The Use of Non-Resident Trusts for Estate Planning and Asset Protection

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PRÉCIS

L'objet du présent article se limite à l'examen de l'utilisation de fiducies non résidantes et étrangères par des résidents du Canada à des fins de planification successorale et de protection de biens. Dans un premier temps, les nombreuses raisons qui justifient l'établissement de telles fiducies seront examinées. Suit une analyse de certaines considérations fiscales, canadiennes et étrangères, présentant un intérêt pour l'auteur de la fiducie, la fiducie non résidante et ses bénéficiaires. L'article poursuit avec un bref examen de plusieurs considérations non fiscales ayant trait au choix du territoire devant régir la fiducie étrangère, au type de fiducie et au fiduciaire. Enfin, il décrit quelques façons d'utiliser des fiducies non résidantes afin, d'une part, de réaliser des avantages fiscaux et, d'autre part, de protéger des éléments d'actifs au profit de bénéficiaires résidant au Canada.

ABSTRACT

This article examines the use of non-resident and offshore trusts by residents of Canada for estate planning and asset protection. The article begins with a review of the many tax and non-tax reasons for using such trusts. Certain Canadian and non-Canadian tax considerations for the settlor, the non-resident trusts, and the beneficiaries thereunder are then analyzed. This is followed by a brief review of several non-tax considerations for the choice of the offshore trust jurisdiction, type of trust, and trustee. Finally, the article reviews several possible methods of using non-resident trusts to make gifts for tax-deferral, tax-reduction, and estate-freeze purposes and to protect assets for the benefit of beneficiaries resident in Canada.

ADVANTAGES OF USING NON-RESIDENT TRUSTS

In General

The use of common law trusts established and managed in foreign jurisdictions by settlors from common law jurisdictions is steadily increasing as tax and financial planners realize the potential benefits inherent in

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these legal arrangements. Although they have generally been looked upon with a certain degree of skepticism and wariness by civil law professionals, the acceptance and respectability of trusts is growing in civil law jurisdictions as well, since their advantages have made their use inevitable. Indeed, several civil law jurisdictions have succumbed to the pressures from the international financial and tax communities and have introduced trusts by legislation.[1]

In addition to the separation between the legal ownership of property and its enjoyment, which introduces the possibility that the use of trusts results in tax and financial benefits, the trust relationship offers the ability to manage and control assets in a flexible, informal, and confidential manner over several generations. When these features are combined with the capacity to safeguard assets in a protective jurisdiction that may offer additional opportunities to mitigate tax in the country of residence of the beneficiaries, a basic understanding of the use of non-resident and "offshore"[2] trusts becomes essential for legal and tax practitioners.

The use of non-resident trusts is usually associated with the reduction of taxes and the protection of assets. However, trusts may be used to obtain several other advantages that are unrelated to these objectives. For example, the establishment and maintenance of a trust are generally less expensive than for a corporation.

Separation of Legal Ownership and Enjoyment of Property

The basis of the trust relationship is the separation of legal ownership from the enjoyment of property. It is this distinction that results in the ability to use trusts for reducing taxes and protecting assets. In effect, the common law and an increasing number of civil law jurisdictions recognize the trust relationship as a legal entity that is separate and distinct from its settlor and beneficiaries, and therefore allows it to hold property at arm's length from its creditors and to be taxed as a separate person.

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[1] For example, Liechtenstein statutorily introduced the trust in 1928. Furthermore, although the trust has been recognized in Quebec's civil law system since 1888 in articles 981a to 981v of the Civil Code of Lower Canada, the greater role of trusts in commercial matters in modern Quebec has been recognized by the adoption of completely overhauled and widely expanded trust rules in articles 1260 to 1298 of the Civil Code of Quebec, which replaced the Civil Code of Lower Canada as of January 1, 1994. In addition, the national courts of several civil law states, such as Belgium, France, Switzerland, and Germany, have recognized the separate legal ownership by foreign common law trusts of land and other assets situated in their jurisdictions.

[2] The expression "offshore trust" is generally considered to connote, when used in Canada, a trust whose primary beneficiaries are resident in Canada and that has been formed under and subject to the laws of a non-Canadian jurisdiction. Accordingly, a trust need not be a non-resident of Canada for it to be considered to be "offshore." Although the use of offshore trusts that are resident in Canada presents some interesting planning opportunities and possible tax advantages, a discussion of those possibilities is beyond the scope of this article. As a result, unless otherwise stated, the discussion in this article is limited to the use of trusts that are both non-residents of Canada and subject to the laws of non-Canadian jurisdictions.

Separation of Entitlement to Income from Entitlement to Capital

The distinction between legal ownership and the enjoyment of property also allows the use of the trust arrangement to separate the entitlement to income generated by trust property from the bare ownership of the property itself. Such separation cannot be perfectly achieved with the use of types of entities for transferring legal but not beneficial ownership, such as corporations.

Flexibility of Management and Control

In a properly drafted discretionary trust deed, the trustee is provided with flexibility in investment direction, distribution desires, and administrative matters. The trustee may be empowered to add or delete beneficiaries from time to time. Provisions in the trust instrument may allow for changes in the terms and conditions of the trust. For example, the trustee may be given the power to make distributions to beneficiaries, to change the governing law, and to change the investments in response to changes in tax laws, political climate, solvency of beneficiaries, and births and deaths among the beneficiaries.

Notwithstanding the extensive powers of investment and distribution that may be conferred on trustees, they are nevertheless governed in their actions by long-established fiduciary duties, which are common to the laws of all of the offshore centres, of loyalty, concern, honesty, even-handedness, and personal management.[3] When these obligations are coupled with a judicious choice of trustee (discussed below), the settlor can rest assured that his wishes, as set out under the trust deed, will be professionally adhered to.

Unfettered Distribution of Assets

The trust arrangement makes it possible for someone to transfer property out of his patrimony while maintaining control over its ultimate devolution.

Trusts are sometimes used to distribute assets other than pursuant to the succession or matrimonial rules of the settlor's domicile on a divorce or on death. In effect, the transfer of assets to a trust takes those assets out of the patrimony or the estate of an individual so that on the individual's divorce or death, their distribution or management is determined pursuant to the terms of the trust deed and not by the matrimonial or succession rules otherwise applicable to the individual's patrimony or estate. Furthermore, the delays and complications inherent in a probate procedure are avoided.

