Canadian Perspectives

A limited circulation newsletter keeping you informed on Canadian issues

Offshore Trusts, Which Jurisdiction?

by Thomas Lee LL.M, FHKSA

Offshore trusts remain the best tax planning tool for immigrants to Canada. By using them properly, tax can be avoided (legally) for a period of up to five years from the date of arrival. In some cases, this period can be extended.

The trustees manage the affairs of the trust and have a responsibility to the beneficiaries (the people who will ultimately receive the trust's property). We normally recommend that a professional trustee be used, such as a bank or trust company. These entities are typically located in tax haven jurisdictions.

One question which often arises is which jurisdiction is best?

In the rare case where an immigrant trust needs the benefit of an international tax treaty with Canada, the choice of jurisdiction becomes quite limited. Normally this will confine the selection to one of Singapore, New Zealand or Barbados. Otherwise, for Canadian tax purposes, any tax haven jurisdiction will be suitable. No particular jurisdiction is best, or even preferred over another

If you anticipate having extensive contact with the trustees (suppose for example, they are managing a stock portfolio on your behalf) you may wish to visit them once or twice a year. You should then select a location which is convenient to you. Also, you may want the location

continued on page 2

Foreign Reporting Modified, But Will Proceed

by Michael Cadesky, FCA, TEP

In 1996, Canada proposed a system for reporting foreign assets. This system was broken down into four basic categories, being:

- Personal holdings of foreign assets costing over $100,000 in total
- Shares of foreign affiliates where you and related people have at least a 10% shareholding
- Transfers to foreign trusts that have Canadian beneficiaries
- Distributions from foreign trusts to Canadian residents

The rules were passed into law in April, 1997, applicable to 1996 and 1997. However, immediately after this, the first category of foreign reporting, being personal holdings, was postponed pending further study. The Auditor General was requested to review the suggested methodology of having individuals report ownership of foreign assets. His report this June concluded that the methodology was appropriate, and was the best way to enforce Canada's tax system in the foreign area.

Revenue Canada has now responded with how they intend to proceed with the personal holdings category of foreign reporting.

The forms are to be simplified, and now it will no longer be necessary to give specific details of foreign assets. Instead, there are to be a series of "yes" and "no" questions concerning an individual's foreign assets, which will obviously be designed to determine the existence of these assets and possible sources of income that may result from them.

We will have to wait to see the final version of the form, but it is likely that it will be quite easy to complete.

This new approach represents a reasonable compromise between giving the government the information they need to enforce Canada's tax laws, and maintaining confidentiality.

For more details on the foreign reporting rules, see the article "Foreign Reporting Rules/Myths and Realities", later in this newsletter.

The reporting will apply to 1998, with the forms being due April 30, 1999 for most Canadian resident individuals. The extremely harsh penalties for non-compliance remain in effect.

What's Inside

Foreign Reporting rules
some myths and realities

by Grace Chow,C.A., TEP

Canada's new foreign reporting rules have been extremely controversial, and highly criticized. However, aside from the compliance burden that they represent, there is really no need to be overly concerned. This short article is designed to clear up some of the myths and misconceptions surrounding the rules.

Myth: Canada's new foreign reporting rules will now require foreign income to be reported.

Reality: The Canadian tax system has always required that foreign income be reported.

Myth: Completing the foreign reporting forms will lead to an audit.

Reality: Compliance with the law, and completion of the foreign reporting forms, will not necessarily lead to an audit. If your tax affairs are in order, then any questions raised by the Revenue authorities should be easy to deal with.

Myth: Shares in foreign companies need to be reported only if they cost over $100,000.

Reality: If the shareholdings in the foreign company represent 10% or more of any class of shares, then foreign reporting applies from 1996. The cost of the shares is not relevant for this purpose.

Myth: Foreign reporting is the first step to taxing Canadians based on their citizenship, like the U.S.

Reality: The U.S. tax system is fundamentally different to the Canadian tax system. To pay tax based on citizenship would require a complete overhaul of Canada's tax system, which is not likely to occur.

Myth: Offshore trusts cannot be set up now, due to the foreign reporting.

Reality: Offshore trusts are still the best tax planning method for immigrants to Canada, and the foreign reporting rules have no impact at all on tax planning with foreign trusts.

Revenue Canada has strong concerns that there are serious non-compliance problems in the foreign area.

These do not just relate to immigrants; on the contrary, by far the greater concern is Canadians who have taken money offshore in arrangements of questionable validity.

