TAXATION OF NON-RESIDENT TRUSTS

How did we get here and where do we go from here?

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Taxation Of Non-Resident Trusts

- Bottom Line - international tax structures involving non-resident trusts seek to keep the non-resident trust outside the Canadian tax system in order to avoid Canadian taxation. To the extent that the non-resident jurisdiction does not tax the Trust's income, income taxes are avoided completely (even when paid to a Canadian resident). Why? Distributions of income from a non-resident (or resident) trust to Canadian resident beneficiaries fully taxable in hands of beneficiary (paragraph 104(13)(a)) **BUT** Distributions of capital from a non-resident (or resident) trust to Canadian resident beneficiaries tax free (paragraph 104(13)(a)).
Income earned by the Trust will not be distributed at year end but will be added to the capital account of the Trust.

The Trust will distribute proceeds to the Canadian resident beneficiaries from the capital account. Canadian resident beneficiaries will receive distributions tax free.
Starting Point
Time To Review Old Principles

- Do we even have a Trust? (Three Certainties, Trust vs. Agency, Sham Trust, Bare Trust)
  - See Antle v. The Queen
- Is the Trust Resident in Canada (Common Law)
  - See Garron v. The Queen
- Is the Trust Resident in Canada (Statutory)
Antle et al v. the Queen (Antle)

• In 1999, Mr. Antle and his business partner agreed to sell their shares in a Canadian corporation (“CanCo”) to a third party.
• Mr. Antle implemented a tax planning strategy to avoid paying Canadian income tax on the accumulated gain on the sale of his CanCo shares (“capital property step-up strategy”).
• Antle settled a qualifying spousal trust (for the benefit of his wife) by transferring the shares to a Barbados resident Trustee.

Antle - Summary

• Pursuant to paragraph 94(1)(c), the Antle Trust was deemed to be a Canadian resident, therefore the spousal rollover rules (subsection 73(1)) applied and no tax liability arose on the transfer.
• The Antle Trust then sold the property to the beneficiary wife (at “FMV”) in exchange for a promissory note, who in turn sold it to a third party for the same amount and used the proceeds to pay off the Promissory Note (the proceeds were distributed to the wife [as capital] and the Antle Trust was wound up).
Antle – Summary Cont’d

• Provided the “capital property step-up strategy” was successful, the capital gain arising to the Antle Trust would not be taxable in Barbados and the Antle Trust, being resident in Barbados would be exempt from Canadian income tax pursuant to Article XIV(4) of the Canada-Barbados Tax Treaty.

• The Minister of Revenue challenged the strategy on a number of grounds, issuing assessments against both Mr. Antle and the Antle Trust.

• The Minister of Revenue reassessed Mr. Antle to include in his income the taxable capital gain arising from the sale of the shares, arguing that the trust was not validly constituted or, if found to be validly constituted, was a sham, and that the requirements of subsection 73(1) of the Act were not met.

• In the alternative, the Minister took the position that the taxable capital gain should be included in the trust’s income, on the basis that it was a resident of Canada (as in Garron, the Minister relied on paragraph 94(1)(c).

• Lastly, the Minister invoked the GAAR in respect of the transactions.
Antle - Findings

• Justice Miller concluded that the trust never validly came into existence:
  – no “certainty of intention” (Mr. Antle never intended to settle a trust),
  – no “certainty of subject matter” (property was not in fact transferred).
• Justice Miller held that if his conclusion on the validity of the trust was incorrect:
  – the Antle Trust was not a sham;
  – if “deemed” resident pursuant to 94(1)(c), it would not be resident for treaty purposes (same conclusion as Garron); and
  – the transactions were subject to the GAAR (different conclusion than Garron).

