust (which, in general, we believe not to be relevant in any event). Also, the beneficiaries are assumed to be either Canadian residents or non-residents. We do not generally consider the possibility of adding beneficiaries to the trust, especially since the definition of "beneficially interested" has been amended to encompass this situation, except where specifically stated. The classifications are based on the person who created or funded the trust (basically the governing mind and source of funds) and the residency of the beneficiaries. We do not consider international tax treaties.

In keeping with this introduction, the structures are outlined below.

Created By	Beneficiaries Are	Name
a) Non-resident	Canadian resident	Pure Inbound Trust
b) Short term resident †	Canadian resident	Immigrant Trust
c) Long term resident ‡	Non-resident	Outbound non-Canadian Trust
d) Long term resident	Canadian resident	Outbound Canadian Trust
e) Former long term resident	Non-resident	No Connections Trust
f) Former long term resident	Canadian resident	Close Connections Trust
g) Long term resident - deceased	Non-resident	Outbound non-Canadian Testamentary Trust
h) Long term resident - deceased	Canadian resident	Outbound Canadian

		Testamentary Trust

† less than 60 months in all

‡ more than 60 months

a) **Pure Inbound Trust**

Description:

In its simplest form, this is an inter-vivos or testamentary trust created by a non-resident who has never been a Canadian resident. This category can also include persons who have been Canadian resident during their lives, but for less than a total of 60 months. (Persons who have been Canadian resident for over 60 months will be classified as former long-term residents and analyzed under the No Connections Trust or Close Connections Trust as the case may be.) The beneficiaries include Canadian residents.

Old Rules:

Under the existing rules in section 94, this trust is not subject to tax, because no Canadian resident person has contributed property to the trust. As a result, it fails the contributor test of existing subsection 94(1).

Capital distributions received by a Canadian resident will be free of tax. Of course income distributions to Canadian residents will be taxable. (Since this is the case for all of the trusts analyzed here, this comment will not generally be repeated.)

New Rules:

Under proposed subsection 94(3), the trust will not be deemed resident because it does not have a *resident contributor* or a *resident beneficiary*. Accordingly, the proposed rules have no impact on this structure.

b) **Immigrant Trust**

Description:

The so-called Immigrant Trust is a trust created by a person who has immigrated to Canada, and who has not been previously resident for an aggregate of 60 months during his or her lifetime. This person may establish a non-resident trust by contributing property to it, either before or after becoming a resident of Canada, that will be exempt of Canadian tax until the taxation year in which the immigrant has been resident for a total of more than 60 months. Typically the beneficiaries of such a trust are family members of the immigrant (spouse and children) who have also immigrated to Canada.

The Immigrant Trust structure has been the subject of very close examination, for ways to extend the tax-exempt period beyond 60 months. All manner of transactions have been contemplated, including a gift by the immigrant of substantial assets to a non-resident, with that non-resident then establishing the trust. This attempts to convert the Immigrant Trust into the Pure Inbound Trust in the hope of extending the tax-exempt period indefinitely. Other arrangements to prolong the life of the Immigrant Trust have included not naming Canadian resident beneficiaries as beneficiaries of the trust, but allowing for the possibility that these persons can be added.

Old Rules:

Under existing law, the Immigrant Trust is exempt until the taxation year in which the immigrant becomes a resident of Canada for more than 60 months in his/her lifetime. After this, the conditions of existing paragraphs 94(1)(a) and (b) will be met, if the trust, in that taxation year, has Canadian resident beneficiaries. If the trust, in that taxation year, does not have Canadian resident beneficiaries, then the trust can continue to be exempt until such time as it has Canadian resident beneficiaries. It should be noted that the amendment to the definition of beneficially interested will deem persons related to the contributor of property to the trust to be beneficiaries of the trust, if the trust document contains the power to add beneficiaries.

Indirect transfers of property to non-residents, followed by such persons establishing non-resident trusts for the benefit of the immigrant and his/her family, will likely not succeed in avoiding the criteria for existing subsection 94(1) to apply. Existing paragraph 94(1)(b) looks to whether the trust has <u>acquired property, directly or indirectly in any manner whatsoever</u>, from the immigrant. Any sequence of transactions which commence with property owned by the immigrant, and end with property finding its way into an Immigrant Trust, through one or more non-residents, will most likely constitute an indirect transfer of property. However, this is not totally clear or free from doubt.

New Rules:

Under proposed subsection 94(3), the Immigrant Trust continues to enjoy its tax-exempt status for 60 months. There are no significant changes to the requirements for establishing such a trust. In fact, if anything, by providing that subsection 75(2) will not apply to such a trust while it is within its tax-exempt period, the rules are in fact less stringent than before.

