AMENDMENTS TO CANADIAN TAXATION OF NON-RESIDENT TRUSTS

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A. INTRODUCTION

In February 1999, rules were announced to fundamentally change the Canadian taxation of non-resident trusts. These rules met severe criticism and were significantly altered. However, the thrust of the rules remained.

In October 2002, the latest version of the legislation was released, to come into effect January 1, 2003. This paper analyzes this draft legislation which is not yet law (referred hereon as new legislation). Although it is unlikely that major changes will be made to the legislation, and it will come into force as of January 1, 2003, nevertheless further changes could be made before it is passed into law.

Scope and Organization of Paper

The topic of the Canadian taxation of non-resident trusts is a very extensive one, and this paper could easily have been far longer. We have made an attempt to cover the most important aspects of the subject but have not covered every aspect exhaustively.

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

In Section B, we give a general overview of the area and explain what lead to the new rules. We also discuss some of the tax policy considerations. Section C looks at the old system of taxing non-resident trusts in detail.

The paper then analyzes the new legislation in detail in Section D.

Once the reader has an understanding of the new legislation, as set against the current rules, it is possible to analyze the impact of the changes on existing structures (Section E).

[1] This paper is based on a paper prepared by the authors at the Canadian Tax Foundation's 2000 Annual Conference, September 24-27, 2000, Toronto. It has been updated and was published by STEP Worldwide in Quarterly Trust Review.

Section F discusses tax planning strategies available with non-resident trusts, considerations in the transition to the new system, and the interaction of the rules with international tax treaties.

Finally, the paper summarizes problems with the new legislation and some of the difficulties likely to be encountered by practitioners (Section G).

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 avoid (or evade) tax. What follows from this would be 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 (like all governments) didn't constantly meddle with the tax system to achieve social, economic and political goals. But they do, and as this article will demonstrate repeatedly, the reduction of Canadian tax through what the government determines to be appropriate tax planning is not only permitted under the Income Tax Act (sometimes called the "Act"), but is encouraged. It is specifically sanctioned through the use of non-resident trusts. In fact, certain planning can only be done with non-resident trusts. The new legislation which are the main subject of this paper actually promote the use of non-resident trusts for certain permitted tax planning purposes.[2]

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, 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.[3]

For ease of reference, a non-resident trust that is 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

[2] 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 (discussed later), 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 October 11, 2002 are generally referred to as new section 94 etc.)
[3] See, for example, the proposal to exempt U.S. resident trusts from Canadian taxation.

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 the general anti-avoidance rule,[4] or on transfer pricing legislation[5] 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 aggressive clients and promoters cannot pretend to misunderstand. 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.[6]

Whether or not the old rules were imprecise is still something of a matter for debate, and it is not at all clear that old section 94 contained the number of loopholes and deficiencies that certain tax planners might fancy. These issues have never been tested in court. More will be said about this later. However, while the law may have lacked some clarity in certain places, it is probably fair to say that old 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 was lax enforcement.

The Auditor General of Canada has commented on numerous occasions on the Canada Customs and Revenue Agency's (from hereon referred to as the CCRA) handling of various matters in the international area.[7] In response to these comments, the CCRA has made great progress by expanding the International Tax Directorate, formalizing its mandate, developing a comprehensive audit strategy for tax havens, 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[8]. The CCRA clearly took these comments seriously, and acted accordingly.

[4] Section 245.
[5] Section 247.
[6] It should not be forgotten that most tax planning structures involving non-resident trusts seek to bring the non-resident trust outside of the tax system, in order to avoid taxation entirely. 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.
[7] 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."
[8] The 2000 and subsequent versions of the T-3 Trust and Information Return asks if the trust is an "offshore trust".

Yet the CCRA has fallen behind badly in its support for 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 old subsection 94(6) etc. How are taxpayers at large supposed to understand these rules with very little guidance?

The pace of legislative change in recent years has far exceeded the resources available in both the International Tax Directorate and the Rulings Directorate, resulting in out of date or non-existent interpretation bulletins, forms and information circulars.

Certain forms are required to be filed by persons who have transferred property to foreign trusts. It can be hinted from the design of the foreign reporting forms themselves that the CCRA needs to be more focused. On the forms, special emphasis is placed on the protector and on letters of wishes, leading certain practitioners to conclude that the CCRA may challenge non-resident trust structures merely because they have say Canadian protectors[9]. 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[10].

The noose has been tightened year by year on arrangements involving non-resident trusts. Consider, for example, the foreign reporting forms which became effective in 1996, the expansion to the definition of beneficially interested in 1998[11], changes to how foreign accrual property income is calculated for a non-resident trust (also 1998), and the expanded definition of taxable Canadian property, changes to section 116 and the tightening of the clearance certificate procedures all effective from 1996. 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 caught under old section 94. However, given the imprecise nature of certain aspects of old section 94, there may still be arguments to support the proposition that certain structures are not currently “off side”, but 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 with a non-resident trust, due to yet further expanded foreign reporting rules. Given this, a harder look must be taken at existing structures, since the requirement to disclose such structures will raise the probability of detection and the risk of challenge.

[9] Form T-1141.
[10] Campbell v. R., 1999 Carswell Nat 186, 99 DTC 1073, T.C.C.
[11] Subsection 248(25).

A sobering thought is that if a non-resident trust is potentially deemed resident under section 94 (old or new), there is no statute of limitations governing 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 may be. Penalties and interest may also be levied on the unpaid tax. In all, the tax, penalties and interest can exceed the entire trust fund.

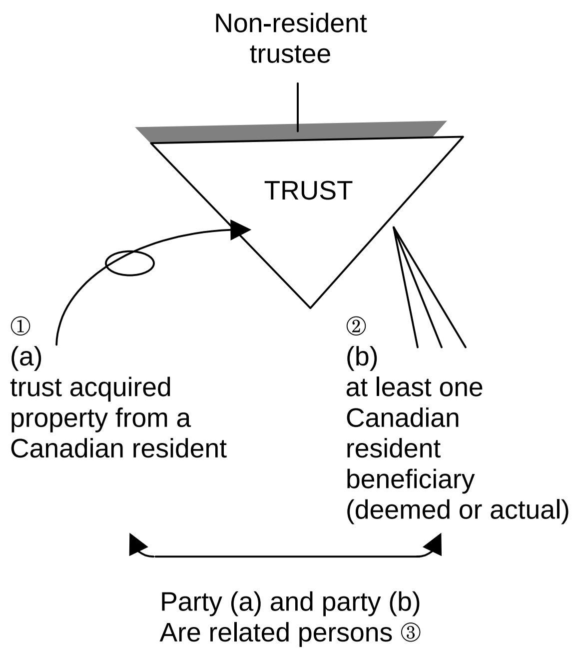
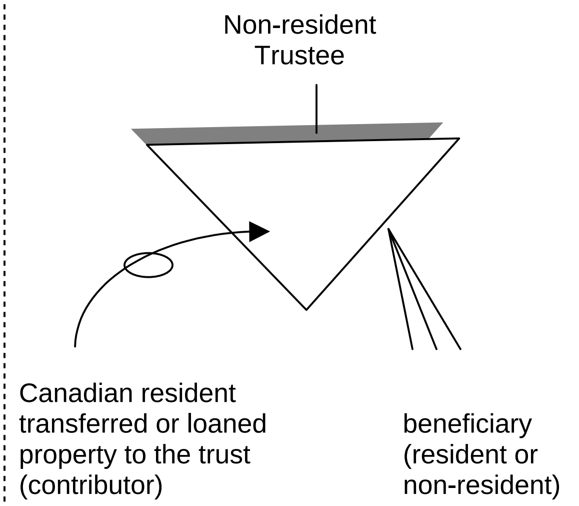
February 1999 Budget Proposals

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, with certain exceptions, regardless of whether they have Canadian beneficiaries. There was to be an exemption for U.S. trusts, as well as the 60-month immigrant trust. No mention was made of trusts established by non-residents;

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 liable for the trust's tax liability, in order to provide a means to enforce collection of the tax.

<table>
<tr><th>Old Section 94</th><th>February 1999 Proposals
Of New Section 94</th></tr>
<tr><td>
</td><td>
</td></tr>
<tr><td>▪ Trust deemed resident if all tests met.
▪ Capital distributions tax-free
▪ Tax liability (if any) rests with trust primarily
▪ Trustee and Canadian beneficiary liable for tax of trust to extent of distributions.</td><td>▪ Trust deemed resident if Canadian contributor
▪ Capital distributions taxable to Canadian beneficiary (not implemented)
▪ Tax liability (if any) rests with the trust primarily
▪ Trustee and Canadian beneficiary liable for tax of trust to extent of distributions <u>and</u> Canadian resident contributor liable for trust's tax in an unlimited amount.</td></tr>
</table>

While the first point 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,[12] and that the joint and several liability issue has been modified slightly but nowhere near far enough.

[12] See November 30, 1999 Press Release – Update on Proposals for the Taxation of Non-Resident Trusts and Foreign Investment Funds. Note that distributions out of current income of trusts to Canadian beneficiaries are taxable under subsection 104(13).

It is useful to consider the main aspects of the February 1999 proposals, since they give some additional insight into the rationale behind the new legislation.

While it is debatable as to whether old 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 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 to rewrite 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 (or at least not hinting at what they might be). This objective has generally been achieved in the new 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 new legislation has gone to extraordinary lengths to define the circumstances under which a transfer or loan of property (or using the terminology in the new 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 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 represented a fundamental shift in policy, whereby trust income that is intentionally exempt of Canadian tax would be tax-deferred but not tax-free. The taxing of trust distributions changes a tax exemption into a tax deferral. But what of the five-year tax exemption clearly emphasized as being applicable to new immigrants?[13] Furthermore, what grandfathering was to be granted to existing situations not currently subject to tax?

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

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.

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.

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[14], 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 distribution is akin to a gift. The non-resident settlor could retain the funds and give gifts which would be non-taxable[15].

A number of inter-vivos and testamentary “inbound” 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 a substantial incentive to do so. Canadians might later become non-resident and then receive distributions at that time, thereby escaping taxation altogether.