Offshore Trusts, which Jurisdiction?

by Thomas Lee LL.M, FHKSA

CONTINUED FROM PAGE 1

to be within the same time zone as the place where you live.

Some financial institutions can offer a wide choice of jurisdictions (typically Jersey, Guernsey, Bermuda, Bahamas, British Virgin Islands, Cayman Islands and more). However, other equally qualified financial institutions may have operations only in one or two tax haven locations, so the choice may be made for you.

Far more important than the jurisdiction itself are the characteristics of the financial institution that you select: reputation, experience in managing international trusts, compatibility. Also, we normally find it advantageous if the institution has at least a general knowledge and understanding of the Canadian tax system.

Tax Tales
An actual case history

by Elaine Pui CGA, AHKSA

Some people believe that falling markets in Asian countries makes the need for tax planning obsolete. If you agree with this, then the story below will interest you.

Mr. Chow and his family (not his real name) moved to Canada in 1997 after working for 25 years for the Hong Kong Government. He now works in Toronto and receives a pension from Hong Kong. He also has a property in Hong Kong which he rents. His total income is about $120,000 per year and he pays about $45,000 annually in Canadian tax.

The Hong Kong property cost $800,000 H.K. in 1974, was worth $10 million H.K. when Mr. Chow came to Canada, and is now worth $4 million H.K. Mr. Chow believes that the property will go back up in value.

Mr. Chow's cost for Canadian purposes is $10 million H.K. (the value when he arrived). If he sets up an offshore trust now and transfers the property to it, he will realize a loss of $6 million H.K. which will be substantially tax deductible in Canada. This wipes out Mr. Chow's Canadian tax for nine years, for a savings of about $400,000. The offshore trust, meanwhile, will be exempt of tax until 2002, and can be used to shelter any increase in value from tax. This type of planning lets you have your cake and eat it too.

Offshore Trusts

Restructuring After Five Years

by Michael Cadesky, FCA, TEP

In previous issues of Canadian perspectives, we discussed the use of an offshore trust for immigrant tax planning. Generally, this trust has a usefulness of five years, and at the end of that period, a decision has to be made on whether to keep the trust, modify the trust, or liquidate it entirely.

In this article we will use an example of Mr. Lee who set up an offshore trust for his wife and three children.

An immigrant trust will be exempt of Canadian tax until the beginning of the year in which the person who has contributed property to the trust in the first place (usually the settlor) has been a resident of Canada for 60 months or more. For example, if the trust was established by Mr. Lee in April, 1994 who became resident in Canada at that time, the trust would become taxable effective for 1999 (i.e. January 1, 1999).

There are four types of plans that can be considered for an offshore trust at the end of the five year period. Each of these is discussed below.

If the original contributor of property to the trust (Mr. Lee in our example) becomes a non-resident of Canada before being resident for 60 months in his lifetime, then the trust can continue to be exempt of Canadian tax. Therefore, Mr. Lee must become a non-resident before March 31, 1999. If not, the trust is deemed to be Canadian resident effective January 1, 1999. However, it can become non-resident again if Mr. Lee later leaves Canada, after an 18 month waiting period.

Often it is not feasible for the settlor to become a non-resident. Perhaps Mr. Lee likes living in Canada and does not want to leave. So here is the second alternative. Suppose two of his children now live outside Canada. If the Canadian beneficiaries are deleted absolutely and permanently before January 1, 1999, then the trust will not become taxable by Canada.

A third alternative is to allow the trust to become taxable by Canada, but to ensure that it does not then retain any income. A trust can generally allocate income to a beneficiary, which makes the income taxable in the hands of the beneficiary and not in the trust. Therefore, suppose in the Lee Trust, the income is allocated to the non-resident children. The trust itself would then have no tax liability. If the beneficiaries are non-residents, then they would not normally be taxable by Canada on receiving this income if it is non-Canadian source.

CONTINUED ON PAGE 4

Customs Duty

by Grace Chow, C.A., TEP

If you are moving to Canada for the first time to make this country your permanent home, you can bring in your personal and household effects as settler's effects free of duties and taxes. However, you must have owned, possessed and used these goods before you arrived in Canada.

It is important that you meet all three requirements of ownership, possession, and use. For example, if you owned and possessed goods without using them, the goods are subject to duties.

Personal and household effects include such items as: antiques; appliances; boats; books; family heirlooms; furnishings; jewelry; linen; musical instruments; private aircraft; private collections of coins, stamps or art; silverware; vacation trailers, and cars.