With respect to plans designed to extend the life of the Immigrant Trust beyond 60 months, however, a host of anti-avoidance provisions are now applicable. These extend the circumstances under which property is deemed to be contributed to the trust.[128]

It should also be noted that since the *resident contributor* test will apply whether or not there are Canadian resident beneficiaries, the restructuring of Immigrant Trusts by deleting Canadian resident beneficiaries will not be effective after 2001. Accordingly, structures which attempt to extend the 60-month period by deleting Canadian resident beneficiaries (i.e., converting the Immigrant Trust to the Outbound Non-Canadian Trust) while effective in the past, will not be effective in the future. Instead, as the Technical Notes point out,[129] in the event that the trust earns only foreign-sourced income and makes full current distributions of the income to non-resident beneficiaries, no tax will arise[130].

c) Outbound Non-Canadian Trust

Description:

This trust is created by a long term resident for the benefit of non-residents. It is assumed here that there is no ability to add Canadian residents. This structure is sometimes used as a way to reconfigure an Immigrant Trust.

This type of structure has been commonly used by Canadians to benefit non-resident family members. It may be used as part of an estate plan, in combination with an estate freeze, to transfer wealth to future generations. It may also be used to protect the beneficiaries from taxes in a foreign jurisdiction, such as estate taxes or succession duties. It can be used in circumstances where the beneficiaries might otherwise be subject to forced heirship laws (as is common in many civil law jurisdictions). It can also be a useful structure for asset protection and wealth preservation, particularly

[128] Proposed subsection 94(2).
[129] See Technical Notes under Commentary of Proposed subsection 94(3).

where the beneficiaries reside in litigious countries such as the U.S. The trust serves the purpose of preserving confidentiality, which can be important in certain countries to protect the beneficiaries from such things as kidnapping, and other serious crimes where tax information is supposedly routinely leaked to criminal elements. The use of a non-resident trust, typically resident in a tax haven, can also be beneficial to minimize the tax that the beneficiaries may pay in the country where they are resident.

Old Rules:

Under current rules, the Outbound Non-Canadian Trust is not subject to tax under existing subsection 94(1), because although it is established by a long term Canadian resident, it does not have Canadian resident beneficiaries. Accordingly, the requirement of existing paragraph 94(1)(a) is not met, which is a prerequisite for existing subsection 94(1) to apply.

New Rules:

Under proposed subsection 94(3), a long term resident who contributed to the Outbound Non-Canadian Trust will be considered a *resident contributor*. As a result, the trust will be deemed to be resident in Canada, and will be taxable accordingly.

It is possible for the income of the trust to be paid out to non-resident beneficiaries, and to thereby obtain a tax deduction in the trust, provided the income is not subject to the limitations of proposed subsection 104(7.01). This would be totally in keeping with the structure of the proposed amendments, and this plan can eliminate the incidence of Canadian tax.

Unfortunately, a great number of persons will not be satisfied by this potential solution, for any one of the following reasons:

i. The trust document may not allow for distribution of income or capital to beneficiaries until, for example, they attain a certain age;

ii. The trustee may not have decided on the allocation among beneficiaries;

iii. There may be punitive income tax consequences to making distributions to beneficiaries. For example, in the U.S., the distributions might, in addition to

[130] Care must be taken to avoid subsection 56(4.1).

simply being taxable, be subject to an interest charge as well, which compounds the tax, and is designed to take into account the fact that the trust has been accumulating income for many years. Quite possibly though, the beneficiaries never intended to become long term residents or citizens of the U.S., and intended to become non-residents prior to receiving trust distributions;

iv. The payment of income distributions to residents in certain foreign countries may possibly alert the criminal element to the existence of wealth, where these income distributions or any distributions must be disclosed;

v. Establishing a pattern of distributions to beneficiaries could be detrimental in certain situations where forced heirship is sought to be avoided;

vi. Establishing a pattern of distributions and in fact any payment of distributions is detrimental in situations calling for asset protection;

vii. Certain countries may consider that a pattern of distributions has established ownership rights to the assets of the trust, which could give rise to a liability for estate taxes or succession duties on the death of a beneficiary. This may be especially true in civil law countries.

For all of these reasons, a great many persons will not be pleased with the planning alternatives now available to mitigate Canadian tax.

All of this aside, the most commonly levied criticism of the new rules is the lack of grandfathering for circumstances such as this, especially where the arrangements have been entered into prior to the announcement of the new rules in February 1999.