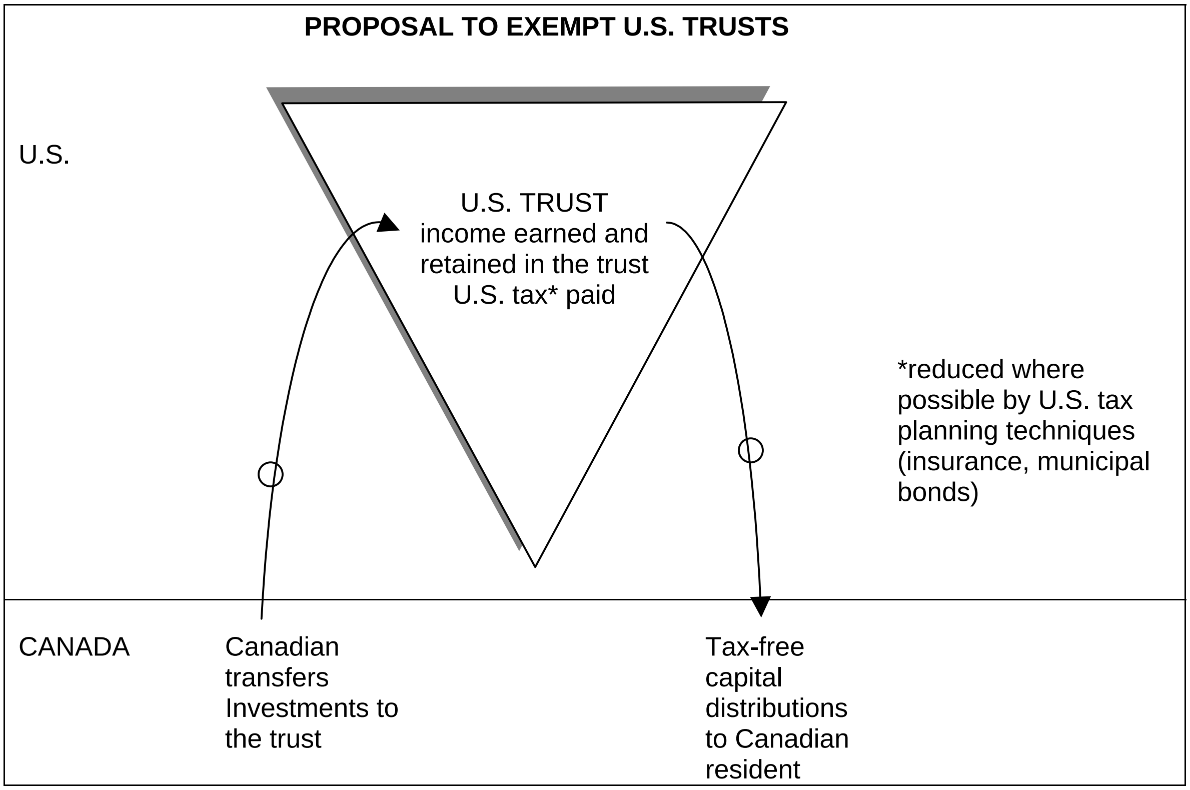
All in all, this proposal had the makings of bad economic policy, a high level of complexity, problematic administration and the prospect of recovering very little in tax revenue.

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

[14] 60 months under the new rules.
[15] Canada does not have a gift tax.



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. 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% (about half the Canadian rate at that time). Moreover, certain types of investment income, especially municipal bond interest, are exempt of federal taxation, in order to provide a tax incentive for U.S. municipal development. Such income could be earned tax-free.

And why limit the exemption 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[16]. Canada would effectively be importing these exemptions into its own taxation system. Others give a step-up in the cost base of capital assets upon becoming resident[17].

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 having appropriately refocused the conceptual framework of the original proposals, the Department of Finance then set about the task of drafting the detailed legislation. Nobody thought that this would take 3 years, but it did.

The proposed draft legislation immediately ran into serious difficulty, not because of the non-resident trust rules but because of the foreign investment entity rules (which mainly apply to foreign corporations) 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. It was further delayed by one year, to be effective January 1, 2003.

C. PREVIOUS SYSTEM OF TAXING NON-RESIDENT TRUSTS

Basic Framework of Old Section 94

Old section 94, in force until December 31, 2002, is generally applicable to deem a non-resident trust to be a Canadian resident trust, 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]

[16] For example, New Zealand.
[17] Denmark and Australia, for example.
[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 corporation.
[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 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 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

The second condition is that there must be a Canadian resident person from whom the trust has acquired property (hereafter called a "transferor") 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, even if the person ceases to exist. Both conditions must be met at some time in a taxation year of the trust, for taxability to result.

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

Deficiencies in Old Section 94 and Past Amendments

Old section 94 allowed for a number of possible scenarios for the creation of non-resident trusts that would not be deemed Canadian resident. So far, there have been no court decisions on these techniques, and therefore it is impossible to say with certainty whether these techniques would be capable of achieving their objectives. In addition, a series of amendments have been made to section 94 over time, in order to make this type of planning more difficult or impossible.

In the sections below, the more common techniques for creating tax-exempt offshore trusts are discussed, together with past amendments relevant to the structures.

No Canadian Resident Beneficiary

A straightforward and obvious way to avoid the application of old section 94 was to not have a Canadian resident beneficiary at any time in a taxation year. It therefore 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.

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an inter-vivos trust that ceases to exist does not 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.

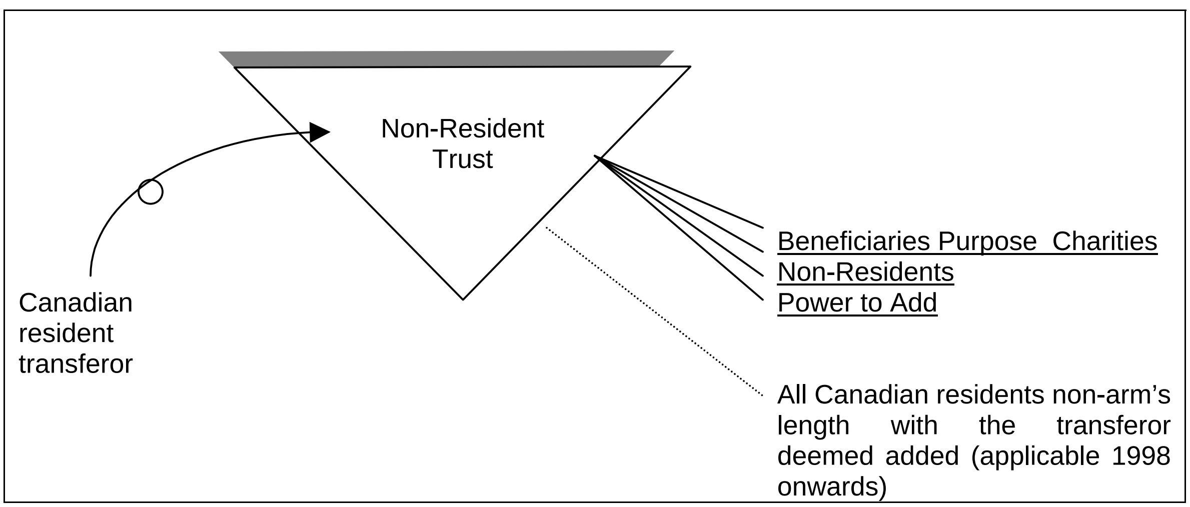
[20] Paragraph 94(1)(b).

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

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:

> 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 his 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 from inception, 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 old 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 old 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, 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 such trusts and especially 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 sham trusts. 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 old section 94 where Canadian resident beneficiaries can potentially be added as beneficiaries of the trust who dealt non-arm's length with the settlor.

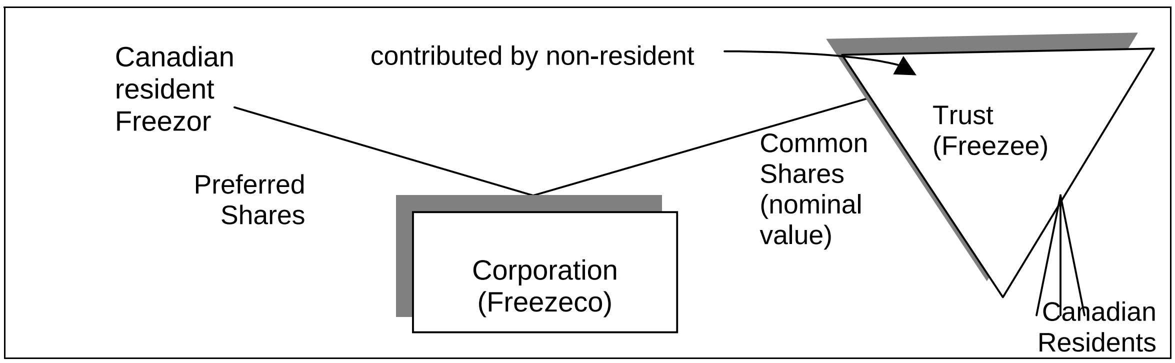
After this amendment, one might have expected a flood of voluntary disclosures and tax filings of section 94 deemed resident "purpose" and "charitable" trusts, but it would seem from informal discussions that very few have come forward. It is possible that the CCRA and others have greatly overestimated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

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 old section 94, unless the transferor became a resident of Canada for a period or periods aggregating 60 months.

[22] For example, The Special Trusts (Alternative Regime) Law 1997 ("Star" Law) was introduced in the Cayman Islands.
[23] The amendment to subsection 248(25) was applicable after 1997.

Various indirect transfer techniques evolved, to make sure that no Canadian resident transferred property to the trust. Of these techniques, the most popular was the international estate freeze, whereby a 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 established 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, this structure might not fall within the normal ambit of old section 94. In other words, a transfer of the future growth in value of Freezeco by allowing a common share subscription for nominal 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”).[24]



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

> 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 definitive view as to what constitutes financial assistance.

Other Gaps in Old Section 94

Old subsection 94(1) deems the trust to be resident in Canada for purposes of Part I of the Income Tax Act, and for certain other limited purposes,[25] and deems it to have taxable

[24] Note that subparagraph 94(1)(b)(i) may apply where a Canadian resident person has made a transfer to a controlled foreign affiliate of the trust. Certain anti-avoidance rules were built into section 94, making this planning difficult in some cases.
[25] Sections 233.3 and 233.4.

income, which consists of certain things which are specifically enumerated. The subsection was amended in 1998 to expand its scope. 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 be included in income[26].

Another way to avoid old section 94 was for the Canadian resident transferor to not be related to a Canadian resident beneficiary. If Mr. Jones set up a trust for the Smith family (unrelated people) arguably this would fall outside of old section 94. A minor legislative amendment could have fixed this.

Tax Treatment of Section 94 Deemed Resident Trust

Old 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.

A trust deemed to fall within old section 94 may obtain a deduction for payments to beneficiaries that are on account of income. 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 (a defined term).[27]

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.

[26] Excluded property is a defined term, generally referring to shares of foreign affiliates that carry on an active business. Subsection 95(1).

[27] 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 and serves to override this result.

Clearance Certificate

Where a non-resident sell taxable Canadian property, a clearance is required, failing which the vendor must deduct 25% of the gross proceeds. This is outlined in section 116.

A section 94 deemed resident trust will be a resident of Canada for purposes of section 116 under the old rules. 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 section 116 clearance certificate procedure for non-resident trusts. This conclusion is not universally accepted and is often misunderstood.

Non-Resident Withholding Tax

For purposes of Part XIII non-resident withholding tax, the trust will be considered a non-resident. Under the old rules, it will be subject to withholding tax upon receiving amounts from Canadian sources, but will not be subject to withholding tax upon making income or capital distributions to Canadian residents or to non-residents.

Part XII.2 Tax

For purposes of Part XII.2 tax (a special 36% penalty 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.

Personal income tax is composed of two components; federal and provincial tax. If the individual (which includes a trust) is not taxable in a province, additional federal tax applies in lieu of provincial tax.