Offshore trusts may be even better suited to this purpose since many offshore trust centres have laws stipulating that the courts of that jurisdiction will not allow legal attacks on a trust's validity simply on the basis

[3] See D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), and "An Overview of the Law of Trusts," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 35:1-28.

that the succession rules or matrimonial property laws of some other country have been ignored.[4]

Confidentiality

Trusts are ideally suited for the protection of confidentiality because, unlike other methods of beneficial ownership, such as corporations and partnerships, the identity of beneficial owners can be more carefully concealed. For example, whereas a company always has shareholders and will issue shares to evidence its ownership, a trust is a self-contained arrangement under which the beneficiaries are defined only in the trust document, and do not have to receive any evidence of their interests. Indeed, individual beneficiaries often discover their interests in family trusts only on or after the death of relatives.

Offshore trusts can offer additional confidentiality because of their general immunity from any Canadian legal and administrative requirements to produce information.[5] In most of the offshore jurisdictions that provide favourable tax and trust legislation, the deed establishing the trust need not be a document of public record, although its existence may have to be registered. Most of the transactions relating to the affairs of the trust are carried out in the name of the trustee, its nominee, or the underlying entities owned wholly or partially by the trustee. A trustee is unlikely to disclose the provisions of the trust or information regarding

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[4] The Canadian succession and matrimonial laws may, however, provide injured persons with rights in respect of properties transferred to trusts, including offshore trusts protected by local legislation. Therefore, the additional protection provided by such offshore legislation may be limited to assets situated outside Canada.

[5] The federal budget tabled on February 27, 1995 proposes that, effective for taxation years commencing after 1995, Canadian individuals and corporations who hold or acquire investments outside Canada will be required to disclose additional information regarding their interests in those investments. Specifically, the types of additional information that will be required will include details of certain transfers to, or deposits with, a foreign trust or estate, and an annual information return in respect of a non-resident trust to which money or property was transferred from an individual or a corporation resident in Canada or in respect of which a Canadian resident is a beneficiary. This information return will include the financial statements of the trust as well as information on contributions to and distributions from the trust. The budget proposal indicates that these new administrative requirements are intended to "provide Revenue Canada with additional information regarding offshore investment made by Canadians, . . . allow a more efficient administration of the *Income Tax Act* and . . . help ensure that Canadian individuals and corporations pay an appropriate amount of Canadian tax on income accruing with respect to their foreign holdings." See Canada, Department of Finance, 1995 Budget, Budget Plan, February 27, 1995, 152.

Although this proposal will obviously decrease the confidentiality of non-resident trusts, it is important to note that Revenue Canada is subject to strict rules regarding the confidentiality of information communicated to it, so such information will not become known to the public (for example, creditors). Furthermore, there are practical restrictions regarding the administration of these requirements. For example, Canadian-resident settlors or beneficiaries of non-resident trusts may not have access to the financial statements of the trusts. Moreover, certain Canadian residents may not even be aware that they are or may be beneficiaries of non-resident trusts.

trust assets except in the extremely rare occurrence that it is compelled to do so by order of a local court.

Reduction of Taxes

In many circumstances, the use of an offshore trust established in a low- or no-tax jurisdiction for the benefit of Canadian residents can effectively defer, reduce, or avoid income taxes, estate taxes, and taxes arising as a result of migration in the jurisdiction of residence of the trust settlor or beneficiaries.

Income and Capital Gains Taxes

Offshore discretionary trusts resident in tax-free havens are commonly used for deferring or even eliminating income tax and capital gains tax on income and capital gains received and realized by the offshore trustee. For the most part, offshore trusts have been used to defer, reduce, or eliminate tax on investment types of income. With imaginative planning, however, properly structured trusts established in intermediary tax havens could be used to defer or reduce Canadian income taxes on foreign source active business income as well.

While assets remain in the offshore trust, and no distributions are made to Canadian-resident beneficiaries, current taxation of the beneficiary group cannot occur in the absence of specific legislation. Although such legislation exists in Canada in the form of sections 94 and 94.1 of the Income Tax Act,[6] it shall be seen that these provisions are not exhaustive.

Furthermore, discretionary distributions to Canadian-resident beneficiaries may receive preferential tax treatment if they are structured as "capital" rather than "income" payments.

Estate, Succession, and Wealth Taxes and Probate Fees

Offshore trusts are also used to avoid estate duties and similar taxes arising on death. Certain provinces, notably Ontario, are considering the re-adoption of estate or succession taxes. The offshore trust, preferably in conjunction with an offshore private investment company, is the most ideally suited vehicle for use in planning to reduce or eliminate such taxes because the trust-company arrangement cuts the ownership link between the settlor and the asset, and places the ownership "offshore" in an entity that can outlive the settlor.

Furthermore, since the property held by a discretionary trust remains unallocated until it is distributed, the value of the property should not be included in the taxable estates of the potential beneficiaries if they predecease any distributions made to them.

Although not usually characterized as taxes, provincial probate fees should also be considered in any estate planning. In effect, the fees charged

[6] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

by certain provinces exceed the reasonable cost of performing this function, and therefore appear to represent yet another means of raising revenue. For example, Ontario's probate fees tripled in 1992 to 1.5 percent of the value of an estate over $50,000.[7] It is not unrealistic to expect that certain provinces shall increasingly view such fees as another source of revenues, so planning to avoid these fees will undoubtedly become more important.

Migration

Non-resident trusts that are established in tax-free jurisdictions are especially appropriate for immigrants to and emigrants from Canada. It is no secret that offshore non-resident trusts have been used extensively by Canadian planners in pre-migration tax structures during the last few years, especially in respect of immigration from Asia. This is due to Canada's five-year exemption, provided under section 94 of the Act, from the taxation of properly structured non-resident trusts established for the benefit of new Canadian immigrants (discussed below).

Asset Protection

Creditors

Offshore trusts are increasingly being established with the object of putting the settlor's and the beneficiary's assets beyond the reach of their creditors. Although this object is viewed as morally reprehensible by some, we submit that the criticism aimed at this use is unjustified in most cases. In effect, when asset protection trusts are viewed as a method of creating a fund by inter vivos donation to be used for the future welfare of one's family and descendants, or as an alternative to a corporation for insulating property from business liability, this use may be viewed as praiseworthy. Accordingly, while it is obvious that any plan that involves the defrauding of creditors must be rejected by the tax professional, a plan consistent with legitimate asset protection or conservation in circumstances where no known actual, future, or contingent creditors exist or where the settlor retains assets in a sufficiently liquid form to pay such creditors is perfectly legitimate and should be free from attack and criticism.