It should also be noted that the Canadian resident contributor may be liable for the taxes of the trust if appropriate planning does not somehow mitigate the taxes, and it is not paid from the assets of the trust. It is quite possible that this person may not have the financial resources from which to pay the tax. Furthermore, it is conceivable that a trustee could simply refuse to comply with Canadian rules, on the basis that the rules were extraterritorial, and that Canada has no jurisdiction to tax the trust, at least as far as the laws in force in the jurisdiction where the trust is resident are concerned. Even if a trustee were perfectly willing to pay the Canadian tax, it is conceivable that this could be in violation of the trust indenture. All of this will raise very difficult questions for trustees, particularly in older trusts where Canadian tax issues did not seem to be relevant at the time the trust was established.

Lastly, where the trust was funded by loans from a Canadian resident, subsection 56(4.1) could apply to impute income distributions from the beneficiary to the Canadian resident. Thus the Canadian tax may not be mitigated so easily.

d) **Outbound Canadian Trust**

Description:

This type of trust is set up clearly for minimization of Canadian taxes, using an international trust as the vehicle. Here a long term Canadian resident establishes a trust with the beneficiaries being other Canadian residents.

Such a structure could be used for a variety of reasons, including asset protection, and may not necessarily be for the purpose of reducing Canadian income tax. However, having said this, various structures have been arranged which purport not to be caught under existing subsection 94(1) for a variety of reasons.

Old Rules:

Under existing subsection 94(1), many of these kinds of arrangements will be taxable, and the trust deemed Canadian resident. Some structures may avoid having acquired property directly or indirectly from a Canadian resident. These arrangements will have to be examined closely, on a case-by-case basis.

New Rules:

Under proposed subsection 94(3), it seems quite clear that these types of structures will most likely be taxable, and any creative arguments that might possibly have worked in the past are very unlikely to work under the vast array of anti-avoidance provisions contained in the proposed amendments (especially proposed subsection 94(2) which extends the circumstances under which a transfer can occur).

e) **No Connections Trust**

Description:

This trust structure is created by a former long term resident, who has now become a non-resident. The beneficiaries of the trust are non-residents. Typically this structure is set up either shortly before or shortly after the creator of the trust ceases to be resident.

Old Rules:

Under existing rules, this structure would not be taxable, if set up prior to becoming a non-resident or afterwards. The reason is that the trust would not have Canadian resident beneficiaries, and accordingly would not meet the test of existing paragraph 94(1)(a).

New Rules:

Under the new rules, a trust not otherwise resident in Canada may be deemed to be resident if it has either a *resident contributor* or a *resident beneficiary*.

If the trust is established before the long-term Canadian resident becomes a non-resident, then this person would be considered a *resident contributor*. As a result, the trust will be deemed resident under proposed subsection 94(3), but will be deemed to have a year-end and a deemed disposition upon the *resident contributor* becoming a non-resident. If set up after becoming a non-resident, then there will not be a *resident contributor*.

In order for the trust to have a *resident beneficiary*, there must be a beneficiary of the trust who is a resident of Canada. Under the so called No Connections Trust, there is no beneficiary who is a resident of Canada. Accordingly, this trust arrangement would not result in there being a *resident beneficiary*.

Overall, subject to the possible complication of having a *resident contributor* if the trust is created prior to leaving Canada, this trust will not be subject to tax by Canada.

f) Close Connections Trust

Description:

This trust is created by a former long term resident, and is similar to the No Connections Trust, except that the beneficiaries include Canadian resident beneficiaries.

Old Rules:

Under the current rules, this trust will only be considered a Canadian resident trust if it is established by a person who is resident at any time in the 18 month period prior to the end of the trust's taxation year[131].

New Rules:

The proposed amendments to section 94 contain very limited grandfathering. However, this is one such circumstance. For trusts established prior to June 23, 2000, the 18-month period is retained. Accordingly, the analysis is very similar to that under existing subsection 94(1).

The trust would be considered to have a *resident beneficiary* if it had a Canadian beneficiary resident in Canada and a *connected contributor*. A *connected contributor* is a person who makes a *contribution* of property to the trust at other than a *non-resident* time. A *non-resident* time, prior to June 23, 2000, is a time at least 18 months after a person has ceased to be resident in Canada.

It should be noted that for *contributions* made after June 22, 2000, the definition of *non-resident* time will provide for a 60-month time window, both before the trust is established and after. The latter will provide for a retrospective adjustment if the former long term resident becomes a resident of Canada within the 60-month period after the trust is established. This effectively puts a ten-year window around the trust, making it far less versatile for tax planning purposes.