Antle – Court of Appeal Findings

• The Court of Appeal dismissed the taxpayers’ Appeal and agreed with the Tax Court’s finding that the Trust was not validly constituted.
• Although not necessary to go beyond this conclusion, the FCA (in obiter) concluded that the intention of the parties was to deceive the CRA into thinking that the Trustee had discretion and control over the Trust property, when the reality was that no such discretion or control existed – thus the Trust was a “sham” and thereby “void”.
Common Law

- Common Law position was well established in that a trust deemed to be resident where the majority of the trustees are located (see *Thibodeau Family Trust v. The Queen*).

- The Common Law position has been changed to follow the corporate concept of “residence”. The SCC in *Garron (Fundy Settlement v. Canada, 2012 SCC 14)* held that the residence of a trust should be determined by reference to the “central management and control” of the trust.
Garron et al v. the Queen (Garron)

- Garron involved a standard “corporate freeze” following which international trusts (Barbados) indirectly owned the growth shares of the Canadian Business;
- Garron and his business partner, Dunin, both Canadian residents, owned and operated a Canadian company (“CanCo”). As part of a 1998 reorganization, Garron and Dunin each incorporated Canadian holding companies to own the new growth shares of CanCo (“HoldCos”);
- Two irrevocable, discretionary family trusts (for the benefit of the two principals and their respective families) were settled by a non-resident of Canada (the “Barbados Trusts”):

Garron - Summary

- Each of the Barbados Trusts subscribed for shares in the respective HoldCos;
- The Trustee of the Barbados Trusts was a corporate trustee resident in Barbados (there was no issue that the Trustee actually resided in Barbados);
- In 2000, the business was sold to a private equity fund, which purchased the shares of the HoldCos owned by the Barbados Trusts (resulting in a capital gain of approximately $450,000,000);
- The gains realized by the Barbados Trusts were not subject to income tax in Barbados;
Garron – Summary Cont’d

• Pursuant to the provisions of section 116 of the Act, the applicable non-resident withholding tax was remitted to the CRA;

• Subsequently, the Barbados Trusts then filed Canadian income tax returns requesting a refund of the tax withheld, on the basis that they were residents of Barbados and therefore exempt from Canadian income tax under the Canada–Barbados Tax Treaty:
  – Article XIV(4) of the Treaty provides that gains from the alienation of any property may only be taxed in the country of residence;

The Minister of National Revenue held that the Barbados Trusts were residents of Canada and the treaty exemption did not apply;

Although the Minister’s primary argument was that the “management and control” of the Trusts was in Canada, as a protective measure, the Minister also issued assessments:

- under the attribution rules of subsection 75(2) of the Act
- stating that the allocation of the sales proceeds was not reasonable and that a portion of the proceeds should be reallocated; and
- invoking the GAAR in support of all the assessments.
Garron - Findings

- The appellants, relying on *Thibodeau*, argued that the residence of a trust should be determined with reference to the residence of the trustee (which was not in dispute) and that the central management and control test (historically applied to determine the residence of corporations) was inapplicable to trusts.
- In the alternative, the appellants argued that the corporate trustee exercised management and control of the trusts.

Garron – Findings Cont’d

- Justice Woods concluded that the central management and control test was the appropriate test for determining the residence of the Barbados Trusts and further concluded that central management and control rested with the appellants (Garron and Dunin) in Canada.
- had the Trusts not been resident in Canada by reason of the central management and control test, section 94 would not be operative to deem the Trusts to be resident since there was no “acquisition” of property.
- had the Trusts been “deemed” resident pursuant to section 94, this deeming rule would not result in the Trusts being “resident” for treaty purposes;
- With respect to the GAAR, Justice Woods concluded that the transactions did not constitute an abuse or misuse of the treaty and the GAAR did not apply.
Garron – Court of Appeal Findings

- The Court of Appeal dismissed the taxpayers’ Appeal and basically adopted Justice Woods’ decision in its entirety.
- FCA rejected the “one size fits all” approach to establishing the residency of a taxpayer (whether a corporation, individual, Trust, etc.) – although the Court will look at specific legal principles a complete review of all of the facts is necessary.
- FCA disagreed that section 94 (current section) was not broad enough to deem the Trusts resident in Canada. FCA concluded that section 94 would apply and disagreed with Justice Wood’s conclusion that the Trusts did not “acquire” property “directly” or “indirectly” from a related Canadian resident.
- FCA did not consider the subsection 75(2) issue and whether the exemption in Article XIV(4) takes precedence over the application of subsection 75(2).
- Case was appealed to the SCC (*Fundy Settlement v. Canada*, 2012 SCC 14).