Legitimate reasons for recognizing the protection of personal assets as a necessary aspect of doing business include:

• the increasing exposure to personal liability faced by directors and shareholders of bankrupt corporations for income taxes, deductions at source, sales taxes, environmental penalties, etc.;

• the increasing liability faced by professionals for potential malpractice suits; and

• the increasing cost and difficulty of obtaining adequate insurance coverage.

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[7] By way of contrast, Quebec currently charges probate fees at a flat rate of only $63, regardless of the value of the estate.

Confiscatory Acts of Government

Offshore trusts have traditionally been used to protect wealth from confiscatory acts of governments, such as nationalization and expropriation. Interestingly, Canada has traditionally been viewed and used as a safe haven for the establishment of such trusts.

Exchange Controls

Where the introduction or reintroduction of currency exchange controls restricting the exportation of capital is a concern, offshore trusts are regularly used to maintain a pool of capital offshore for international investment free of exchange control restrictions, for avoiding currency conversion requirements, and for accumulating foreign exchange offshore.

It is interesting to note that a number of influential Canadian investment counsellors have recently been counselling Canadians to increase their foreign investments because they believe there is a risk that Canada will adopt foreign exchange controls.

CANADIAN TAX CONSIDERATIONS

In the planning of an offshore trust structure, whether for creditor-proofing, estate-planning, or other purposes, consideration must be given to the Canadian income tax implications. An initial decision is whether the trust should be resident in Canada, in the jurisdiction whose trust laws are to govern the trust, or elsewhere. Although it may be attractive and practical in certain circumstances for the trust to be subject to the laws of another jurisdiction (for example, one that offers asset protection legislation) but be resident in Canada for tax purposes,[8] a discussion of the use of resident trusts is beyond the scope of this article. Accordingly, the comments hereunder are based solely on the use of non-resident trusts with Canadian-resident beneficiaries.

Taxation of Settlor

Transfer of Property to the Trust

Because there is no tax deferral available on the transfer of property to a trust, the tax consequences applicable to transfers of property to trusts are the same as those that apply in the case of gifts generally. Accordingly, the settlor will be deemed to have received proceeds of disposition for

[8] Where an offshore trust is to be used only for asset protection, Canadian residence for the trust offers several tax and non-tax advantages that should be considered by the planner, including:

- the trust would not be subject to the foreign accrual property income rules;
- Canadian source investment income would not be subject to Canadian withholding tax;
- a Canadian operating company controlled by the trust would be viewed as Canadian-controlled for the purposes of benefiting from the small business deduction in respect of active business income earned in Canada, and claiming a dividend refund in respect of investment income; and
- where the assets are situated in Canada, it may be desirable to manage them here.

any property transferred to a trust by gift inter vivos equal to the fair market value thereof.[9] Where the settlor-transferor is a Canadian resident, or where the property transferred is "taxable Canadian property,"[10] recaptured depreciation and capital gains could thus be triggered on the transfer.

It is interesting to note that section 54 of the Act provides that there is no disposition where there has been a change in legal title without a change in beneficial interest. Accordingly, where the trust is structured so that the settlor is the sole beneficial owner of the trust property, the settlor will not realize a capital gain on a gift of property by him to the trust. However, this exemption expressly does not apply on a transfer by a trust resident in Canada to a trust not resident in Canada.

Attribution Rules

In deciding how the offshore trust will be settled, which powers, if any, will be reserved by the settlor in the management of the trust, and which beneficiaries will be chosen, consideration must be given to the possible application of the attribution rules in subsections 56(4.1) to (4.3), sections 74.1 to 74.5, and subsection 75(2) of the Act. In certain circumstances, the attribution rules may attribute income and capital gains realized by the trust to the Canadian-resident settlor (or any other transferor or lender of property to the trust) even if the trust is neither resident nor taxable in Canada.

Transfers to Trusts

Where a trust directly or indirectly acquires property from a person, subsection 75(2) of the Act may apply to attribute to that person any taxable capital gain or allowable capital loss from the disposition of the property and any income or loss from the property or from property substituted therefor, provided that the property is held on the condition that it may

- revert to that person;
- pass to persons to be determined by him at a time subsequent to the creation of the trust; or
- not be disposed of, during the lifetime of that person, except with his consent or in accordance with his direction.

Accordingly, the settlor or any other transferor of property to a trust may be taxable on the income and capital gains of the trust if that person is

[9] Paragraph 69(1)(b). The definition of the term "disposition" provided in section 54 confirms that "any transfer of property to a trust" constitutes a "disposition" of the entire interest in the property.

[10] Subject to possible treaty protection, paragraph 2(3)(c) provides that non-residents are subject to Canadian income tax in respect of dispositions of "taxable Canadian property." Subsection 248(1) and paragraph 115(1)(b) define "taxable Canadian property" as including real property situated in Canada, capital property used in a business carried on in Canada, shares of non-public corporations and significant interests in public corporations, interests in trusts resident in Canada, and certain other properties with a significant Canadian nexus.

included as a discretionary beneficiary of the trust, if the terms of the trust instrument otherwise allow the trust property to revert to that person, or if that person reserved the right to determine the devolution of the trust property.

To avoid the application of subsection 75(2), the trust must be irrevocable and the settlor must be neither a possible capital beneficiary nor a trustee thereunder. Furthermore, the settlor should not retain any power of appointment or discretion to distribute trust capital. Under common law, trust property reverts to the settlor if a trust fails—for example, when all the beneficiaries have died. To prevent an argument that a possible reversionary right exists as a result of this common law rule, and that subsection 75(2) should therefore be applied, the trust instrument could contain a clause requiring the transfer of trust property on the failure of the trust to a person other than the settlor, such as a registered charity.[11]

Where the settlor insists on maintaining some legal control over the trust, it may nevertheless be possible to structure the trust so that subsection 75(2) will not apply. In some cases, however, such as where asset protection is the only objective in establishing the trust, the tax considerations are secondary and the settlor would not mind continuing to pay the tax with respect to the property.

Subsection 75(2) of the Act does not apply in respect of property that is loaned to a trust pursuant to a bona fide arrangement, as opposed to property that is otherwise transferred to it. Furthermore, subsection 75(2) appears not to apply to an income interest in a trust, since it refers only to the property, and not the income from it, possibly reverting to the settlor.

Another possible means of avoiding the application of subsection 75(2) is to ensure that the trust has no income to attribute back to the settlor. This can be achieved by transferring assets to a corporation wholly owned by the trust and ensuring that no dividends are paid by the corporation to the trust.