Special standards apply to cars that are less than 15 years old. If your vehicle does not meet Canadian standards, you will have 45 days to bring the vehicle into compliance.

Because animals may harbour pests or diseases, special rules apply to the entry of animals and household pets.

Since Canada has stringent regulations on firearms, you should check first before bringing a firearm into Canada. There are also restrictions on endangered species (e.g., ivory).

Before you arrive, you have to prepare two copies of a list (preferably typewritten) of all the goods you intend to bring into Canada as settler's effects, showing the value, make, model, and serial number (when applicable). Divide the list into two sections: the goods you are bringing with you, and the goods to follow. You have to present this list to the customs office when you arrive in Canada, even if you are not bringing in any goods at that time. The customs officer will prepare Form B4, Personal Effects Accounting Document, on your behalf based on the list of goods you provide. You will need to present your copy of Form B4 to claim duty and tax-free entry of your "goods to follow" when they later arrive.

If you sell or give the goods away within the first year of importation, you immediately have to pay any duties that apply. The same applies to goods you begin using for commercial activities.

Canadian Residency
The Basic Rules

by Thomas Lee LL.M, FHKSA

One of the most fundamental and yet most confusing aspects of Canadian income tax is the concept of residency. It is fundamental, because a person's liability for Canadian income tax is dependent upon whether or not they are resident in Canada. It is confusing because there is no real definition of residency.

It has been held that everyone must be resident somewhere, and that a person can be a dual resident (i.e. resident in more than one place).

You will be considered a resident of Canada if you have sufficiently close ties to Canada to constitute residency. In this determination, the most important factor is where you live. Having a house or an apartment in Canada, whether owned or rented, is a very significant residential tie. Other significant residential ties are where your spouse and dependent children live, where personal possessions are located, where you spend the majority of your time, where you work or have a business, your club memberships, and any other aspects of your day to day life.

In some immigrant families, one spouse may live in Canada with the children, while the other spouse continues to live and work in the country of origin. Revenue Canada's position, in general, is that both spouses are residents of Canada in this situation. It is generally not thought to be possible in a normal marriage to have one spouse resident of Canada while the other is a non-resident of Canada and resides overseas.

Having said this, the February 1998 Federal budget may change this for some people. Where an individual is a resident of a foreign country with which Canada has an international tax treaty, and under the definition in that treaty, the individual is a resident of the foreign country, then the individual will not be considered a resident of Canada. In the past, such an individual could have been considered a dual resident.

Canada has over 50 international tax treaties, including one with China. At the present time, Canada does not have treaties with Hong Kong or Taiwan, so this new rule will be of no use to such residents unless and until treaties are negotiated and come into force.

Publisher

Lee, Cadesky & Company Ltd.
Mr. Michael Cadesky, Editor-in-Chief
Ms. Grace Chow, Editor
Mr. Thomas Lee, Editor

★ ★ ★

Cadesky and Associates
2225 Sheppard Avenue East,
Suite 903
Toronto, Ontario M2J 5C2
Tel: 416-498-9500
Fax: 416-498-9501

Moores Rowland
34/F The Lee Gardens
33 Hysan Avenue, Causeway Bay
Hong Kong
Tel: 852-2909-555
Fax: 852-2581-1289

Offshore Trusts
Restructuring After Five Years

by Michael Cadesky, FCA, TEP

CONTINUED FROM PAGE 3

A fourth alternative is to make the trust a resident of Canada. This has two main benefits. The first is that the act of making the trust a Canadian resident causes the trust to have a year end. If done immediately before the 60th month expiry date, the full 60 months exemption period can be obtained. For example, if the Lee Trust above were to become a Canadian resident on March 31, 1999, the income from January 1, 1999 to that date would be exempt of Canadian tax. Otherwise, this income would be taxable. The second advantage of this planning is that the assets of the trust are re-valued to fair market value (with the exception of certain Canadian assets). Suppose the Lee Trust had a U.S. stock portfolio which had appreciated in value during the five years of the trust's existence. If the trust became a resident of Canada, this appreciation would not be subject to Canadian tax.

In planning to restructure five year immigrant trusts, there are four main planning alternatives. Each is quite different from the others. The alternative which will work the best in any particular case will depend very much on the facts of that case.

Each situation deserves personal attention, in order to arrive at the best possible solution.

One last thought to keep in mind: It is often necessary to carry out the tax planning one year before the year in which the trust's exemption will end. Do not underestimate the time it will take to complete the restructuring process. Start early.