Garron – SCC Findings

- The Supreme Court of Canada dismissed the appeal and reached the same conclusion as the two Lower Courts, and in doing so confirmed that the residence of a trust under the Income Tax Act, Canada, is the place where the central management and control of the Trust is exercised. This will not always be the same place as where the trustees or the majority of the trustees reside.
Trust Residence

Determining Residence from a Statutory Perspective?

Statutory Residency

- Section 94 deems an otherwise non-resident Trust to be resident in Canada (Deeming Rule).
- Apart from section 94, there is no statutory definition of the residence of a trust in the Act.
That Was Then…
Old Section 94

- If the trust is a discretionary trust it will be deemed to be a Canadian trust for tax purposes if the following conditions are satisfied (two tests) (paragraph 94(1)(c)):
  - TEST ONE (Beneficiary Test)
  - TEST TWO (Contribution Test)

Even though trustees of the Trust may reside in an offshore jurisdiction and the management of the Trust conducted offshore, the Trust will be deemed resident in Canada for Canadian tax purposes.
Broadening The Scope

Despite a number of amendments to the Act (aimed at reducing the effective utilization of non-resident Trusts), the use of non-resident trusts continued to be prevalent in international tax planning.

- Amendments included:
  - expanding definition of “beneficially interested” (little to no effect)
  - foreign disclosure rules (hard to convince a taxpayer that doesn’t intend to pay tax to provide disclosure)

Interestingly, These Measures Seemed To Have Little Or No Effect On The Use Of Non-resident Trusts

WHY??

- Practitioners either quickly found ways around these changes;
- There simply were not as many offshore arrangements as people may have been led to believe; or
- Clients/advisors accepted the “risk/reward”.

Despite all of the attempts to eradicate the use of non-resident trusts, the department of finance still felt that it was necessary to drastically amend the rules.

February 1999 Budget Proposals

Interestingly, the changes announced in the February 1999 Budget Proposals provided that all distributions (including capital distributions) to Canadian beneficiaries should be subject to tax, except to the extent that tax had previously been paid on the income of a non-resident trust, in which case some form of a credit or deduction would be given.

This proposal was abolished by Finance in a Press Release dated November 30, 1999.
New NRT Rules

Amendments to Canada’s NRT rules, which had been in proposal form for many years, were finally enacted on June 26, 2013, generally with application to taxation years that end after 2006. A nonresident trust to which these rules apply will be deemed to be resident in Canada for certain purposes and taxed on its worldwide income and gains.

Under the new NRT rules, a non-resident trust that acquires property or receives loans from a Canadian resident would be deemed to be resident in Canada and would be taxed on all of its undistributed income (regardless of having a Canadian resident beneficiary). Transferor, the Trust and certain beneficiaries (subject to certain recovery limits [94 (7) –(9)]) would be jointly liable for the tax (would be entitled to credit for foreign taxes paid on undistributed income).

Under the new NRT rules the Trust, the Settlor and certain beneficiaries will be jointly liable for Canadian tax on all undistributed income of the Trust (regardless of residence of beneficiaries).
Subsection 94(3) Charging Section

- Proposed subsection 94(3) is the main charging section. The Trust (otherwise non-resident) is deemed to be resident in Canada throughout the year for the purposes of an extensive list of items (Note: specific exclusions set out in subsection 94(4):
  - Trust deemed resident for computing income under Part I of the Act;
  - Foreign disclosure reporting (also covers reporting of Trust’s foreign property);
  - Trust deemed resident for purposes of tax filing, administration and enforcement;
  - Trust deemed resident for Part XIII (withholding);
  - Trust deemed resident for purposes of 21-Year Rule

What To Expect?