In Revenue Canada's view, to prevent double taxation, an amount that has been attributed to a person under subsection 75(2) should normally be excluded from the income of a resident beneficiary to whom it was paid or payable in the year, and from the income of the trust if it was not paid or payable to the resident beneficiary.[12]

The application of subsection 75(2) of the Act must be considered in conjunction with the application of subsection 107(4.1). The latter subsection provides that if subsection 75(2) was applicable at any time in

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[11] Revenue Canada confirms this possibility in paragraph 3 of *Interpretation Bulletin* IT-369R, "Attribution of Trust Income to Settlor," March 12, 1990, in which it states that subsection 75(2) may apply where property received from the settlor may revert to him as a consequence of the death of the last of all other beneficiaries under the trust.

[12] Ibid., at paragraph 10. For additional information regarding the application of subsection 75(2), see John H. Saunders, "Inter Vivos Discretionary Family Trusts: A Potpourri of Issues and Traps," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 37:1-58.

respect of any property of a trust, a tax-deferred rollover of property out of the trust under subsection 107(2) can, while the person from whom the trust directly or indirectly received the property (or substituted property) is alive, only be made to that person or that person's spouse. It appears from the use of the word "applicable" that it is not necessary that attribution actually occur pursuant to subsection 75(2) for subsection 107(4.1) to apply. Accordingly, subsection 107(4.1) could apply even if the trust has never earned any income.

Indebtedness Owing by Trusts

Where an individual ("the transferee"), or a trust in which the transferee is beneficially interested, receives a loan from, or becomes indebted to, another individual with whom the transferee does not deal at arm's length ("the transferor"), and it is reasonable to consider that one of the main reasons for making the loan or incurring the indebtedness was to reduce or avoid tax by causing income from the loaned property, or property substituted therefor, to be included in the income of the transferee, then subsection 56(4.1) of the Act applies to attribute the income from the transferee to the transferor. Subsection 56(4.1) does not apply to attribute any income, gain, or loss derived from loaned property or property substituted therefor where the conditions set out in subsection 56(4.2) are met—that is, where interest at a reasonable rate is charged and paid on the loan.[13]

A condition of the application of subsection 56(4.1) of the Act is that the individuals between whom the indebtedness exists do not deal with each other at arm's length. In Revenue Canada's view, unless the facts indicate the contrary, the following relationships are non-arm's-length:

1) a trust and its settlor, unless the trustee is a professional trustee such as a public trust company, or unless the settlor loses his legal ownership rights over the property settled in the trust and the trustee is free of the settlor's influence;

2) a trust and the beneficiaries thereunder; and

3) a trust and trust assets that are legal entities, such as corporations, controlled by the trust.[14]

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[13] The conditions set out in subsection 56(4.2) are as follows:

1) interest is charged on the loan at a rate at least equal to the lesser of the prescribed rate in effect at the time the loan was made and the rate that would have been agreed upon at that time between parties dealing with each other at arm's length;

2) the amount of interest that was payable in respect of a particular year was actually paid not later than 30 days after the end of the particular year; and

3) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the loan was paid not later than 30 days after the end of each such taxation year.

[14] *Interpretation Bulletin* IT-419, "Meaning of Arm's Length," July 10, 1978, paragraphs 17 and 18.

Finally, subsection 56(4.1) of the Act does not apply to the extent that section 74.1 (discussed below) is otherwise applicable.

Spouses and Minors

Where an individual loans or gives money or property, other than for value,[15] to a spouse or a minor who does not deal at arm's length with or who is the niece or nephew of the individual, whether directly or by means of a trust, sections 74.1 and 74.2 of the Act, respectively, will attribute any income and, in the case of a spouse, any capital gains from the money or property back to the individual transferor.[16]

Section 74.3 of the Act contains rules that determine the amount of any income or taxable capital gains that may be attributed to an individual under sections 74.1 and 74.2 where the individual has transferred or loaned property to a trust in which his spouse or certain minors have a beneficial interest at any time. This provision ensures that the attribution rules will apply where property is loaned or transferred to a spouse or a related minor through a transfer or a loan to a trust in which the spouse or minor has an interest. In the case of a non-resident personal trust, the amounts determined under section 74.3 will be nil, and no attribution will therefore occur, so long as no distribution of income or otherwise than out of the capital of the trust is made to the spouse or minor, no benefits capable of valuation are conferred by or under the trust on them, and they have not disposed of their interests.

Section 74.4 of the Act applies where an individual has transferred or loaned property, either directly or indirectly, by means of a trust or by any other means to a corporation, and one of the main reasons for the transfer or loan is to reduce the income of the individual and to benefit a person who

- owns, directly or indirectly, at least 10 percent of the issued shares of any class of the corporation or any other corporation (other than a small business corporation) that is related to the corporation; and

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[15] These rules do not apply to most transfers for fair market value consideration (which can include indebtedness, provided that interest at a reasonable rate is stipulated and paid) or to loans on which a reasonable rate of interest is stipulated and paid. Specifically, subsections 74.5(1) and (2) provide that the following conditions must be satisfied in order for consideration consisting of indebtedness or a loan of property to be exempt from these attribution rules:

1) interest must be charged on the loan or indebtedness at a rate at least equal to the lesser of the prescribed rate in effect at the time the loan was made or the indebtedness incurred and the rate that would have been agreed upon at that time between parties dealing with each other at arm's length;

2) the amount of interest that was payable in respect of a particular year was actually paid not later than 30 days after the end of the particular year; and

3) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the loan or indebtedness was paid not later than 30 days after the end of each such taxation year.

[16] It should be noted that this description of the application of sections 74.1 and 74.2 is not exhaustive.

• is a spouse of the transferor, or is under 18 years of age and either does not deal with the transferor at arm's length or is the niece or nephew of the transferor.

When section 74.4 is applicable, the transferor will be deemed to realize a notional income on the amount of the loan outstanding or the fair market value of the transferred property equal to interest at a prescribed rate less any interest actually paid to him on a loan or certain amounts in respect of taxable dividends paid to him on any shares received as consideration for transferred property. Such deemed income is taxable whether or not any income is actually generated by the transferred or loaned property.

Section 74.4 does not apply where the transfer was made for fair market value consideration (other than consideration in the form of indebtedness, shares, or rights or options in respect of shares) or where property is loaned on commercial terms and a reasonable rate of interest is stipulated and paid.