Note however the introduction of the *testamentary beneficiary* concept which may prove useful in certain situations.

g) Outbound Non-Canadian Testamentary Trust

Description:

[131] This rule is somewhat ambiguous. The ambiguity rests in existing subclause 94(1)(b)(i)(A)(ii) where it says "a particular person who was resident in Canada at any time in the 18 month period <u>before the end of that year</u>". The most conservative view is that a non-resident trust established by a former Canadian resident will not be deemed resident under existing subsection 94(1) if it is established no earlier than 18 months after the person ceases to be resident. Another view is that if the person is non-resident at all times in the 18 month period before the first year-end of the trust, that is sufficient for exemption. A person who became a non-resident in say June 1999 could establish the trust in January 2000.

This trust is created by a long term Canadian resident who is deceased, and by will creates a non-resident testamentary trust. Experience has shown that this structure is not very common, and that most persons create resident trusts, if a trust is created at all. Part of the reason for this is the spousal rollover which, in the case of the creation of a trust, requires among other things that the trust be resident in Canada. Nevertheless, on occasion, a testator may establish a non-resident trust for the benefit of non-resident beneficiaries. This we call the Outbound Non-Canadian Testamentary Trust.

Old Rules:

Under the existing rules, this structure will not be taxable because it does not have Canadian resident beneficiaries.

New Rules:

Under new rules, this structure will not be taxable because the trust does not have, at the end of its taxation year, either a *resident contributor* or a *resident beneficiary*. The trust does not have a *resident contributor* because a *contributor* must be in existence. The trust does not have a *resident beneficiary* because although there is a *connected contributor* (which can include a person who has ceased to exist), the trust does not have a beneficiary resident in Canada. Accordingly, the trust is not subject to tax under proposed subsection 94(3).

h) Outbound Canadian Testamentary Trust

Description:

Under this structure, a long term Canadian resident creates a non-resident trust by will. Among the beneficiaries of this trust are Canadian residents.

Old Rules:

Under existing subsection 94(1), this trust will be deemed to be resident by virtue of the deceased having been a long-term Canadian resident, and having been resident within the 18-month period preceding death. In addition, the trust has one or more Canadian resident beneficiaries.

New Rules:

Under the new rules, this trust will be considered Canadian resident by virtue of having a *resident beneficiary*. Therefore, there is no significant change between the old rules and the new rules.

Summary

It is extremely interesting to note the similarities between existing subsection 94(1) and proposed subsection 94(3) as to how the rules apply to the various structures.

Structures	Old Rules	New Rules
Pure Inbound Trust	Not taxable	Not taxable
Immigrant Trust	Not taxable	Not taxable, more difficult to restructure after 60 month period
Outbound Non-Canadian Trust	Not taxable	Taxable unless income distributed to non-residents
Outbound Canadian Trust	Taxable	Taxable with more extensive anti avoidance rules
No Connections Trust	Not taxable	Not taxable if set up after contributor has left Canada
Close Connections Trust	Not taxable, (provided outside of 18-month period.)	Not taxable, (provided 10 year window test met (18 months if set up prior to June 23, 2000))
Outbound Non-Canadian Testamentary Trust	Not taxable	Not taxable
Outbound Canadian Testamentary Trust	Taxable	Taxable

The only structures that are significantly impacted by the proposed rules are the Outbound Non-Canadian Trust and the Close Connections Trust.

The Outbound Non-Canadian Trust is severely impacted by the new amendments, with harsh consequences. More will be said later.

Use of the Close Connections Trust will be more restrictive in the future, given the 60-month time window, both before and after the establishment of the trust. However, the *testamentary beneficiary* rule allows some planning scope.

The anti-avoidance rules serve to tighten up the gap between the obvious policy intent of the existing legislation and the clarity and explicitness of the language that should have been employed in the first place. This gap has been significantly narrowed by the additional rules and more extensive language of the amendments.

It should be noted that if the proposal to tax trust distributions had gone forward, then all of the structures involving Canadian resident beneficiaries would have been affected. When this proposal was abandoned and for good reason, the main focus of the amendments became to combat schemes that are clearly not within what the current rules were intended to allow. In this regard, it would seem that the draft legislation has met its objectives.

However, since so few structures are actually impacted, one has to question whether it was in fact necessary, in retrospect, to completely rewrite section 94 or whether some fine tuning would have sufficed. Also, the rules apply to bona fide estate planning structures set up for non-residents. Thus the main focus of the rules targets an area in which there were no abuses and in this way is misguided.