Additional Federal Tax

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. Currently, no provinces have specific legislation to address this. 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. The combination together approximates the tax returns applicable to Canadian individuals. However it is not entirely clear that additional federal tax is exigible.[28]

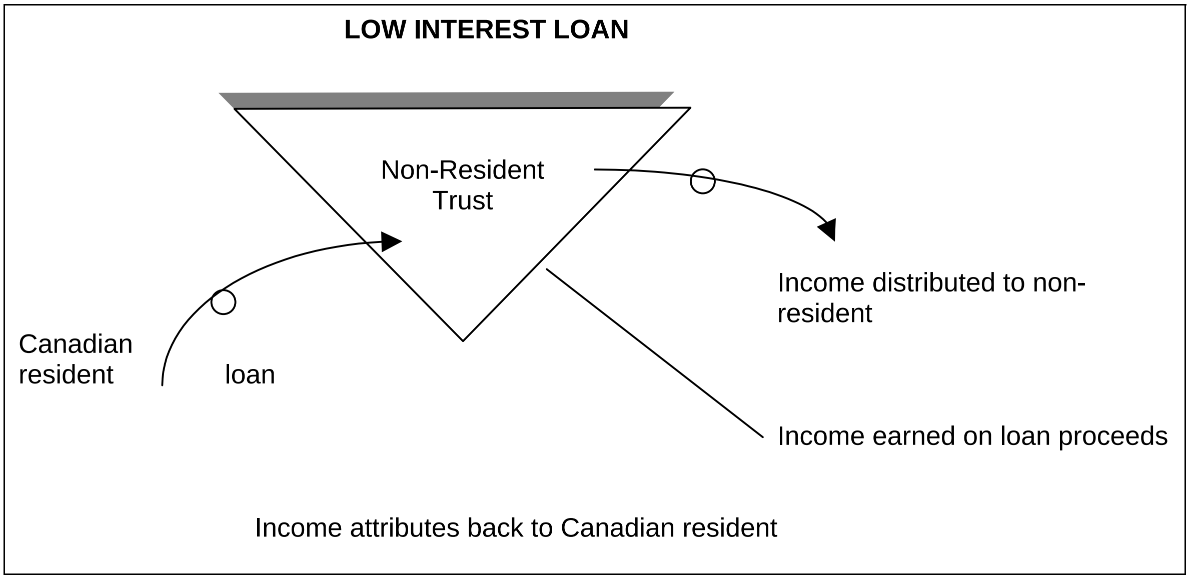
[28] Under subsection 120(1), additional federal surtax is applicable to tax otherwise payable that the individual's income for the year, other than the individual's income earned in the year in a province bears to the individual's income for the year. The individual's income for the year is defined 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

Tax Credits

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.[29] There are, however, special rules for claiming a foreign tax credit which are too technical to explain here.

Low Interest Loans

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

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. The Courts might reach a different view.

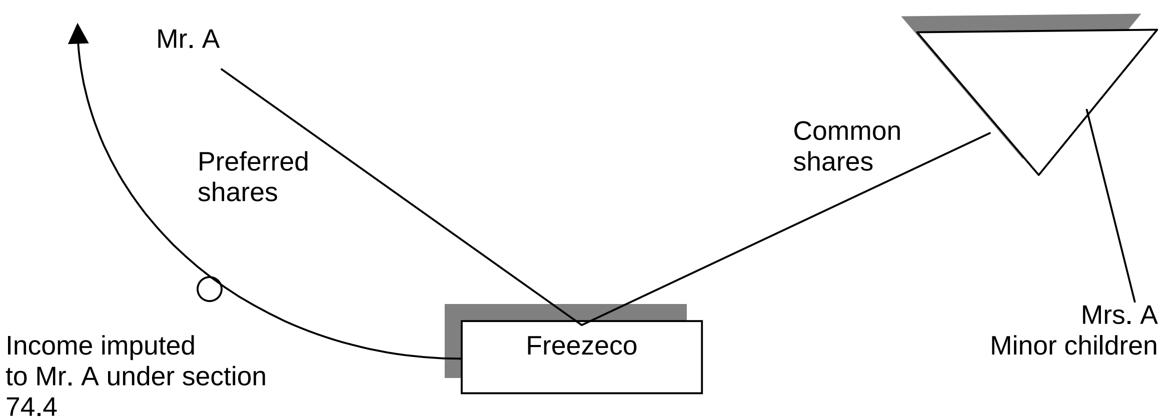
[29] A dividend tax credit is a special credit given to Canadian individual (including a trust) on receiving Canadian dividends). The CCRA has stated that a section 94 deemed resident trust may claim a dividend tax credit in a technical interpretation dated February 5, 1980.

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[30] via an interest-free or low interest rate loan.[31]

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.

Imputation of Interest

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, 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.



If the preferred shares are worth say $2 million, and the prescribed interest rate for the year was 5%, Mr. A would include $100,000 in income for that year.

Reversion

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

[30] Note the amendment to subsection 251(1) which codifies that beneficiaries and persons who deal at non-arm's length with the beneficiaries deal non-arm's length with the trust.
[31] 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.

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 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. However, this applies only while this person is resident in Canada.[32]

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.

Income v. Capital Distributions

Subsection 104(13) will subject a 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. 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.

Other Provisions

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 all 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 (e.g., shares of Canadian private companies or Canadian real estate), the gain from which is subject to tax in Canada.

[32] 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.

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.[33] 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 trust. In some cases, entities have been used which may arguably not be trusts, and are perhaps difficult to classify in a Canadian context. 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.

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.

For the old foreign reporting rules to apply, a number of conditions must be met. 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. Therefore the rules are sometimes possible to work around, and have not proved very useful to the CCRA thus far.

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 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.

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.

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

D. SCHEME OF NEW SECTION 94

Main Features

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

For most purposes, the requirement for there to be a Canadian resident beneficiary under the trust before the section is applicable has been dropped.[34] All that is required is to have a Canadian *resident contributor*. (Defined terms in this section are written in *italics* for ease of reference).

Any person who has contributed property to the trust and is resident in Canada may be liable for the trust's tax. There are, however, certain limitations to the amount that may be recovered, but these are seldom helpful.[35]

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 "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, so it will need to obtain a clearance certificate on sale of taxable Canadian property.[36]

There are special circumstances under which a non-resident trust may be exempt of new section 94. For the most part, these involve trusts that are set up to benefit non-residents in situations of marital breakdown or infirm beneficiaries. This allows the trust to accumulate income tax free, rather than being forced to pay out the income to beneficiaries to avoid Canadian taxation.[37] These exemptions are not generally useful in tax planning, because of the strict limitations placed on them.

There are exemptions for *arm's length transfers* such that these transfers or loans of property are not considered to be a *contribution* of property for purposes of new section 94.[38]

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

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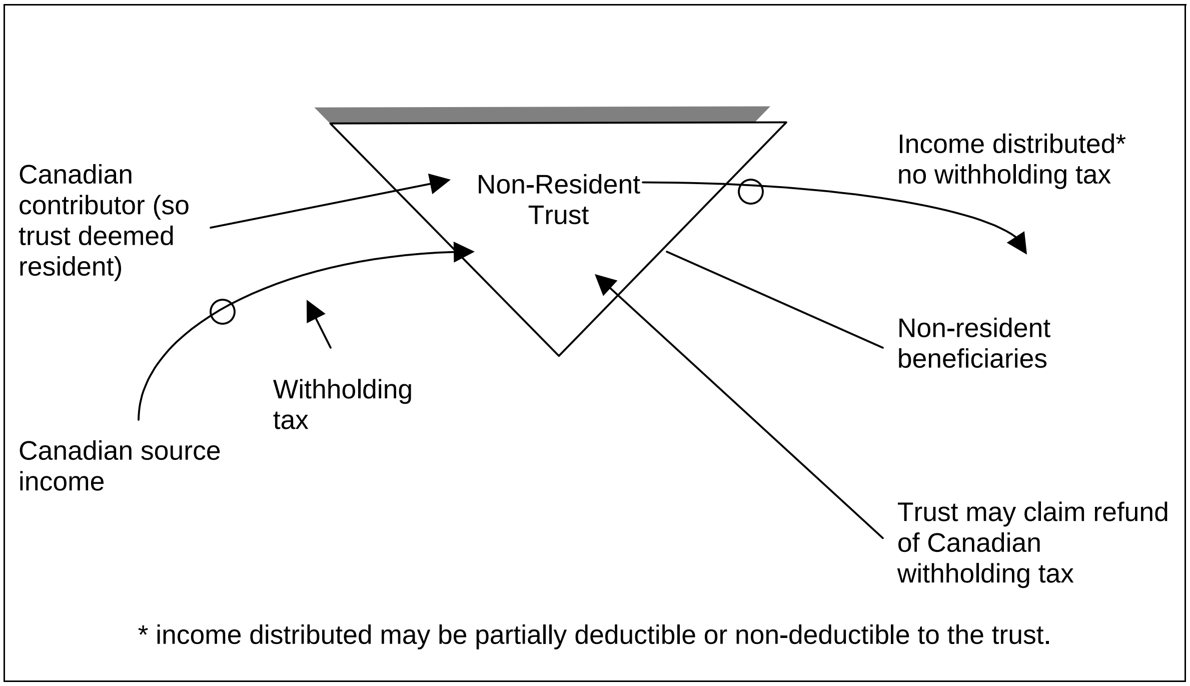
[34] Retained in the concept of *Resident Beneficiary* (discussed later), but not *Resident Contributor*.
[35] New subparagraph 94(3)(d)(i) and subsection 94(7).
[36] See new paragraph 94(3)(a). Section 116 is not one of the sections for the purposes of which the trust is deemed to be resident in Canada.
[37] See new subsection 94(3) and definition of *exempt foreign trust*, in new subsection 94(1).
[38] Subsection 94(1).

Canadian tax purposes, even though all the income has in fact been paid out to the beneficiaries.[39]



While the trust is considered a resident for purposes of determining non-resident withholding 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.[40] The trust is, however, still considered to be a non-resident for purposes of determining non-resident withholding 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),[41] the trust is deemed to have a year end immediately prior thereto, and to sell all of its property at fair market value.[42]

There are also many similarities between new section 94 and old section 94. These include:

[39] New subsection 104(7.01). The scope of this is extended well beyond the old subsection 94(3) limitations which perhaps did not work anyway.
[40] New subparagraph 94(3)(a)(v) and new paragraph 94(4)(b).
[41] Specifically neither a *Resident Contributor* or a *Resident Beneficiary*, both defined terms of much precision and complexity, see proposed subsection 94(1).
[42] New 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.

- 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 and is not subject to non-resident withholding tax on payments made by the trust to beneficiaries.
- Certain of the indirect transfer rules of old section 94 have been retained.[43]

Under the old as well as the new 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 the trust assuming Canadian residency or deemed Canadian residency.[44]

New Charging Provision of Proposed Subsection 94(3)

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

New 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.

Definitions

The flow of the legislation immediately leads into an analysis of definitions contained in new 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.

[43] Subsection 94(6), financial assistance, appears as new paragraph 94(2)(e). Also new paragraph 94(2)(n), trust to trust transfers is essentially the rule contained in old clause 94(1)(b)(i)(B).
[44] Section 128.1 will be applicable, by virtue of proposed paragraph 94(3)(c).

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 rules contained in new subsection 94(5) whereby a trust is deemed to have ceased to be resident in Canada.

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. Provided the person contributing property to the trust has not been resident in Canada for more than 60 months during his or her lifetime, there is neither a *resident contributor* nor a or *resident beneficiary*. New subsection 94(3) is thus not applicable.