- New NRT Legislation is to be effective and enforceable as of January 1, 2007 (numerous elections that need to be done – i.e. resident and non-resident portion)
- Different “effective” dates make compliance virtually impossible
- No grandfathering (i.e. trusts that were set up years ago where there may be no ability to amend the Deed could be caught)
- Unexpected results (applicable to more than just traditional offshore tax structures)
What to Expect? Cont’d

- Extremely complex to the point that even seasoned tax practitioners cannot reach consensus on the application of the rules.
- Difficulty in distinguishing “resident” vs “non-resident” portion especially in light of the deemed contribution rules proposed in subsection 94(2).
- Application of the proposed amendment to the Income Tax Conventions Interpretation Act will prove very controversial (is this amendment even possible or legal?) The Income Tax Conventions Interpretation Act will be amended to “clarify” that a trust that is deemed resident in Canada under the NRT rules will be considered resident and subject to tax in Canada for tax treaty purposes. It is unclear how this proposal will affect treaty tiebreaker rules in cases of dual residence, or trusts with contributions by residents and non-residents.

More emphasis on avoiding disclosure of international structures as opposed to attempting to comply?

- Is there a move away from offshore tax planning or are we going to see a resurgence in “offshore” planning for high net-worth clients?
- Can we rely on the Courts for an objective finding of facts and interpretation of law or can we expect the Courts to fill in the tax gaps now?
- As a result of Garron and Antle we can expect the CRA to take a very aggressive stance in auditing trusts (offshore and onshore) on basis of residency and validity.
OLD SECTION 94 STRATEGIES

Old Strategies

There were essentially three (possibly four) ways to avoid Canadian taxation utilizing non-resident trusts:
1. Avoid having a Canadian resident settlor (contributor) (usually involved indirect transfers)
2. Avoid having a Canadian resident “beneficially interested” in the trust
3. Avoid having income in the trust (i.e. distribute all income)
4. Treaty override???
Non-Resident Settlor (Contributor)

* Difficulty with this strategy is how to introduce real money into the offshore structure. (Note: obviously CRA felt there were enough “indirect” contributions to non-resident trusts to warrant the introduction of proposed subsection 94(2))

Based on old rules, Trust will not be deemed resident in Canada pursuant to subsection 94(1). Income will grow on a tax-free basis.
Foreign Operating Company

Non-Resident Settlor

Non-Resident Discretionary Trust

Foreign Operating Company (Opco)

Canadian Resident

Canadian Resident Beneficiaries

Income generated by Opco can be distributed tax-free to Canadian resident beneficiaries. Proceeds of sale of the shares of Opco can be distributed tax-free to Canadian resident beneficiaries.

Freeze Structure

Canadian Resident (Mr. X)

100% common shares

Canadian Operating Company (Opco)

Canadian resident owns the shares in Opco and anticipates that Opco will increase in value significantly over the next 3-5 years. Mr. X is looking for options to reduce the potential capital gains tax if Opco is sold.
Freeze Structure Cont’d

Canadian resident owns the shares in Opco and anticipates that Opco will increase in value significantly over the next 3-5 years. Mr. X is looking for options to reduce the potential capital gains tax if Opco is sold.

Sale of Opco

- Sale of Freeze Shares by Mr. X triggers capital gains tax in Canada
- Sale of Common Shares by OffshoreCo – taxable in offshore jurisdiction? – i.e. Barbados – does not impose capital gains tax (Note: there has always been a concern that the Trust may be resident in Canada because Mr. X provided “financial assistance” [subsection 94(6)])
Non-Resident Beneficiaries

Difficulty with this strategy is how to get the money back into the hands of the Canadian resident that ultimately wants to benefit. (Interestingly, the foreign disclosure rules do not catch this transfer since the Non-resident Trust would be “exempt” given that it is not caught under section 94 of the Act.)