Furthermore, and of particular interest in the context of this discussion, subsection 74.4(4) provides that for the purposes of subsection 74.4(2), one of the main purposes of a transfer or a loan by an individual to a corporation shall not be considered to be to benefit a designated person in respect of the individual, and therefore this corporate attribution rule will not apply where:

1) the only interest that the designated person has in the corporation is a beneficial interest in shares of the corporation held by a trust;

2) by the terms of the trust, the designated person may not receive the use of any income or capital of the trust while he is a designated person in respect of an individual; and

3) the designated person has not received the use of any of the income or capital of the trust, and no deduction has been made by the trust in computing its income under subsection 104(6) or (12) in respect of amounts paid or payable to, or included in the income of, that person while he was a designated person.

Accordingly, to avoid the application of section 74.4 of the Act, either an underlying holding company should not be used to hold trust assets, or "designated persons" should be excluded as beneficiaries—that is, spouses should be wholly excluded and related minors should be excluded until they attain the age of majority.

Situations Where the Attribution Rules Do Not Apply

Notwithstanding the seemingly comprehensive application of these rules, there still exist a number of circumstances implicating individuals who do not deal with each other at arm's length in which the attribution rules discussed above appear not to apply. First, if the property (or substituted property) that was directly or indirectly loaned or transferred to the trust does not produce any income, loss, capital gain, or capital loss, there can be no attribution under these provisions. This is why trusts are often settled with a non-income-producing asset, such as a gold coin. Second, sections 74.1 and 74.2 and subsection 56(4.1) do not apply to attribute any income, gain, or loss derived from "loans for value"—that is, loaned property or property substituted therefor where certain conditions are met.[17] Subsection 74.4(2) will not apply where property is loaned or transferred to a small business corporation that remains a small business corporation at all relevant times.[18]

Taxation of Trusts Not Resident in Canada

Residence of Trusts[19]

The Act does not provide a definition of the residence of a trust, although paragraph 94(1)(c) deems certain non-resident discretionary trusts to be resident in Canada for the purposes of part I of the Act. However, subsection 104(1) of the Act states that any reference to a trust shall be read as a reference to the trustee or the executor, administrator, heir, or other legal representative who has ownership or control of the trust property. This indicates that the residence of a trust should be considered to be the residence of its trustees. Therefore, if all of the trustees reside in one jurisdiction, the trust should be considered to reside there for Canadian tax purposes. Accordingly, if all of the trustees of a trust reside in Canada, the trust will be a resident of Canada. Conversely, if none of the trustees of a trust resides in Canada, the trust will not be a resident of Canada. Furthermore, if all of the trustees of a trust reside in a single foreign jurisdiction, the trust will be considered to reside only in that jurisdiction.

However, this principle does not determine the residence of a trust that has several trustees residing in different jurisdictions. This issue was addressed in the Canadian case of *Thibodeau Family Trust v. The Queen*.[20] In that case, the court held that a trust was a resident of Bermuda and not of Canada, even though one of the three trustees was a resident of Canada, on the basis of the facts that the majority of the trustees (that is, two of the three) were resident in Bermuda and that the trust deed required

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[17] Supra footnotes 16 and 13.

[18] Paragraph 74.4(2)(c).

[19] For more information regarding the residence of trusts for Canadian income tax purposes, see Edwin G. Kroft, "Jurisdiction To Tax: An Update," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 1:1-138, at 1:35-40; Robert D.M. Flannigan, "Trust Obligations and Residence" (March 1985), 7 *Estates and Trusts Quarterly* 83-102; Gordon C. Bale, "The Basis of Taxation," in Brian G. Hansen, Vern Krishna, and James A. Rendall, eds., *Canadian Taxation* (Don Mills, Ont.: De Boo, 1981), 21-57, at 50; D. Bernard Morris, "Jurisdiction To Tax: An Update," in *Report of Proceedings of the Thirty-First Tax Conference*, 1979 Conference Report (Toronto: Canadian Tax Foundation, 1980), 414-44, at 420-23; Richard A. Green, "The Residence of Trusts for Income Tax Purposes" (1973), vol. 21, no. 3 *Canadian Tax Journal* 217-31; Martin L. O'Brien, "Residence of a Trust" (August 25, 1978), issue no. 34 *Canadian Current Tax* 313; and Maurice C. Cullity, "Nonresident Trusts," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 646-67, at 648-51.

[20] 78 DTC 6376 (FCTD).

majority decisions on all matters of trustee discretion. In effect, under common law, trustees cannot delegate their fiduciary powers and duties. Accordingly, the court reasoned that the directing authority of a trust can abide only with its trustees. In the circumstances at hand, since neither of the Bermuda trustees could be assumed without clear evidence to have breached his trust by delegating authority to the Canadian trustee, and since in the absence of such delegation no trust power could be exercised without their concurrence in Bermuda, the trust was found to reside where a majority of its trustees resided, in Bermuda.

Although the *Thibodeau* decision does not resolve this issue under all the possible permutations and combinations of trustees resident in different jurisdictions, rendering decisions in other jurisdictions, and managing assets situated in yet other jurisdictions, it does establish a number of guidelines. Most important, the residence of the settlors and, to a lesser extent, of the beneficiaries is irrelevant in determining the residence of a trust. Furthermore, the residence of a trust cannot be determined by reference to the central management and control test applicable to corporations.

In *Interpretation Bulletin* IT-447,[21] Revenue Canada states that a trust is generally considered to reside where the trustee who manages the trust or controls the trust assets resides. Where more than one trustee is involved in exercising the management and control over the trust, the trust will reside in the jurisdiction in which the trustees who exercise more than 50 percent of the management and control reside. Where it is not clear who has management and control of the trust, the department will examine other factors including the location where the legal rights with respect to the trust assets are enforceable and the location of the trust assets. Finally, where the facts indicate that a substantial portion of the management and control of a trust rests with persons other than the trustees, such as the settlor or the beneficiaries, the residence of those other persons may be considered to be the determining factor for the trust, regardless of any contrary provisions in the trust instrument. For these purposes, Revenue Canada states that the normal factual tests of residence for individuals and corporations determine the residence of trustees. However, in the case of a corporate trustee only, where the management and control of a trust are exercised by a branch office, the trust may be considered to reside in the jurisdiction where the branch office is located, regardless of the corporation's own jurisdiction of residence. In general, it appears that Revenue Canada has adopted the hybrid test that a trust resides at the place where the persons who exercise its central management and control reside.

On the basis of the Act, the *Thibodeau* decision, and Revenue Canada's administrative position, the following guidelines should be adhered to in order to ensure, where it is desired, that a trust is considered not to reside in Canada and to reside in a particular jurisdiction:

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[21] *Interpretation Bulletin* IT-447, "Residence of a Trust or Estate," May 30, 1980.