A *resident contributor* does not include an individual who contributed to an inter vivos trust prior to 1960 while a non-resident. [45]

It should also be noted that the test of applicability in new 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 old 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 calendar year.

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 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 <u>or before that time</u> has made a *contribution*. Therefore, if a person makes a *contribution*

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

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 and also fundamental 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 by an *arm's length transfer*).[46] Note the extension of the concept of *contribution* to include a loan[47].

Meaning of Transfer

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 transfer. The word "transfer" is not defined in the new legislation, although certain transactions are deemed to be transfers.[48]

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."[49]

(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.…

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[46] Definition of *contribution* in new subsection 94(1) in paragraph (a).
[47] It should also be noted that under the case Dunkelman v. MNR, [1959] C.T.C. 375, 59 DTC 1242, Exch Court of Canada, (discussed later)a loan was held not to constitute a transfer of property.
[48] See discussion on Extended Meaning of Transfer and new subsection 94(2) later.
[49] Hamel v. M.N.R., [1966] 2 C.T.C. 2046 at 2053, T.C.C.

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.…"[50]

(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 to his wife."[51]

(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 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."[52]

(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."[53]

(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."[54]

(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

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[50] Algoa Trust v. Canada, [1993] 1 C.T.C. 2294, 93 D.T.C. 405 at 2303-2304, 411-412, T.C.C.
[51] Kieboom (A.) v. M.N.R., [1991] 2 C.T.C. 106, 91 D.T.C. 5478 at 116, 5487, F.C.T.D.
[52] Boardman v. The Queen, [1986] 1 C.T.C. 103, 85 D.T.C. 5628 at 106, 5631, F.C.T.D.
[53] Murphy v. The Queen, [1980] C.T.C. 386, 80 D.T.C. 6314 at 392, 6320, F.C.T.D.
[54] 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.

physical transfer but a transfer of the right of ownership attached to the property."[55]

(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."

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.'[56]

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 in a series of transactions with a common link. 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 new legislation has specifically used the expression "a transfer or loan". This is in stark contrast to the language of old subsection 94(1) which speaks of the trust having acquired property directly or indirectly in any matter whatever.

[55] 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.
[56] 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.

Sequential Transfers

Where a particular transfer or loan of property is made by a person 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 person.[57] 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.

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.[58]

It should also be noted that under the special provisions of new subsection 94(2) discussed later, there are at least 12 further rules which may 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 new subsection 94(3) if at the end of the year of the trust there is a resident beneficiary. This is an unfortunate choice for a defined term because the term does not mean what it appears to mean.

The term *resident beneficiary* is more complicated to understand conceptually than *resident contributor*. Under old 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 considered appropriate to continue to allow some form of an exemption in these types of circumstances. However, the 18-month period was considered too short, and has been extended to a 60-

[57] Definition of *contribution*, subsection 94(1) in paragraph (b).
[58] Definition of *contribution*, subsection 94(1) in paragraph (c).

month period, which looks to both the past and to the future. The rule is however only applicable if there is also a Canadian resident beneficiary under the trust (other than a *testamentary beneficiary*).

A *resident beneficiary* at any time under a particular trust means an *entity* that is resident in Canada and is a *beneficiary* 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*.[59]

A *connected contributor* to a trust means an *entity* (including a person who has ceased to exist) who is a *contributor* to the trust, but does not include an individual (other than a trust) who was before the particular time not resident in Canada for a total of 60 months during that person's lifetime. It also excludes a person whose contribution to the trust is made at a *non-resident time*. A *non-resident time* is a time at which the person is non-resident and has not been Canadian resident for five years (60 months), and does not become Canadian resident within five years. For transfers before June 23, 2000, the period of non-residency is 18 months.[60] Where the trust arose as a consequence of the death of a person, the period of non-residency is shortened to 18 months before the contribution.

Testamentary Beneficiary

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 a person related to that *contributor*.

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

This rule will exempt a non-resident trust from taxation in limited circumstances where there is a *connected contributor*. Note that the *testamentary beneficiary* definition can apply to both an inter vivos and a testamentary trust.

A person can be a *testamentary beneficiary* at certain times and not at other times. A person may cease to be a *testamentary beneficiary,* for example, after the death of the person upon whom the trust interest is contingent.

[59] Subsection 248(25) defines the term beneficially interested.
[60] See Enacting Provision 10(2), paragraph (d).

Summary of Resident Beneficiary

To recap, a non-resident trust will fall within new 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.

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 least 60 months after ceasing residency and the person remains non-resident for at least 60 months after the time of contribution. For long-term Canadian residents who become non-resident, this puts a ten-year time line around any transfer of property to a trust. (As stated above, the time frame where residency is permitted preceding the transfer is shortened to 18 months in the event of death or *contributions* before June 23, 2000.)

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 of making of the *contribution* to the non-resident trust, the trust would be deemed resident under new subsection 94(3) from inception, and not merely upon the return of the *contributor*.

It should be noted that in the case of testamentary trusts, the trust is not deemed resident under the new rules 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, once deceased, can never subsequently become a resident of Canada.

The *testamentary beneficiary* exception may offer some limited planning opportunities for non-resident persons wishing to establish non-resident trusts who do not meet the 60-month non-residency requirement and yet want to establish a trust for Canadian beneficiaries.

Exempt Foreign Trust

The legislation exempts from the ambit of new subsection 94(3) an *exempt foreign trust*. There are many circumstances under which a non-resident trust can be considered an *exempt foreign trust*. Among these, however, 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 of having an *exempt foreign trust* is the ability to accumulate income in a non-resident trust free of Canadian tax.

The *exempt foreign trust* is a trust that 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 new subsection 94(3) when the conditions for exempt status cease to be met. A year-end is deemed to occur on transition.[61]

The consequence of being an *exempt foreign trust* is that the trust is not within the ambit of new subsection 94(3). It would seem then that the trust would not 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.

The main circumstances where a trust will be an *exempt foreign trust* are the following:

- Trusts established for an infirm beneficiary who is a non-resident.[62]
- Trusts established for an estranged spouse on a marital breakdown who is a non-resident.
- Charitable trusts meeting certain conditions.

Arm's Length Transfer

Throughout new section 94, there are references to an *arm's length transfer*. The main definition of *contribution* and the extended transfer rules exempt from being 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 new subsection 94(3). As might be imagined,

[61] New subsection 94(6).
[62] Funds placed in the trust may not exceed what is reasonable for the beneficiary's needs.

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

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.

Share subscriptions to private Canadian companies cannot be *arm's length transfers*, even if they are in fact arm's length. This means that owning shares of a Canadian private company will invariably taint an international trust, however created, unless the shares are transferred to the trust by a non-resident and are not altered in any way.[63]

For more details, reference should be made to the legislation itself.

Extended Meaning Of Transfer

As if the rules were not complex enough, new subsection 94(2) has been added to define at least 12 situations where a transfer is specifically deemed to occur. This subsection has two main purposes, namely to extend the circumstances under which a transfer will be considered to have taken place, 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.

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

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

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

This can only occur for transactions where fair value consideration is not received or given at the time of the transaction.

[63] See discussion later under paragraph 94(2)(m).

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

This paragraph deals with indirect transfers, but is more complex to interpret than new 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:

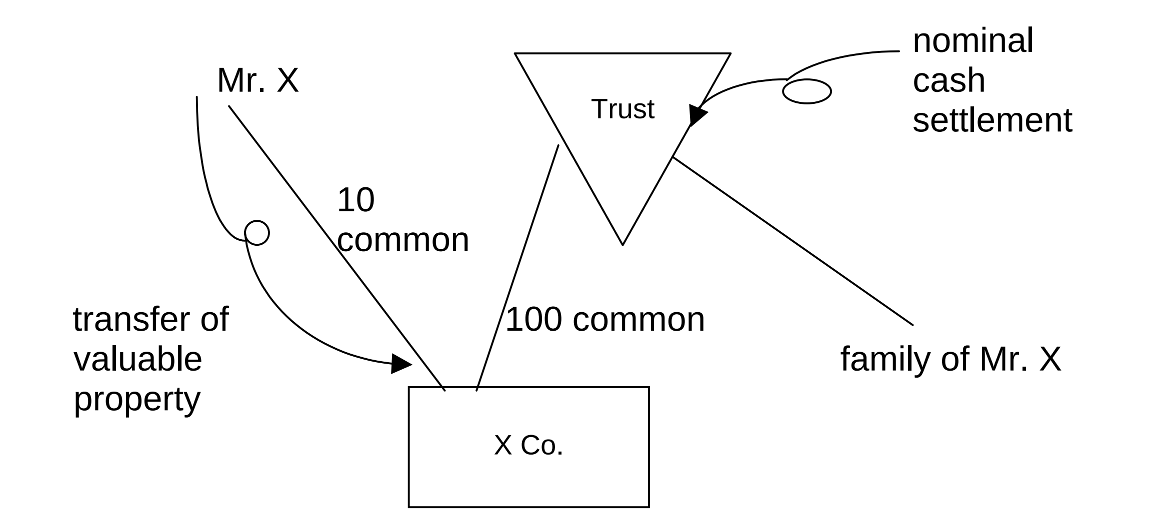
i) a trust must hold property at or after the time of the transfer the fair market value of which is derived, in whole or in part, directly or indirectly, from properties held by the recipient, and

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.

This rule is probably best understood by reference to 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 for 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. By doing this, a substantial amount of value is immediately transferred to the trust. Clearly the reason for the transfer to X Co. 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. See ***Figure 8***.

Figure 8



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

The rule may be applicable even if fair value consideration is taken back by Mr. X, because it might be considered that a future benefit may be conferred on the trust by the transfer to X Co. If so, this eliminates the opportunity to set up an international estate freeze with a tax-exempt non-resident trust.

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

New paragraph 94(2)(e) is virtually identical to its predecessor in old subsection 94(6). 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.

New 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 new 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 in rendering the 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 of the service pays fair value for the service.

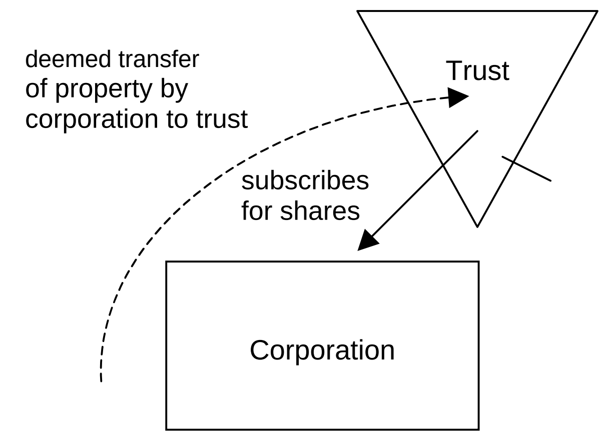
This means that if a Canadian resident performs services for a non-resident trust, this may cause the trust to be deemed a Canadian resident, unless fair value is received. The exempt service rule should excuse arm’s length arrangements, although this is not explicitly stated.

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

This paragraph applies in five circumstances, all of which involve the acquisition of some property.[64]

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 five rules in new 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, say, common shares of a Canadian corporation. In such circumstances, the corporation, a Canadian resident, will be considered a *resident contributor*. See ***Figure 9***. It will thus cause the non-resident trust to be deemed resident.