Based on existing rules, Trust will not be deemed resident in Canada pursuant to subsection 94(1). Income will grow on a tax-free basis.

Trust Indenture will often provide specific exclusion prohibiting Canadian residents from being named as beneficiaries (some jurisdictions also allow purpose trusts [i.e., Cayman Islands (The Special Trusts Alternative Regime Law 1997)])

Tax Deferral Strategy

In order to give the Settlor some control and access to the Trust funds, if needed, the Trust Indenture provides that the Trust is revocable at the option of the Settlor. To prevent adverse operation of subsection 75(2), Trust invests money in Holdco below.

Trust proceeds will be invested in Holdco and will grow tax-free until paid to Trust. If income paid to Trust, Settlor would be required to include income in his return (subsection 75(2)).
Non-Resident Discretionary Trust

Settlor transfers capital to the Trust. Trust uses the capital to purchase a portfolio of investment assets (assume shares of publicly traded companies – i.e., Non-TCP).

Trust will be deemed resident in Canada for purposes of section 94 of the Act.

Distribution of Income

Canadian Resident Settlor

Non-Resident Discretionary Trust

Portfolio

Canadian-resident Beneficiaries

Trust Indenture appoints the Cdn. Settlor and/or family members as discretionary beneficiaries of the Trust.

Settlor transfers capital to the Trust. Trust uses the capital to purchase a portfolio of investment assets (assume shares of publicly traded companies – i.e., Non-TCP).

Trust distributes all of its income to a non-resident beneficiary in the current year.

At a future point, Trust will dispose of portfolio assets. At this point Trust can either pay tax in Canada on the capital gains OR beneficiary could become a non-resident of Canada and the Trust could distribute all of the gain to the non-resident Beneficiary (Note: Trust would have been entitled to deduct the distribution and would therefore have no Canadian tax exposure – however October 2003 draft added new 94(3)(a)(vii) [now (ix)] which blocks this (creates a withholding tax obligation).
Immigrant Trust

Canadian Resident Settlor

Non-Resident Discretionary Trust

Canadian Resident Beneficiaries

PORTFOLIO

The portfolio will grow tax-free as long as the Trust is not subject to tax in the jurisdiction where it is resident. Distributions of capital may be made tax-free to Canadian resident beneficiaries.

Old Rules: Not Taxed
New Rules: Not Taxed
2014 Federal Budget: Taxed

Beneficiaries will generally be the Immigrant and/or his/her family (Note: such Trusts are now excepted for the provisions of subsection 76(2)).
Inheritance (Inbound) Trust

Non-Resident settlor transfers assets on death to Non-Resident Trust (provisions of Will provide for the creation of Trust or Trust already established by Non-Resident Settlor and Trust named as a beneficiary under the Will). (Note: must be a transfer outside of the 18 month window in case of death or 60 month window if not on account of death).

The portfolio will grow tax-free indefinitely. Distributions of capital may be made tax-free to Canadian resident beneficiaries.

Old Rules: Not Taxed
New Rules: Not Taxed

Outbound Trust

Trust will be deemed resident in Canada pursuant to the provisions of subsection 94(3) and taxed on its world-wide income.

Old Rules: Not Taxed
New Rules: Taxed
Mr. X exchanges his common shares for Class A Freeze Shares (this is done pursuant to section 86 of ITA - tax-free exchange). This freezes the value of Opco.

OffshoreCo will subscribe for new common shares - for nominal consideration. Any future gain in Opco will accrue to OffshoreCo.

Old Rules: Probably not Taxed
New Rules: Taxed (possible Treaty override?)
Income Tax Conventions: Taxed
Interpretation Act: Taxed