• all or a majority of the trustees and protectors,[22] if any, should be non-residents of Canada and residents of the desired jurisdiction;

• if any trustees reside in Canada, the non-resident trustees should in all cases have the authority to make decisions contrary to the wishes of the Canadian-resident trustees;

• the non-resident trustees should be charged with the control and administration of the trust and no other person can be determined to have such authority;

• the decisions of the trustees should be made, and the custody and control of the trust assets should be maintained, in the desired jurisdiction;

• the governing law of the trust should not be Canadian;

• if the trust is to have a majority of its trustees in the desired jurisdiction and the other trustees elsewhere, the trust instrument should, as in the *Thibodeau* trust deed, provide that all decisions must be made by a majority of the trustees; and

• in the case of a corporate trustee, which may be resident in several jurisdictions, the trust instrument should provide that the affairs of the trust must be effectively managed and controlled in the desired location.

Taxation on Settlement

In addition to triggering capital gains in the hands of the settlor, other taxes may be imposed on the non-resident trust itself when property is transferred to it by the settlor. For example, transfers of real property may trigger significant transfer duties under the legislation of a province in which the property is situated.[23]

General Rules of Taxation of Non-Resident Trusts

A trust that is not resident in Canada is subject, like any other non-resident individual, to Canadian income tax. Accordingly, it is subject to part I income tax solely on its income from carrying on business in Canada (including profits from dispositions of Canadian resource properties and real property inventory)[24] and on gains from dispositions of "taxable Canadian property."[25] The rate of tax applicable to an inter vivos non-resident trust is the highest marginal rate applicable to a non-resident individual taxpayer.

Furthermore, a non-resident trust is liable to tax under part XIII of the Act in respect of payments of certain Canadian source passive investment

[22] The function of "protectors" is discussed below.

[23] For example, under the Quebec Land Transfer Duties Act, RSQ, c. D-17, as amended, Quebec levies duties on transfers of "land" to non-residents equal to 33 percent of the value of the transferred land.

[24] Paragraph 2(3)(b) and section 253.

[25] See supra footnote 10.

types of income including interest, dividends, rents, and royalties. This tax is levied at a rate of 25 percent on the gross amount of such payments.[26]

Finally, the 21-year deemed realization rules[27] and the exempt beneficiary election rules[28] apply to all trusts regardless of their residence. However, non-resident trusts are subject to these rules only in respect of any "taxable Canadian property," Canadian resource property, and Canadian real property inventory held by them on the deemed disposition dates, since only gains on the dispositions of those properties are brought within the scope of Canadian taxation of non-resident trusts.[29]

As a result of these rules, there is no effective advantage for a Canadian resident to hold Canadian income-producing properties through a non-resident trust. However, subject to the application of the attribution rules (discussed above) or the foreign accrual property income or offshore investment fund properties rules (discussed below), a non-resident trust offers the advantages of the deferral and, possibly, the avoidance of tax where non-Canadian property that would otherwise give rise to taxable income in the hands of a Canadian resident is held by a non-resident trust and income is accumulated in the trust.

Foreign Accrual Property Income Rules

The Canadian foreign accrual property income (FAPI) rules are anti-avoidance rules applicable to foreign corporations and trusts that are intended to limit the deferral or avoidance of Canadian tax in respect of investment income and capital gains accumulated through non-resident entities. The specific rules applicable to non-resident trusts are set out in section 94 of the Act.

Conditions of Application

In addition to the non-residence of the trust, the conditions of application of section 94 relate to the trust's beneficiaries, the person(s) from whom it acquired its property, and the manner in which the beneficiaries acquired their interests.

1) Conditions Relating to the Trust Beneficiaries

The beneficiaries of the trust must include a person resident in Canada, a corporation or a trust (wherever resident) with which a person resident in

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[26] Section 212. This rate of tax is subject to reductions pursuant to applicable income tax conventions to which Canada is a party.

[27] Subsections 104(4), (5), and (5.2).

[28] Subsections 104(5.3) to (5.8). It should be noted that the federal budget tabled on February 27, 1995 proposes the elimination, effective January 1, 1999, of the special election to extend the 21-year rule and the postponement of capital gains taxation on trust property until the death of the last "exempt beneficiary" under the trust. Those trusts that have, at any time before that date, elected to postpone capital gains taxation will be subject to a deemed disposition of trust assets at fair market value on that date.

[29] See supra footnote 10 with respect to "taxable Canadian property," and supra footnote 24 with respect to resource properties and real property inventory.

Canada does not deal at arm's length, or a "controlled foreign affiliate"[30] of a person resident in Canada. For these purposes, a person will be considered to be beneficially interested in a trust if the person 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) to receive any of the income or capital of the trust either directly from the trust or indirectly through one or more other trusts.[31]

2) Conditions Relating to the Acquisition of Trust Property

The trust must have acquired its property directly or indirectly in any manner whatever from a person who satisfies the following conditions:

1) the person is the beneficiary referred to above in satisfaction of the first condition, or a person related to that beneficiary, or the uncle, aunt, nephew or niece of that beneficiary;

2) the person must have been resident in Canada at any time in the 18-month period before the end of the trust's relevant taxation year (or, in the case of a person who has ceased to exist, was resident in Canada at any time in the 18-month period before the cessation of existence); and

3) where the person is an individual, he must have, before the end of the trust's relevant taxation year, been resident in Canada for a period of, or periods the aggregate of which is, more than 60 months.

For these purposes, a trust is 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.[32] Section 94 will also apply if the property was acquired from a trust or a corporation that itself acquired the property from a person meeting the above requirements with whom it was not dealing at arm's length.

It is where these specific conditions are not met that most planning opportunities in relation to section 94 arise. The following are examples of such opportunities.

First, section 94 cannot apply where trust property has been acquired only from a non-resident of Canada, even if the trust has Canadian-resident beneficiaries related to that person. Notwithstanding the views of certain commentators who consider this to be a loophole in the application of section 94, we submit that the non-application of section 94 in this

30 A "controlled foreign affiliate" is defined in paragraph 95(1)(a) as a non-Canadian-resident corporation in which a Canadian resident owns 10 percent or more of the shares of any class and that is controlled by that Canadian, by him together with not more than four other persons resident in Canada, by not more than four other persons resident in Canada, by persons with whom he does not deal at arm's length, or by him and persons with whom he does not deal at arm's length.