Figure 9



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 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.[65]

[64] There is no longer any grandfathering provision to this rule. This rule will apply to acquisitions even if made on or before June 22, 2000. A previous version of the legislation had an exemption for such transactions.
[65] Other persons may also be *resident contributors* per new paragraph 94(2)(o) discussed later.

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.

Lastly, where 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*. This only applies to rights granted after June 22, 2000.

New Paragraph 94(2)(i) - 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 new 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.

New Paragraph 94(2)(j) - 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, if resident in Canada prior to death, will be a *resident contributor* until death. At death, the deceased will cease to be a *resident contributor*.

The rule, however, also has application under the *resident beneficiary* test.[66] The deceased would be considered a *connected contributor* to the trust if resident in Canada at any time in the 18 months preceding death. The contribution would not have been made at a *non-resident time*.

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 new section 94 until death. This will merely be a moment in time. Whether the trust will continue to be subject to the rules of new section 94 by virtue of the *resident beneficiary* test will depend upon the residency of the beneficiaries and the nature of their interests.

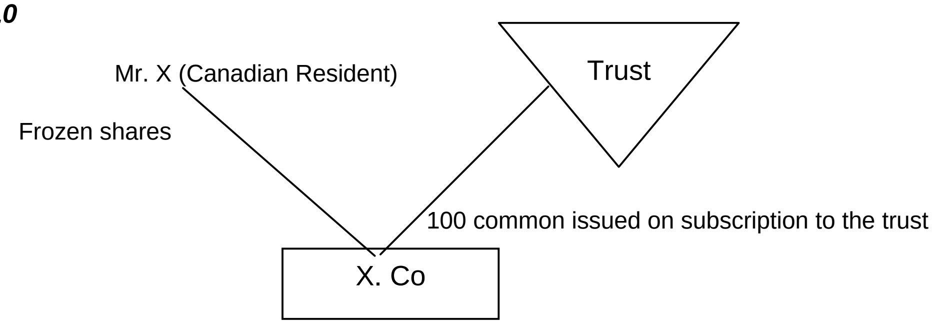
[66] Recall that this definition requires a *connected contributor* and a beneficiary resident in Canada.

New Paragraphs 94(2)(k) and (l) – 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 liability for tax under these rules. The *contribution* is then deemed to be made jointly by the third party.

Suppose that under an estate freeze, a Canadian corporation issues common shares to a non-resident trust. This is deemed to be a *contribution* of property by the corporation to the trust.[67] Mindful of this, the shares could be issued to a non-resident who gifts them to the trust. This rule catches that situation. See ***Figure 10***. New paragraph 94(2)(k) will deem the person who "orchestrated" the freeze, Mr. X, to have transferred property to the trust if it is reasonable to conclude that the arrangement was designed to avoid the rules of section 94. Thus, he will be a *resident contributor*. It may also deem X Co. to be a *resident contributor*.

Figure 10



Case 1
Mr. X freezes shares and allows Trust to subscribe to new common shares

Case 2
A non-resident subscribes to shares of X Co and gifts them to the Trust. This was made with the concurrence of Mr. X and X Co.

New paragraph 94(2)(l) extends the rule to a controlled foreign affiliate of the third party.

These rules block an international estate freeze of a Canadian corporation or a foreign corporation where a Canadian resident participates in the arrangement.

It should be emphasized that in order for these rules to apply, there must first be a potential tax liability of the trust that is sought to be avoided by the structuring. If it is genuinely believed that there will be no such liability, new paragraph 94(k) or (l) may be inapplicable.

[67] New paragraph 94(2)(g).

New Paragraph 94(2)(m) – Transfer to Corporation

New paragraph 94(2)(m) applies for greater certainty and deems a transfer of property by a taxpayer to a corporation to occur if:

a) the taxpayer is a shareholder and the terms or conditions of the share change; or

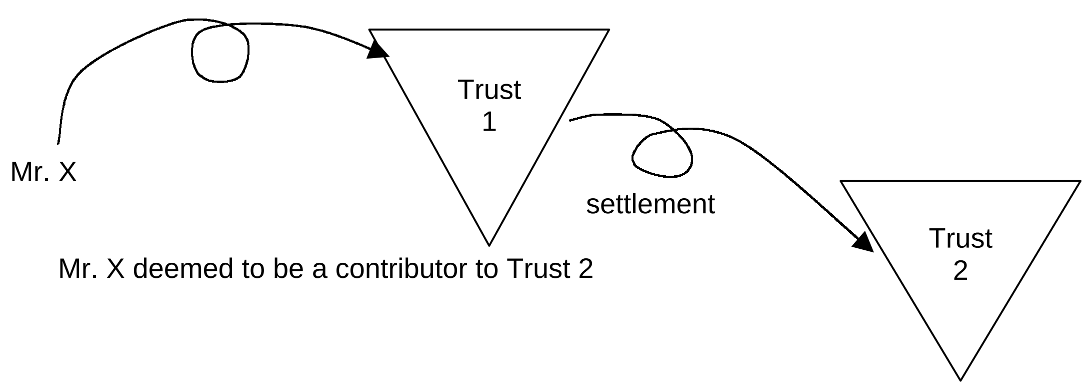
b) the taxpayer received or became entitled to receive shares of the corporation.

This rule seems to be for the purposes of reinforcing paragraphs 94(2)(k) and (l), and possibly paragraph 94(2)(c).

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

This rule is similar to the rule in old subsection 94(1).[68] It applies where a particular trust makes a *contribution* to another trust. It deems 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 new section 94 as the first trust. See ***Figure 11***.

Figure 11



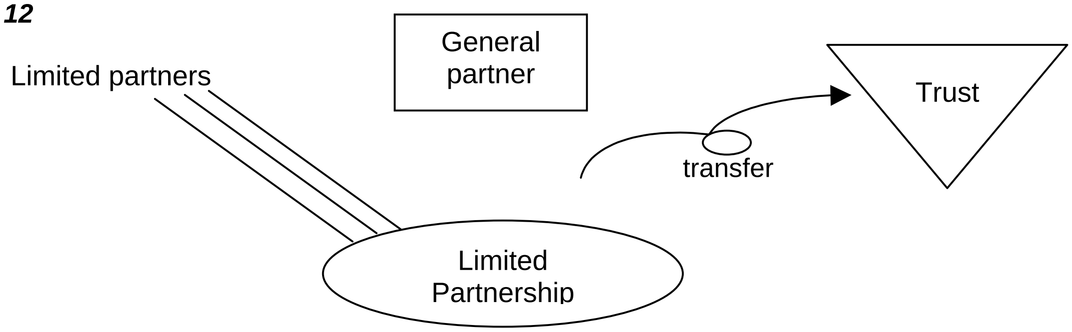
New Paragraph 94(2)(o) – Partnership to Trust Contribution

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

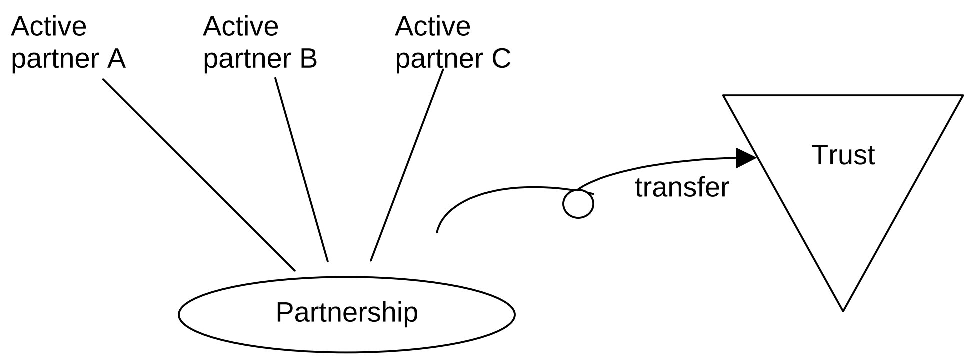
[68] See old clause 94(1)(b)(i)(B).

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 by the partnership itself, but not by the limited partners. See ***Figure 12***.

Figure 12



Only General Partner is deemed to have made a contribution jointly with Limited Partnership.



Partners A, B, C deemed to have made contributions jointly with Partnership.

New Paragraph 94(2)(q) – Treasury Interest of Trust

This paragraph applies where an entity acquires a treasury interest in a trust from another entity and deems that a contribution has been made by the entity acquiring the treasury interest to the trust. The amount of contribution is equal to the fair market value of the treasury interest at the time of acquisition. If not for this, Canadian residents would be precluded from subscribing to foreign mutual fund trusts as one Canadian subscriber could deem the trust to be Canadian resident.

New Paragraph 94(2)(r), (s), (t), (u)

Under new paragraph 94(2)(r), (s), (t) and (u), certain transfers are deemed not to be contributions to a trust, where a number of arm's length conditions are met.

Paragraph 94(2)(u) relieves the joint and several liability for a Canadian settlor who is unrelated to the beneficiaries and contributed under $500 and 1% of the total contributions. Other conditions also apply.

Joint and Several Liability

Under new 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 each entity shall be subject to the provisions of Part XV in respect of those rights and obligations. These rules deal with payment of taxes, interest, penalties, and enforcement. The joint and several liability 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.

For Canadian resident beneficiaries, the liability is limited to distributions received.[69] For Canadian resident contributors, there is no limit to the liability unless certain rules are met (which is unlikely).

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 dealing with vicarious liability 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.

Concluding Comments on New Subsection 94(2)

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

The rules in new subsection 94(2) can perhaps be applied sequentially, meaning several of the rules can apply to a transaction or an arrangement.

[69] New subsection 94(7), 94(8) and 94(9).

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

These deeming rules do not preclude the application of other rules in the Income Tax Act or general principles. For example, the fact that a particular form of transfer is not listed in new subsection 94(2) does not mean that it is not a transfer.

In most cases, the rules apply to transactions at any time (even if carried out many years ago).[70] Therefore all existing situations must be analyzed in accordance with these new rules. Certainly some unusual and unintended results will arise along the way, with unhappy and surprised taxpayers and professional advisors.

E. DETAILED MECHANICS OF SUBSECTION 94(3)

New subsection 94(3) is the main charging section of new section 94 in that it outlines the manner in which the trust is taxed. It must be read in conjunction with new subsection 94(4), which lists a number of provisions to which new paragraph 94(3)(a) does not apply. Under paragraph 94(3)(a), the trust is deemed to be resident in Canada throughout the year for purposes of an extensive list of items. Unlike old section 94, the trust is not in general a resident of Canada,[71] but is only resident for the purposes specifically.

The trust is considered Canadian resident first and foremost for purposes of computing its income.[72] It is also resident for purposes of the foreign reporting rules 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 important 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. Unlike the old rules, a section 94 deemed resident trust will now have to apply for a clearance certificate where it sells taxable Canadian property (other than property that is exempted).[73] 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.

[70] New paragraph 94(2)(f) and subparagraph 94(2)(g)(vi) are exceptions.
[71] Under old section 94, the trust was deemed resident for Part I of the Income Tax Act.
[72] New subparagraph 94(3)(a)(ii).
[73] Public company shares are exempted, for example. See subsection 116(6).