G. <u>TAX PLANNING IMPLICATIONS</u>

In this section, we discuss certain tax planning ideas for non-resident trusts, in light of the transition to the proposed new tax system.

Constraints on Planning Options

In considering tax-planning options, it must be kept in mind that the trust arrangement itself may place severe limitations on the choice of alternatives. For example, while it may be desirable to allocate income to certain beneficiaries, and in particular to non-resident beneficiaries, this may not be possible under the terms of the trust agreement. In some cases, winding up the trust may be the most desirable alternative, but if the trust arrangement does not provide for an early termination of the trust, then this may be impossible. This is commonly encountered in testamentary trust arrangements, but of course can occur in other circumstances as well. In addition, sometimes it may be appropriate to continue a non-resident trust as a resident of Canada, by changing the trustee from a non-resident to a Canadian resident. However, this may not always be possible due to limitations imposed under the trust agreement, the refusal of the trustee to resign in favour of a Canadian resident, the inability to find a suitable Canadian resident trustee to take over the trust, and a host of other circumstances. Accordingly, the tax planning options considered below must be reviewed on a case-by-case basis in light of these constraints.

Note also that trustees can be personally liable for unpaid taxes of a non-resident trust that is deemed resident under section 94, to the extent of distributions to beneficiaries[132].

Impact of Proposed Amendments

Before looking at the tax planning options themselves, it is important to evaluate how a particular trust arrangement will be affected by the proposed new rules. This is critical to the transitional planning.

The table below illustrates four possible scenarios for a non-resident trust.

Category	**Existing Section 94 Applicable (Y/N)**	**Proposed Section 94 Applicable (Y/N)**
Category 1	Y	Y
Category 2	N	Y
Category 3	N	N
Category 4	Y	N

Under Category 1, the non-resident trust falls within the ambit of both existing section 94 and proposed section 94.

Under Category 2, the non-resident trust is not deemed resident under existing section 94, but will be deemed resident under the proposed rules.

Under Category 3, the trust is considered a non-resident for purposes of existing section 94, and also for purposes of proposed section 94.

Under Category 4, the non-resident trust is subject to existing section 94, but will be exempt under proposed section 94.

[132] Subsections 227(5) and 227(5.1).

Category 1

Under Category 1, the non-resident trust falls within the ambit of both existing section 94 and proposed section 94. As a result, the trust is deemed resident in Canada under the existing and proposed rules. The impact of this status will generally be as follows:

i) There will be no step-up in the cost base of the trust's assets upon the transition.[133]

ii) There will be limitations on deductions for distributions to non-resident beneficiaries.[134]

iii) Upon there being no *resident contributor* and again if there is subsequently no *resident beneficiary*, the trust will be deemed to have sold its assets at fair market value, resulting in accrued gains being recognized.[135]

Taking these matters into account, the impact of the proposed rules will depend upon the nature of the assets and income of the trust, and whether this income is accumulated, allocated to resident beneficiaries, or allocated to non-resident beneficiaries. If the income is mostly or exclusively foreign sourced income, and is allocated to non-resident beneficiaries, then the proposed rules will have little impact on the overall tax situation. On the other hand, if the assets have substantial capital appreciation potential from taxable Canadian property, or if the income is Canadian sourced income, then a strategy of allocating such income (including capital gains) to non-resident beneficiaries will have severe limitations under the proposed new rules. Furthermore, the deemed realization that can occur upon ceasing to have a *resident beneficiary* or a *resident contributor* can have catastrophic consequences to the trust's tax position. Therefore, serious consideration should be given to winding up the trust arrangement.[136]

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[133] Proposed paragraph 94(3)(c) provides that where a trust was non-resident throughout the preceding year, for the purposes of subsection 128.1(1), the trust is deemed to have become resident in Canada immediately after the end of that preceding year. Hence, there will be step up in the cost base of property other than taxable Canadian property.

[134] These limitations under proposed section 104(7.01) apply to taxable capital gains from the disposition of taxable Canadian property, and components of income that would be subject to non-resident withholding tax if paid in the normal course to a non-resident. In the latter situation, a deduction of 50% of such amounts is permitted. For more details, see discussion under Distributions to Beneficiaries.

[135] Proposed subsections 94(5) and (5.1) provide that a trust is deemed to have ceased to be resident in Canada under such circumstances. For more details, see discussion under proposed subsections 94(5) and (5.1).