31 Subsection 248(25).

32 Subsection 94(6).

circumstance is appropriate; otherwise, Canadian income tax jurisdiction would extend to future gifts of property by non-residents to Canadian residents.

Second, where trust property has been acquired only from a person who has never resided in Canada before that time and who takes up Canadian residence, section 94 will not apply until January 1 of the year in which he has resided in Canada for an aggregate of 60 months. This planning opportunity was designed to provide an incentive to foreigners to immigrate to Canada.

Third, where trust property has been acquired from a Canadian resident or a non-resident who subsequently became one, and section 94 applies only because of that person's residence in Canada, section 94 will cease to apply as of January 1

- of the second year following the year in which he ceases to reside in Canada, if he so ceases to reside in the first six months of the year; or
- of the third year following the year in which he ceases to reside in Canada.

3) Conditions Relating to the Acquisition of a Beneficiary's Interest

As an alternative to the preceding condition, section 94 can apply where all or any part of the interest of the beneficiary described above in satisfaction of the first condition was acquired directly or indirectly by the beneficiary by way of purchase, or by way of gift, bequest, or inheritance from, or the exercise of a power of appointment by, a person described above in satisfaction of the second condition.

Effects of Application

Where the conditions of application of section 94 of the Act are fulfilled, its effects depend on whether or not the trust is discretionary.

1) Application to Discretionary Trusts

For the purposes of the application of section 94, a trust is considered to be discretionary if the amount of the income or capital of the trust to be distributed at any time to any beneficiary depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power.[33] If the trust is considered to be discretionary, section 94 deems the trust to be a resident of Canada whose taxable income for any year to which the provision applies will be the aggregate of

1) its taxable income earned in Canada, otherwise determined under section 115 of the Act;

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[33] Paragraph 94(1)(c).

2) its FAPI[34] for the year; and

3) the FAPI of its controlled foreign affiliates.[35]

Against that taxable income, the trust is entitled to claim, inter alia, deductions for foreign taxes paid, for any part of the income referred to in (1) that may reasonably be considered to have become payable to a beneficiary resident in Canada,[36] and for any part of the income referred to in (2) and (3) that may reasonably be considered to have become payable to a beneficiary in the year.[37] It is then liable to Canadian tax at the highest marginal rate applicable to individuals on the taxable income remaining, subject to any available foreign tax credits. Although the trust is deemed to be a resident of Canada, it is not deemed to be a resident of a province in Canada. Consequently, in addition to the usual federal tax, the trust is also liable to the tax under section 120 of the Act on its foreign source income.

Even though a discretionary trust to which section 94 applies is deemed to reside in Canada, in order to ensure the payment of Canadian tax by a non-resident trust whose trustees and assets may be situated offshore, subsection 94(2) of the Act provides that any beneficiary of the trust is jointly and severally liable for any amounts imposed on the trust, to the extent of the amounts paid or payable to him by the trust or received by him on the disposition of an interest in the trust.

2) Application to Non-Discretionary Trusts

When section 94 applies to a non-discretionary trust, it is deemed to be a "controlled foreign affiliate" of each beneficiary whose beneficial interest in the trust is at least 10 percent of the fair market value of all the beneficial interests in the trust. Accordingly, a corresponding share of the trust's FAPI is included in the income of each such Canadian-resident beneficiary,[38] except for amounts that may reasonably be considered to have become payable to a beneficiary in the year.[39]

Offshore Investment Fund Properties

Section 94.1 of the Act is an anti-avoidance rule that was introduced in 1984 in response to certain offshore investment funds that were designed to circumvent the FAPI rules. In effect, before the enactment of section 94.1 of the Act, it was possible to avoid the application of section 94 by

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[34] FAPI is defined in paragraph 95(1)(b) generally as income from property (such as interest and dividends), income from business other than an active business, and capital gains.

[35] For the definition of the expression "controlled foreign affiliate," see supra footnote 30.

[36] Subsection 104(6).

[37] Subsections 94(3) and 104(24).

[38] Paragraph 94(1)(d).

[39] Subsections 94(4) and 104(24).

structuring a non-discretionary trust with 11 or more beneficiaries, each of whose interests were worth less than 10 percent of the fair market value of all the beneficial interests in the trust.

Section 94.1 applies where a Canadian-resident taxpayer holds property (referred to as an "offshore investment fund property") that is, inter alia, an interest in a non-resident entity that may reasonably be considered to derive its value, directly or indirectly, primarily (that is, more than 50 percent) from certain portfolio investments of that or any other non-resident entity.[40] For these purposes, the expression "non-resident entity" is defined in paragraph 94.1(2)(b) of the Act as "a corporation that is not resident in Canada, a partnership, organization, fund or entity that is not resident or is not situated in Canada or a trust with respect to which the rules in paragraph 94(1)(c) or (d) apply." Accordingly, the definition of the term "entity" is very broad and could be interpreted to include a trust. However, it is arguable that because this paragraph specifically addresses trusts, the term "entity" should be interpreted to exclude any trust to which the rules in paragraph 94(1)(c) or (d) of the Act do not apply. The result is logical in view of the legislative intent to exclude such trusts (which include immigration trusts) from the application of the Canadian FAPI rules. Furthermore, Revenue Canada has apparently confirmed this interpretation in a number of non-binding responses to interpretation requests.

Moreover, section 94.1 will not apply unless it may reasonably be concluded, having regard to all the circumstances, that one of the main reasons for the taxpayer's acquiring, holding, or having the interest in the offshore investment fund property is to derive a benefit from the portfolio investments in such a manner that the taxes, if any, on the income, profits, and gains from the investments for any particular year are significantly less than the tax that would have been applicable if the income, profits, and gains had been earned directly by the taxpayer.[41]

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[40] Pursuant to paragraph 94.1(1)(b), the portfolio investments must be in (1) shares of the capital stock of one or more corporations, (2) indebtedness or annuities, (3) interests in one or more corporations, trusts, partnerships, organizations, funds, or entities, (4) commodities, (5) real estate, (6) Canadian or foreign resource properties, (7) currency of a country other than Canada, (8) rights or options to acquire or dispose of any of the foregoing, or (9) any combination of the foregoing.

[41] Subsection 94.1(1) specifies that the circumstances to be considered in applying this test include:

> (c) the nature, organization and operation of any non-resident entity and the form of, and the terms and conditions governing, the taxpayer's interest in, or connection with, any non-resident entity,
>
> (d) the extent to which any income, profits and gains that may reasonably be considered to be earned or accrued, whether directly or indirectly, for the benefit of any non-resident entity are subject to an income or profits tax that is significantly less than the income tax that would be applicable to such income, profits and gains if they were earned directly by the taxpayer, and
>
> (e) the extent to which the income, profits and gains of any non-resident entity for any fiscal period are distributed in that or the immediately following fiscal period.