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, as to how the tax liability of the trust is to be calculated. One would assume that it is calculated in the normal manner applicable to Canadian resident trusts. 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 (created after June 18, 1971), 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 upon election).

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 under subsection 120(1), so the additional federal tax will be applicable (now 48% of tax otherwise payable). The trust will of course pay tax in a province if it earns business income there.

Withholding Tax

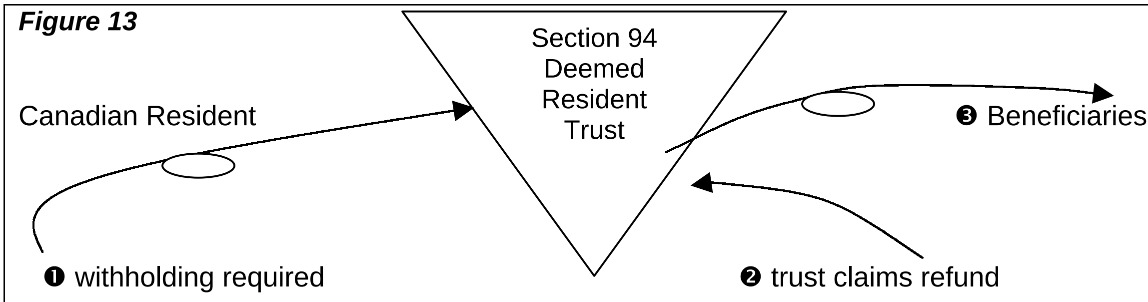
The trust is considered a resident of Canada for purposes of determining the liability of the trust for tax under Part XIII on amounts paid or credited to the trust.[74] This means that payments from Canadian residents to the trust will not be subject, ultimately, to non-resident withholding tax because the trust is considered resident. The trust is resident only for purposes of determining the liability for Part XIII tax on amounts paid or credited to the trust, but not 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 new paragraph 94(4)(b). This states perhaps surprisingly that new 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. New 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

[74] New subparagraph 94(3)(a)(v).

must consider the trust to be a non-resident. The payment is therefore subject to non-resident withholding tax, even though the trust is not itself liable for this tax. 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. See ***Figure 13*** for the overall withholding scheme.

Figure 13



❶ withholding is required at non-treaty rates, even though trust is not liable for withholding tax.
❷ trust claims refund of withholding tax by filing a tax return.
❸ no withholding on distributions to beneficiaries, but deduction to the trust may be restricted (see discussion later)

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.

Special Rules For Foreign Tax Credit

New 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 claiming a foreign tax credit. These are very technical and have certain limitations. Care must be taken if the trust pays foreign (i.e., non-Canadian) income tax. If the foreign income is from interest or dividends, the foreign tax credit will be limited to 15%. The excess may be taken as a deduction.

If the trust so elects, then all non-business income may be sourced to the country where the trust is factually resident.[75]

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

Subsection 128.1(1) applies to deem a year-end of the trust to occur and to give a step-up in cost base of property, where a non-resident trust becomes resident in Canada. New paragraph 94(3)(c) states that where a trust was non-resident throughout the preceding

[75] This may be useful because otherwise the foreign tax credit must be calculated on a country-by-country sourcing basis.

taxation year and is then deemed resident under new subsection 94(3), 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.[76]

This is a very significant transitional rule, but will require a careful analysis as to whether the trust was a deemed section 94 trust in a previous year (under old section 94 if before 2003).

New Subsection 94(5) – Ceasing to be Deemed Resident

The special rule in new subsection 94(5) applies to deem the trust to have ceased to be resident in Canada at any time where there is neither a *resident contributor* nor a *resident beneficiary.* [77]

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, 2003.

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, 2003. Accordingly, the conditions of new subsection 94(5) would be met. The trust is deemed to cease to be resident in Canada at that time. As such, it is deemed to have disposed of all its assets immediately before that time. This will precipitate any accrued gains that are on hand.

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 ago. It is quite possible that he has had very little contact with the trust since 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, solely due to John's death. It is debatable as to whether or not income created as a result of the deemed disposition of

[76] See paragraph 128.1(1)(b). Note that the step-up in cost base does not apply to taxable Canadian property.
[77] 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 to have a taxation year immediately prior to ceasing to be resident, with all of the ensuring consequences of subsection 128.1(4).

assets within the trust can be paid out to beneficiaries, so as to not subject such income to tax in the trust. 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.[78]

Note, however, that new subsection 94(5) does not apply if the non-resident trust becomes Canadian resident. It can also be avoided by distributing the trust property to beneficiaries so that at the time the deemed sale occurs, the trust has no assets on hand.

Because of the deemed disposition problems with non-resident trusts, that would not result from Canadian resident trusts, care must be taken before deciding to use a non-resident trust for Canadian estate planning purposes. The trust will require on-going monitoring. It may be sensible to wind up the trust by distributing the trust property to beneficiaries before the death of the last Canadian resident contributor.

21-Year Rule

A Canadian resident trust is deemed to have disposed of and reacquired all capital property every 21 years. This prevents trusts from obtaining an indefinite deferral of capital gains. This rule has always applied to a section 94 deemed resident trust. Now the rule also applies where the trust ceases to have a resident contributor from whom recovery under the joint and several liability rule is limited.[79]

This rule supplements the rule in new subsection 94(5). Note that even if there remains a *resident beneficiary*, the 21-year rule provision can still apply because it is triggered if there is no *resident contributor*.

Changes to Foreign Reporting Rules

All tax practitioners will readily agree that very few things in the income tax ever get simplified. When they do get simplified, it is either noteworthy or cause for alarm. The scoop now is that the foreign reporting rules of section 233.2 have been substantially simplified.

In new 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 new section 94.

[78] 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?
[79] New paragraph 104(4)(a.5).

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 new subsections 94(1) and (2) to new 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 new section 94.

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 non-resident trust at any time in a taxation year or a preceding year (other than an *exempt foreign trust*, with certain modifications).

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

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 old rule.

There is an interesting addition to the foreign reporting rules, contained in new subsection 233.2(4.1). This deals with so-called similar arrangements, and is designed to require the reporting of arrangements that may not be trusts, but which are similar to trusts. For example, these rules could apply to foundations set up in civil law jurisdictions such as Liechtenstein, Switzerland or the Netherlands-Antilles and to hybrid companies.

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.[80] 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

[80] Paragraph 104(6)(b).

21-year deemed disposition rule.[81] Note that this rule has now been extended to specifically address non-resident trusts.[82]

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 36% tax under Part XII.2 where these distributions are made to a non-resident.[83] However, this tax does not apply to a non-resident trust.[84] Since a trust that is deemed resident under new subsection 94(3) is not resident for most purposes 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 subject to this tax. Accordingly, without a limitation, 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, and 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. It 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 if it were to be distributed to a non-resident beneficiary.

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 new subsection 94(3) to be resident in Canada, where the trust had certain Canadian source income. This limitation is placed in new 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 a certain fraction of amounts which would, under general principles, be subject to Part XIII tax upon being paid by a Canadian resident 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

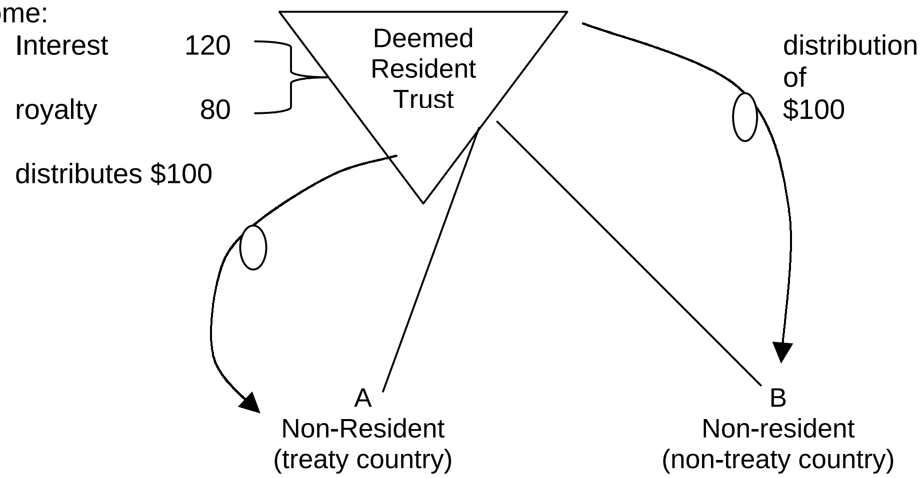
81 See clause 104(6)(b)(i)(C).
82 New paragraph 104(4)(a.5).
83 Section 210.2.
84 Paragraph 210.1(e).

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. It is 65%, if the beneficiary is in a treaty country, and 40% otherwise. For an example, see ***Figure 14***.

Figure 14

Example of Limitation on Distributions to Non-Residents
Canadian income:



	A		B
Income	100		100
Deduction (65%)	(65)	40%	(40)
Amount taxable	35		60
Effective tax rate	15%		26%

*assumed 43% tax rate on income

Note that these rates approximate the normal withholding tax rates – typically 15% for treaty residents and 25% for non-treaty residents.

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, new paragraph 75(3)(c.2) is being added which states that attribution of income to a Canadian resident contributor to the trust will not be applicable to a non-resident trust funded by an individual who has not been resident in Canada 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.[85]

This rule applies for 2001, rather than 2003.[86]

F. IMPACT ON COMMON STRUCTURES

So far, this paper has discussed the history of the legislation in the non-resident trust area, the policy intent behind the legislation, and the mechanics of the old and new 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.

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[87].

[85] Subsection 107(2.1) will apply, which may preclude a tax-free rollout to a beneficiary.
[86] See subsection 6(4) of the enabling legislation.
[87] Subsections 227(5) and 227(5.1).

Commonly Used Structures

There is no universally 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 as indicated. 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

† less than 60 months in all

‡ more than 60 months

a) Pure Inbound Trust

Description:

In its simplest form, the Pure Inbound Trust 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 may include Canadian residents.

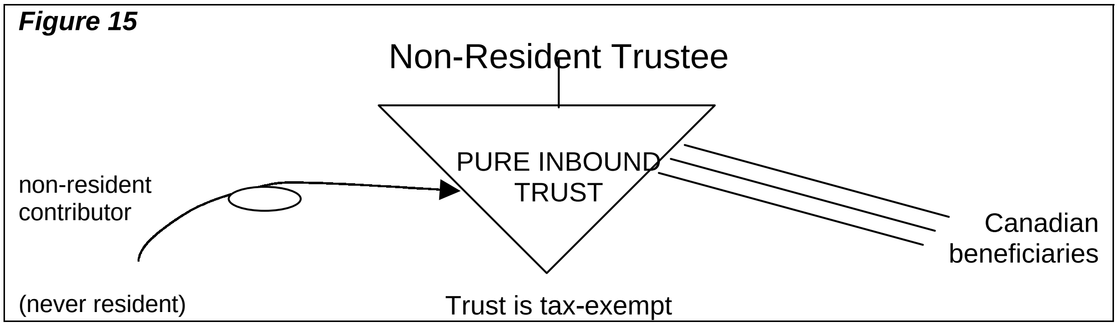
Non-residents of Canada may structure Pure Inbound Trust arrangements for the benefit of Canadian residents, where income can be earned in a tax-free jurisdiction, and distributed as tax-free capital to Canadian residents. These capital distributions will not be subject to Canadian tax, although the receipt of such distributions must be reported on foreign reporting forms by the beneficiary.