[136] Under subsection 107(2), assets may be distributed on a rollover basis to beneficiaries. Where there is a non-resident beneficiary, it may be beneficial to elect under subsection 107(2.001) or 107(2.002) to have property disposed of at fair market value.

Category 2

Trusts which are not deemed resident under existing section 94, but will be deemed resident under the proposed rules are included in our analysis in Category 2. This result can occur for two main reasons. The most obvious situation is trusts created by Canadian residents, but with only non-resident beneficiaries. These trusts are not currently subject to section 94, but will be taxable under proposed subsection 94(3) because of the deletion of the Canadian resident beneficiary test. The second circumstance will be if the extended transfer rules apply to the trust to deem it resident under the proposed rules, but arguably the trust is not subject to existing section 94 because no property has been acquired from a Canadian resident so as to trigger its application.[137]

Where a trust not previously subject to section 94 becomes taxable under proposed section 94, the following will be the implications:

i) The trust will obtain a step-up in the cost base of property other than taxable Canadian property, equal to its fair market value at the transition date (i.e., January 1, 2002).

ii) There will be limitations on deductions for distributions to non-resident beneficiaries (see discussion above).

iii) Upon there being no *resident contributor* and subsequently, if applicable, no *resident beneficiary*, the trust will be deemed to have sold its assets at fair market value, resulting in accrued gains being recognized.

iv) The trust will be taxed as a non-resident up to December 31, 2001.

The following tax planning points are worthy of note:

i) If the trust holds taxable Canadian property, which has appreciated in value, no step-up will be given at the time of transition. However, if the trust is exempt of Canadian tax under existing section 94 and is resident in a treaty jurisdiction, then any capital gain that it realizes may be exempt of Canadian tax[138]. Therefore, a step-up in the

[137] It is acknowledged that this is an oversimplification of the rules, and reference may be made to comments earlier in this paper for a more precise recital of the rules.

[138] Where the trust wishes to realize a gain from the disposition of taxable Canadian property, and have that gain be exempt of Canadian taxation, then it will be necessary to find a mechanism whereby the taxable capital gain will not be subject to Canadian tax. This will only be possible through the use of an

basis of taxable Canadian property can easily be achieved by triggering a gain. This can be done in a variety of ways, including an outright sale, a transfer to a corporate entity, or a distribution to beneficiaries.[139] The Act does not contain rules to deny the realization of capital gains, even if carried out purely for tax reasons. Note that merely making the trust a Canadian resident will not achieve a step-up in the basis of taxable Canadian property.

ii) Since income (other than income taxable under section 115) may be realized prior to the transition free of Canadian Part I tax, but will be taxable thereafter, it is important to realize as much income as possible prior to the transition. Accordingly, where possible, income should accelerate. For example, if the trust owns shares in a foreign corporation, a dividend could be paid by that corporation to the trust in order to realize the income during the trust's tax-exempt period.

iii) With the step up in cost base, it will be possible to reorganize the share structure of a foreign company to allow for funds to be extracted on a tax-free basis.[140]

iv) Careful consideration must be given to whether the trust should be wound-up prior to the new rules becoming applicable, or should be continued.

v) Where the trust holds shares of what will, after the transition, be a controlled foreign affiliate, a revaluation will apply for FAPI purposes to relieve the trust of gains accrued before the transition[141]

From a review of the eight different trust situations described under **IMPACT ON EXISTING STRUCTURES**, it is clear that the only situation that is significantly affected by the proposed rules is the Outbound Non-Canadian Trust. This is a trust created by a Canadian resident for non-resident beneficiaries. This would clearly fall within the Category 2 analysis. Also, in certain circumstances, a trust created by a Canadian resident for Canadian resident beneficiaries, the Outbound Canadian Trust, may possibly fall outside of the ambit of existing

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international treaty to override Canadian domestic law. Even if the trust is not taxable under section 94, it may nevertheless be taxable under paragraph 115(1)(b) on gains realized from the disposition of taxable Canadian property. Accordingly, an international treaty, which has an appropriately drafted capital gains article, will be required in order to override Canadian domestic law. The trust will, however, be required to apply for a clearance certificate, since it will be considered a non-resident under Canadian domestic law.

[139] In order for a gain to be realized, an election can be made under subsection 107(2.001).

[140] This will involve creating a class of frozen shares equal to the value at transition. After this, the frozen shares may be redeemed, allowing funds to be extracted from the foreign company. As there will be no gain on redemption, there will be no tax.