These types of trusts may be created either inter vivos or by will. Since it is difficult and cumbersome to create a non-resident trust by will, often these trusts are created inter vivos with a nominal contribution of capital, and then designated as beneficiaries under the will. This simplifies the administration of the estate, by creating an inter vivos trust which is funded on death.

There is some controversy as to whether a distribution from a trust is income or capital, particularly where the distribution is traceable to the current year's income. Consequently, we advise that distributions of the current year's income should be deferred until immediately after the end of the year, for greater certainty. It is also useful if the trust document specifically allows for the trustee to determine whether a distribution is income or capital, and this should be appropriately documented in the financial statements of the trust.

This type of trust can be used for non-residents who wish to invest in Canadian real estate. Since trusts are not subject to capital tax, this can be advantageous. See ***Figure 15.***

Figure 15



Old Rules:

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

Because of the extended transfer rules (new subsection 94(2)) and the greatly expanded definition of contribution, great care must be taken to make sure that no property of the trust was derived from a Canadian resident. If the trust subscribes to shares of a Canadian corporation, for example, this could cause the trust be deemed resident. The share issuance will be a transfer from the Canadian corporation (a Canadian resident).

Tax Planning Implications:

The trust is considered a non-resident for purposes of old section 94, and also for purposes of new section 94. As a result, it is treated as a non-resident under both systems, and the tax planning is the same as that applicable to non-residents.

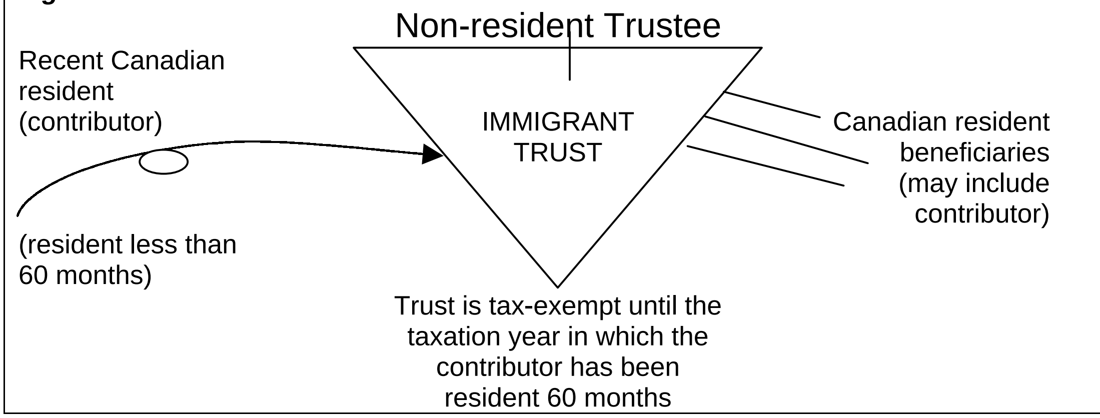
b) Immigrant Trust

Description:

The so-called Immigrant Trust is a trust created by a person who has immigrated to Canada, and who has not previously been 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. The trust 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 the immigrant, and 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. See ***Figure 16***.

Figure 16



Old Rules:

Under old rules, the Immigrant Trust is exempt until the taxation year in which the immigrant has been a resident of Canada for more than 60 months. After this, the conditions of old 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 non-arm's length with the contributor to be beneficiaries of the trust, if the trust document contains the power to add beneficiaries.[88]

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 old subsection 94(1). Old paragraph 94(1)(b) looks to the person from whom the trust has <u>acquired property, directly or indirectly in any manner whatsoever</u>. Any sequence of transactions that commences with property owned by the immigrant, and ends with property finding its way into an Immigrant Trust, through one or more non-residents, may constitute an indirect transfer of property. However, this is not totally clear or free from doubt.

New Rules:

Under new 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

[88] Definition of Beneficially Interested in subsection 248(25).

establishing such a trust. However, the anti-avoidance rules need to be considered carefully if any property which finds its way into the trust originated with a long-term Canadian resident.

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. Because of this, the immigrant who transferred property to the trust may also now be a beneficiary of the trust.

Tax Planning Implications:

This planning is applicable to new immigrants during their first 60 months of residency.

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

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 2002. Accordingly, structures which attempt to extend the 60-month period by deleting Canadian resident beneficiaries (i.e., converting the Immigrant Trust to an Outbound Trust discussed below) while effective in the past, will not be effective in the future.

As the Technical Notes point out,[89] 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.[90]

If the trust was exempt of tax before 2003 and became taxable under the new rules, it will obtain a step-up in the cost base of its assets as of January 1, 2003, to fair market value.

CCRA at one point attempted to apply transfer pricing legislation to immigrant trusts. If the trust was funded through an interest-free loan (a common structure), then interest could be imputed on the loan under transfer pricing legislation. However, it was determined in a private communication between the Department of Finance (who is responsible for drafting income tax legislation) and CCRA (who is responsible for its administration) that transfer pricing legislation should not be applied in such

[89] See Technical Notes under Commentary of New subsection 94(3).
[90] Care must be taken to ensure subsection 56(4.1) under which income will be attributed to the contributor where a trust is funded with a low interest rate or interest-free loan or indebtedness, is not applicable.

circumstances. While there is still the theoretical possibility of such legislation being applicable, the issue is highly unlikely to arise. However, nothing authoritative is available in the public domain concerning this issue.

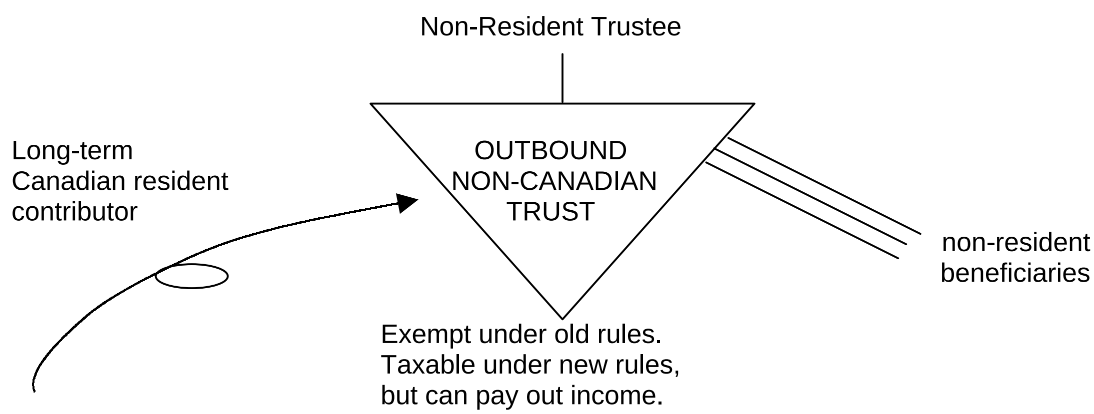
c) Outbound Non-Canadian Trust

Description:

An Outbound Trust is a trust created by a long-term resident. The Outbound Non-Canadian Trust is one created solely 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 at the end of its five-year period.

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 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 may be 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. See ***Figure 17***.

Figure 17



Old Rules:

Under the old rules, the Outbound Non-Canadian Trust is not subject to tax under old subsection 94(1). Although it is established by a long term Canadian resident, it does not have Canadian resident beneficiaries.[91] Accordingly, the requirement of old paragraph 94(1)(a) was not met, which is a prerequisite for old subsection 94(1) to apply.

New Rules:

Under new 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.

Tax Planning Implications:

Where a trust not previously subject to section 94 becomes taxable under new 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, 2003).[92]

ii) There will be limitations on deductions for distributions to non-resident beneficiaries (see discussion above).[93]

iii) Upon there being no *resident contributor*, the trust will be deemed to have sold its assets at fair market value, resulting in accrued gains being recognized.[94]

iv) The trust will be taxed as a non-resident up to December 31, 2002.

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 old section 94 and is resident in a treaty jurisdiction, then any capital gain that it realizes may be exempt of Canadian tax[95]. Therefore, a

[91] Technically, it could not have as beneficiaries a person resident in Canada, a corporation or trust with which a non-resident of Canada was not dealing at arm's length, or a controlled foreign affiliate of a person resident in Canada.
[92] Paragraph 94(3)(c).
[93] Subsection 104(7.01).
[94] Paragraph 104(4)(a.5) and subsection 94(5).
[95] 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

step-up in the 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.[96] 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.[97]

iv) Careful consideration must be given to whether the trust should be wound-up prior to December 31, 2003, 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.[98]

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 new 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.

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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 if it is not a section 94 deemed resident trust.

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

[97] 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.

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

Unfortunately, a great number of persons will not be satisfied by this potential solution, for any one or more 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 the beneficiaries on receiving income distributions. For example, in the U.S., the distributions might, in addition to 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 of the U.S. 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. A pattern 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 tax of the trust if appropriate planning does not somehow mitigate the tax, 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. It is debatable whether a trustee has a duty to the settlor (contributor). The trustee could be in breach of trust by paying a liability of the trust which is not enforceable. 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 received by a non-resident beneficiary back to the Canadian resident who made the loan. Thus, the Canadian tax may not be mitigated so easily.

Canadians wishing to establish non-resident trusts for non-resident beneficiaries will find that these trusts are now taxable under the new rules. Consequently, in order to manage the Canadian tax liability of the trust, the income must be paid out to the beneficiaries on an annual basis. Depending on the circumstances, this may nevertheless be a feasible strategy if the foreign jurisdiction does not tax this income.

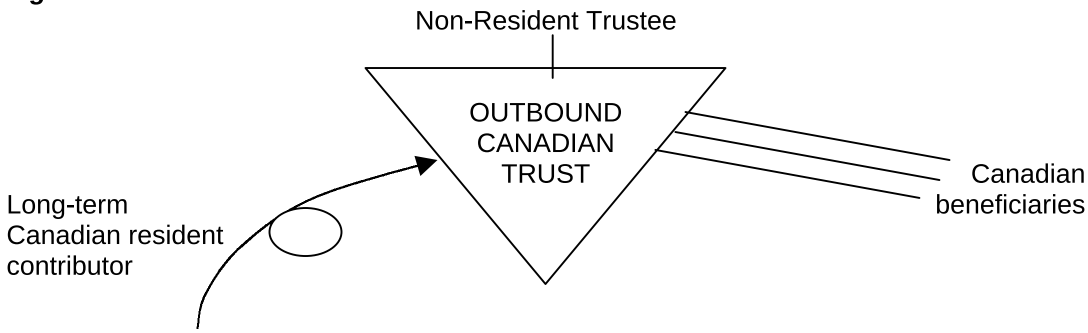
d) Outbound Canadian Trust

Description:

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 purported not to be caught under old subsection 94(1) for a variety of reasons. See ***Figure 18***.

Figure 18



Old Rules:

Under old subsection 94(1), many of these kinds of arrangements are at the borderline of being taxable. Some structures may avoid having acquired property directly or indirectly from a Canadian resident. Other structures relied on the fact that the person transferring property to the trust is not related to the beneficiaries who are resident in Canada. These arrangements will have to be examined closely, on a case-by-case basis.