[141] Paragraph 95(2)(f).

section 94, but may be caught within the scope of proposed section 94. The tax planning considerations will be similar in both circumstances, except that with the Outbound Canadian Trust, there may not be suitable non-resident beneficiaries to which income can be allocated. In addition, where a position is taken for a Outbound Canadian Trust that it is not currently subject to section 94, this must be viewed skeptically, as this will most likely go against the policy intent of the existing legislation, and is liable to be challenged by the CCRA.

Category 3

Under Category 3, the trust is considered a non-resident for purposes of existing section 94, and also for purposes of proposed section 94. As a result, it is treated as a non-resident under both systems, and the tax planning is solely that applicable to non-residents. Accordingly, the considerations discussed above will be of no relevance.

Category 4

It is difficult to conceive many situations where a non-resident trust would be subject to existing section 94, but will not be so subject under the proposed amendments. Accordingly, anyone reaching this conclusion will be well advised to double-check their analysis. It would seem that the only circumstances would be if the arrangement fell within the rules for exempt foreign trusts. Since these instances will most likely be rare, it is not meaningful to discuss general tax planning considerations for them.

Treaties

Some persons have suggested that international tax treaties may in certain cases be capable of overriding proposed section 94, and can also override existing section 94, particularly with respect to capital gains. It seems that the CCRA is clearly of the view that no international tax treaties are capable of overriding proposed section 94, and the Crown Forest case is cited as authority for this.[142]

That case held that in order for an entity to be a tax resident under an international tax treaty, it should be taxable in the country in question in the most comprehensive way. Proposed section 94 does subject a non-resident trust to Canadian taxation in a more comprehensive way than its predecessor. Arguably, prior to these amendments, existing section 94 did not subject a non-resident trust to fully comprehensive taxation. As a result, the Crown Forest case can be taken as support for the proposition that under existing rules a non-resident trust is more likely to be a resident of foreign treaty jurisdiction than a resident of Canada, for

[142] Crown Forest Industries Ltd. v. MNR, [1995] 2 C.T.C. 64 (S.C.C.).

purposes of applying an international tax treaty. Under the proposed rules, the issue will be mute. This is the opposite conclusion to that of the CCRA.

This matter will almost certainly be the subject of future litigation. Persons who intend to rely on a treaty to override Canada's ability to tax, may wish to consider whether the arguments will be as strong under the new legislation, and act accordingly. Note also that provincial tax administrations may not necessarily be bound by international treaties, and with the trend to establish separate personal tax systems, this may become a more and more important issue.[143]

[143] Idea courtesy of Richard Winter, Q.C.

H. RECOMMENDATIONS FOR FURTHER AMENDMENTS

In our paper submitted for the 2000 Canadian Tax Foundation conference, we listed various suggestions for changes to the draft legislation. Some of these have been acted upon, while most have not. Since the consultation period will extend to October 31, 2001, we have submitted a draft of our paper outlining our recommendations for change, with some additional explanation. These fall into three basic categories. Firstly, we would recommend reconsideration of certain tax policy issues. Secondly, there is a need for grandfathering. Thirdly, there are still certain technical amendments that we would propose.

Policy Issues

While it is understandable that there is a need to enforce the offshore trust legislation, and the best way to do so is directly against Canadians who participate in offshore trust arrangements, the unlimited liability for taxes of a non-resident trust, without regard to the amount contributed to the trust, is much too far-reaching. We would recommend that the liability of a *resident contributor* be limited much more significantly than the proposed recovery limit rule of subsection 94(7). We would instead recommend that greater emphasis be placed on making full and timely disclosures, as we believe that this acts as an appropriate deterrent to tax avoidance schemes of little substance. Furthermore, it is our view and our experience that most taxpayers are basically honest, and, when faced with clear and well-publicized rules concerning what is and what is not appropriate offshore planning, the vast majority of taxpayers and professional advisors will comply. The joint and several liability rule will not be of assistance in combating tax evasion, nor will any of the other amendments proposed as part of the total package (including changes to the foreign reporting rules).

There will undoubtedly be situations of grievous injustice where structures have been set up long ago, and for valid reasons, in which the *resident contributor* is now ensnared. The *resident contributor* is basically powerless, with no ability to undo an irrevocable trust. There will be representations to the fairness committee on grounds of hardship, and this will not assist the CCRA in maintaining an image of fairness and even-handedness. One may even see a Charter challenge.

The deemed disposition rule in proposed subsections 94(5) and (5.1) is another instance where tax consequences can result which were never anticipated. If the Canadian resident made a gift to non-residents, then these non-residents would have no reason to be concerned about Canadian tax matters from that point forward. Likewise, if property is contributed to a non-resident corporation owned by such persons, a similar situation will result. However, because a trust is used, possibly for very valid financial and estate planning reasons, totally unexpected Canadian tax consequences may now result. Upon the death of the *resident contributor*, the trust may realize a capital gain for Canadian purposes, which would never have resulted under other types of structures, and was never anticipated at the time the arrangement was established.

Not all non-resident trusts are so-called offshore trusts. Many trusts have been established as U.S. resident trusts for U.S. beneficiaries. The treaty issue will thus be debated over the Canada-U.S. Treaty. It will be difficult for the CCRA to argue that a U.S. resident trust with U.S. trustees, assets and beneficiaries is Canadian resident under the treaty just because the Canadian Income Tax Act deems it so. It seems that the Department of Finance is setting up the CCRA for a fight they will not win. What then?

Grandfathering

Compounding the difficulties described above is the lack of grandfathering for existing situations. There is a very good argument to allow transitional rules for trusts that do not have Canadian resident beneficiaries, or any possibility of adding Canadian resident beneficiaries. To deal with the situation where a trust was established before the February 1999 Budget Proposals were announced, we propose a limited grandfathering be considered. We would add to the list of exempt foreign trusts, the following:

> A non-resident trust established before March 1999 where the trust was not on that date or subsequently a trust to which subsection 94(1) as it read before 2002 would apply, the trust provides the CCRA with prescribed information on a timely basis, all beneficiaries are by December 31, 2001 fully ascertained, and no property is added to the trust after February 1999 (or if such property is added after that time, it is withdrawn before January 1, 2002.)

With such a rule, there is basically no scope for manipulation of the system, but it would greatly enhance the fairness of the legislation as it impacts existing situations.

Technical Changes

The circumstances under which a non-resident trust may be exempted of proposed subsection 94(3) under the *arm's length transfer* rule are still too limited. The rules are too subjective and difficult to interpret. It is difficult to know how the CCRA will administer these rules.

The limitation on trust distributions rule can result in duplication, where certain types of income could be caught twice[144].

The foreign tax credit calculation seems deficient in the case of business income (albeit a situation that does not arise commonly). To match the foreign tax to the foreign income, if all foreign tax is non-business, all income should be deemed non-business as well. Also, it is inappropriate to subject the non-resident trust to the limitations of subsection 20(11), and a specific exemption should be considered for this purpose.

The explanatory notes indicate that one way to mitigate the Canadian tax levied on a non-resident trust which is deemed under proposed subsection 94(3) to be Canadian resident is to pay all the income to non-resident beneficiaries. However, if the trust has been funded by interest-free or low-interest loans, which is quite common, the income will attribute to the Canadian resident lender. Thus, the plan, which is contemplated and stated in the Technical Notes, will not work. We would recommend that the scope of subsection 56(4.1) be narrowed to eliminate its application in this circumstance.

Section 74.4 was put into the Act in 1985 to combat income splitting. Since that time, other sections have also been placed in the Act which have a similar purpose, including the so-called "kiddie tax".[145] Accordingly, one may question whether section 74.4 still serves a useful purpose, or whether it could be eliminated entirely. If it is to be retained, possibly an exemption can be provided for designated individuals who are beneficiaries of non-resident trusts to which proposed subsection 94(3) does not apply. This would make the rule consistent with the amendment contemplated to subsection 75(3) for the immigrant trust.

[144] Paragraph 104(7.01)(b). Rental income, for example.
[145] Section 120.4.

I. CONCLUDING COMMENTS

Once it is determined that Canada's international tax system should not permit Canadian residents to establish non-resident trust structures and benefit under them without paying tax, it is necessary to make sure that the words of the Income Tax Act say this clearly and that the provisions can be and will be properly enforced so as to attain their objectives. While it may seem that we are critical of the proposed legislation, there are many improvements that it brings. It clarifies some of the circumstances under which a transfer of property to a non-resident trust will be said to occur. It also corrects a number of technical deficiencies within the system under existing section 94 (such as imposing the requirement to obtain a clearance certificate under section 116 and correcting deficiencies in the current foreign reporting rules).

The remaining deficiencies in the proposed legislation will not be difficult to correct if one starts with the basic proposition that taxpayers and professional advisors, although possibly aggressive at times, with a huge appetite to save tax, are nevertheless fundamentally honest. If so, a better rule can be devised to tackle outbound trust structures, the joint liability issue and the other problematic aspects of the proposed rules. If one starts from a perspective that Canadians using offshore trusts are dishonest, then these new rules will have no impact. One should be reallocating resources away from the CCRA over to the RCMP.