New Rules:

Under new 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 new rules (especially new subsection 94(2) which extends the circumstances under which a transfer can occur). Trusts not subject to old section 94, will be taxable under new subsection 94(3).

Tax Planning Implications:

The transitional planning will be similar to those discussed above for Outbound Non-Canadian Trust, if the trust was not deemed resident under the old rules.

If the trust also has non-resident beneficiaries, then consideration could be given to distributing income to the non-resident beneficiaries (see discussion above). Any income retained in the trust or distributed to Canadian resident beneficiaries will be subject to Canadian tax.

If the trust is deemed resident in Canada under the old and new 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.[99]

ii) There will be limitations on deductions for distributions to non-resident beneficiaries.[100]

iii) Upon there being no *resident contributor*, the trust will be deemed to have sold its assets at fair market value, resulting in accrued gains being recognized.[101]

Taking these matters into account, the impact of the new 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 new 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 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, consideration should be given to winding up the trust arrangement.[102]

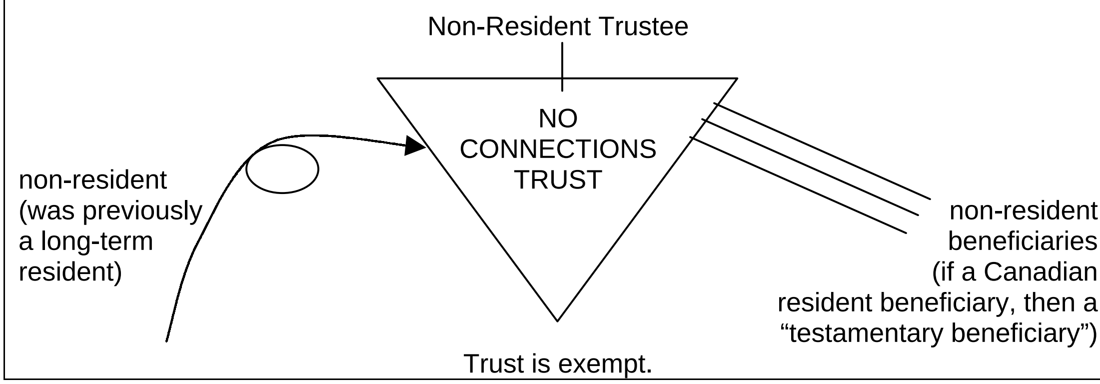
e) No Connections Trust

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. See ***Figure 19***.

[99] The trust will not become resident on transition because it will be deemed resident throughout.
[100] The limitations under new 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 limited deduction is permitted. For more details, see discussion under Distributions to Beneficiaries.
[101] New subsection 94(5) or new paragraph 104(4)(a.5) provides that a trust is deemed to have ceased to be resident in Canada.
[102] 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.

Figure 19



Old Rules:

Under old rules, this structure would not be taxable whether created before or after leaving. The reason is that the trust would not have Canadian resident beneficiaries, and accordingly would not meet the test of old 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 new 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.*[103]

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.

Tax Planning Implications:

[103] A power to add beneficiaries may however lead to a deeming of having Canadian resident beneficiaries which could make the trust taxable.

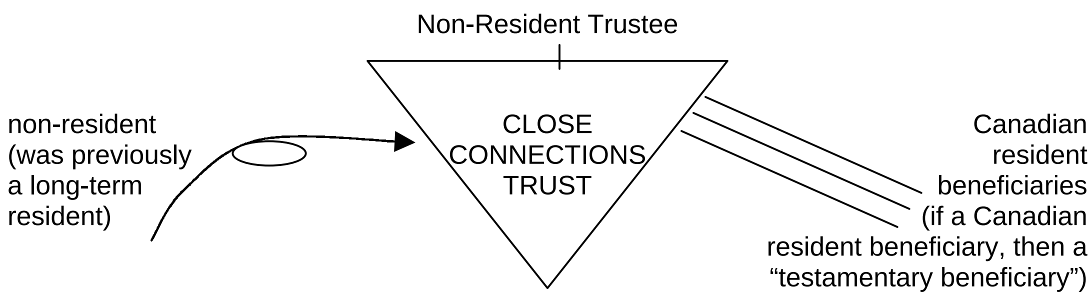
This planning is still applicable for departing Canadian residents who do not wish to include Canadian resident persons among the beneficiaries. The trust will become taxable if these persons return to Canada, commencing January 1 of the calendar year in which they return.

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. See ***Figure 20***.

Figure 20



Trust is taxable if created within 60 months of leaving Canada (18 months on death or before June 22, 2000)

Old Rules:

Under the old 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. There is some ambiguity as to what exactly constitutes the 18-month period.[104]

Some persons have expressed the view that a trust, created by a person within 18 months of becoming a non-resident that has Canadian beneficiaries, will be resident for this 18-month period. After that, it will cease to be resident. We do not agree with

[104] This rule is somewhat ambiguous. The ambiguity rests in old sub clause 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 before the end of that year”. The most conservative view is that a non-resident trust established by a former Canadian resident will not be deemed resident under old 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 view. If such a trust is created by a Canadian within 18 months of departure that has Canadian resident beneficiaries, our view is that the trust remains resident on an ongoing basis.

New Rules:

The new rules under section 94 contain very limited grandfathering. However, this is one such circumstance. For trusts established prior to June 23, 2000 or on death, the 18-month period is retained. Accordingly, the analysis is very similar to that under old subsection 94(1). For *contributions* made after June 22, 2000, a 60-month time window applies.

The trust would be considered to have a *resident beneficiary* if it had a beneficiary resident in Canada and a *connected contributor*. A *connected contributor* is a non-resident person who makes a *contribution* of property to the trust within 60 months of being Canadian resident.

Once deemed resident, the trust remains resident on an ongoing basis unless it no longer has a Canadian resident beneficiary.

Tax Planning Implications:

It may be possible for a long term Canadian resident who leaves Canada to bypass the 60-month period for the 18-month period in the event of death, by using an inter vivos trust as part of the structure. If another non-resident contributed a nominal amount to a non-resident trust for the benefit of Canadian resident beneficiaries, and on death the Canadian, now a non-resident for over 18 months, designated the trust as a beneficiary under his or her will, then arguably the 18-month waiting period would apply rather than the 60-month period.

The introduction of the *testamentary beneficiary* concept may prove useful in certain situations. If Canadian resident persons are testamentary beneficiaries, with their interest contingent upon the death of the contributor or a person related to the contributor, then the trust does not have a *resident beneficiary*. As a result, the trust will not be deemed resident under new subsection 94(3). Note that a Canadian who dies will not be a *resident contributor* thereafter. Therefore, if that person creates a non-resident trust by will, with only Canadian resident beneficiaries who are all *testamentary beneficiaries*, the trust will not be taxable.

Summary

It is extremely interesting to note the similarities between old subsection 94(1) and new subsection 94(3) as to how the rules apply to the various structures. The table below summarizes this.

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 No reversion rule after 2000
Outbound Non-Canadian Trust	Not taxable	Taxable but can distribute income to non-residents with some restrictions to avoid Canadian tax
Outbound Canadian Trust	Taxable in theory but possible to circumvent	Taxable with more extensive anti avoidance rules, very hard to circumvent
No Connections Trust	Not taxable	Not taxable
Close Connections Trust	Not taxable, (provided set up outside of 18-month period.)	Not taxable, provided set up outside 60-month period (18 months if set up prior to June 23, 2000 or on death)

The only structures that are fundamentally impacted by the new rules are the Outbound Trust structures and the Close Connections Trust.

The Outbound Non-Canadian Trust is severely impacted by the new rules, with harsh consequences.

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

The new anti-avoidance rules serve to limit ways to work around the rules, as were available in the past. These will apply most commonly to the Outbound Canadian Trust.

It should be noted that if the proposal to tax trust distributions had gone forward, then all 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 block tax avoidance.

Given that so few structures are actually impacted by the new rules, one has to question whether it was in fact necessary to completely rewrite section 94 or whether some fine-tuning would have sufficed. Also, the rules apply where they should not; that is 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 real abuses and in this way the policy intent is misguided.

Treaties

Some persons have suggested that international tax treaties may in certain cases be capable of overriding new section 94, and can also override old 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 new section 94, and the Supreme Court's decision in *Crown Forest* is cited as authority for this.[105]

Crown Forest held that in order for an entity to be a taxable resident under an international tax treaty, it should be taxable in the country in question in the most comprehensive way. New section 94 does subject a non-resident trust to Canadian taxation in a more comprehensive way than its predecessor. Arguably, prior to these amendments, old section 94 did not subject a non-resident trust to fully comprehensive taxation. As a result, the *Crown Forest* case can in our view 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 purposes of applying an international tax treaty. Under the new 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 a non-resident trust, 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 relevant issue in the future. The States in the U.S. do not generally follow tax treaties, so there is precedent for this.

It may also be necessary to consider whether Canada would apply the general anti-avoidance rule to negate a claim for treaty relief. While CCRA believes this has merit, many tax practitioners are not convinced. They believe that a provision of domestic tax law cannot be used to override an international treaty obligation. This has never been tested.

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

G. RECOMMENDATIONS FOR FURTHER AMENDMENTS

In our original paper submitted for the 2000 Canadian Tax Foundation conference, we listed various suggestions for changes to the draft legislation. Many of these have been acted upon. It is likely that the remaining suggestions will not be accepted. Our concerns 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

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. However, 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. 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 evenhandedness. One may even see a challenge under the Charter of Rights and Freedoms.

The deemed disposition rule in new subsection 94(5) 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 non-residents, 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 which 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 may 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, U.S. assets and U.S. beneficiaries is a Canadian resident just because Canada says so. One wonders if the Department of Finance is setting up the CCRA for a fight they will not win. What then?

We, therefore, still advocate that a category of exempt trust be created where the trust has only non-resident beneficiaries and no ability to add beneficiaries. Further, the trust must register with CCRA and will be taxable from inception if a Canadian resident receives a benefit. Other additional safeguards can also be devised. There is virtually no chance that this proposal will be accepted.

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 proposed 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, 2002 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, 2003).

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

There is also a case to be made for grandfathering certain transfers that were done before the rules were announced.

Technical Changes

The circumstances under which a non-resident trust may be exempted of new 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 rules do not provide for any exemption for Canadian private companies, which is wrong.

There is an argument that some of the extended transfer rules of new subsection 94(2) should be grandfathered. This has also been rejected.

The explanatory notes indicate that one way to mitigate the Canadian tax levied on a non-resident trust which is deemed under new 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 or indebtedness, which is quite common, the income will attribute to the Canadian resident lender. Thus, this plan, which is even contemplated and stated in the Technical Notes to the amendments issued by the government, will not work in such cases. 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".[106] 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 new subsection 94(3) does not apply. This would make the rule consistent with the amendment contemplated in subsection 75(3) for the immigrant trust.

H. 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 new 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 old section 94.

[106] Section 120.4.

The remaining deficiencies in the new legislation will not be difficult to correct if one starts with the basic proposition that Canadian 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 and several liability issue and the other problematic aspects of the new rules. If one starts from a perspective that Canadians using offshore trusts are dishonest, then these new rules will have no impact in any event. One should then assume that people will simply hide their wealth and hope it is never discovered.