Where a Canadian-resident taxpayer has an interest in an offshore investment fund property and the foregoing purpose test is met, there is included in his income an amount calculated as the "designated cost"[42] of the property at the end of each month multiplied by the prescribed rate of interest for the period including that month and then divided by 12. The aggregate of all such amounts for the year, less the taxpayer's income for the year (other than a capital gain) from the offshore investment fund property, is included in the taxpayer's income for the year.

Taxation of Trust Beneficiaries Resident in Canada

Taxation of Distributions During the Trust Period

A Canadian-resident beneficiary of a non-resident trust must include in his income all amounts that became payable in the year by the trust other than as proceeds of disposition of all or part of the beneficiary's interest in the trust or, in the case of a personal trust, a distribution or payment of capital.[43]

The qualification of a trust as a "personal trust" therefore determines the tax treatment accorded to its Canadian-resident beneficiaries. A "personal trust" is defined generally as a testamentary trust or an inter vivos trust under which no beneficial interest was acquired for consideration payable to the trust or to a person who has made a contribution to the trust.[44]

A payment of capital by a non-resident personal trust to a Canadian-resident beneficiary is not subject to tax.[45] Under trust law, any property settled on the trust is treated as capital, and any income not distributed in a period is treated as an accretion to capital. Such accretions could therefore be distributed by personal trusts, including non-resident trusts, to capital beneficiaries on a tax-free basis in subsequent periods.

Any payments made to a Canadian-resident beneficiary by a non-resident trust that does not qualify as a personal trust, whether made out of trust income or out of capital, will be taxed as ordinary income unless they are paid as consideration for all or part of the beneficiary's interest.

Commutations and Dispositions of Trust Interests

If a non-resident trust qualifies as a "personal trust" and if no trust interests are purchased by any of the beneficiaries, the Canadian tax neutrality as between a resident and a non-resident trust is continued in respect of

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[42] The "designated cost" of an offshore investment fund property is defined in paragraph 94.1(2)(a) as the aggregate of the taxpayer's initial cost of acquisition of the property, all amounts included in the taxpayer's income for a preceding taxation year by virtue of this provision, and, where the taxpayer held the property at the end of 1984, the fair market value of the property at that time less the cost amount of the property.

[43] Paragraph 104(13)(c).

[44] Subsection 248(1).

[45] Paragraphs 104(13)(c) and 105(1)(b).

commutations and dispositions of trust interests by beneficiaries resident in Canada.[46]

Where a personal trust distributes property to a beneficiary in satisfaction of an income interest in the trust, the trust is considered to dispose of the property at its fair market value.[47] Thus, the trust may realize a tax liability but the beneficiary would not, it seems, be subject to any tax on the receipt of the property.[48] A distribution of property by a personal trust to a Canadian-resident beneficiary in total or partial consideration of his capital interest in the trust benefits from an automatic tax deferral or rollover, provided that subsection 75(2) was at no time applicable to the trust.[49]

Trusts that are not personal trusts are deemed to have disposed of property distributed in satisfaction of any interest in the trust, regardless of its characterization for trust law purposes, for proceeds equal to its fair market value.[50] The beneficiary will be considered to have received proceeds on the disposition equal to the fair market value of the property received from the trust, and may therefore also realize a taxable capital gain or allowable capital loss, depending on the adjusted cost base of the interest disposed of.[51]

Where paragraph 94(1)(d) of the Act applies to deem a non-resident non-discretionary trust to be a controlled foreign affiliate of a Canadian-resident beneficiary, the special definition of "cost amount" in paragraph 108(1)(d) of the Act is not applicable in determining the adjusted cost base of the beneficiary's capital interest in the trust, which will therefore be the adjusted cost base thereof otherwise determined under the Act. Furthermore, subsection 94(5) of the Act provides for adjustments in computing the adjusted cost base of such capital interests to reflect amounts included or deducted in computing income under the FAPI rules in section 91 of the Act.

Finally, to avoid double taxation that would otherwise occur when an offshore investment fund property is disposed of, amounts included in a taxpayer's income by virtue of section 94.1 of the Act are added to the adjusted cost base of the property, with the eventual effect of either reducing any capital gain or increasing any capital loss accordingly.[52]

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[46] A commutation of a trust interest is considered to occur when a beneficiary receives a distribution of trust property in total or partial satisfaction of his interest in the trust.

[47] Subsection 106(3).

[48] Subsection 106(2).

[49] Subsections 107(2) and (4.1).

[50] Paragraph 107(2.1)(a).

[51] Paragraph 107(2.1)(c).

[52] Paragraph 53(1)(m).

NON-CANADIAN TAX CONSIDERATIONS

The Canadian tax rules applicable to the settlor, the trust, and the beneficiaries constitute only part of a complete analysis when formulating a plan involving the establishment of an offshore trust. Under a properly structured offshore trust, the Canadian tax consequences will be either neutral or favourable in that an opportunity may exist for deferring or avoiding entirely the recognition of income or benefits accruing in the offshore trust to the eventual benefit of Canadian-resident beneficiaries. However, tax rules in the jurisdiction of the settlor, the trust, or the situs of the trust assets may result in double taxation or may wholly or partly negate such favourable Canadian tax treatment. Accordingly, the possible incidence of such foreign taxes must be considered and the circumstances giving rise to them anticipated so that they may be avoided.

Jurisdiction of Residence of Foreign Settlor

Extra care must be taken where the settlor is liable to the tax rules of a non-Canadian jurisdiction.[53] In addition to income and capital gains tax that may be triggered on a transfer of property to the trustees, local tax rules in the settlor's non-Canadian residence may produce adverse tax implications. For example, if the settlor is subject to US income tax, care must be taken in preparing the trust instrument to ensure that the trust is not rendered subject to the US "grantor trust" rules.[54] These rules generally provide that where the "grantor" (settlor) has reserved an interest or significant powers in the trust for himself or his spouse, he may be considered to have remained the owner of the trust assets, and hence of its income for US income tax purposes. The United States also imposes gift taxes on transfers of property for no consideration. Certain other jurisdictions, such as Australia and New Zealand, have recently adopted legislation that deems the residence of a trust to be the residence of its settlor. Of course, any plan involving a settlor who is liable to the tax laws of a foreign jurisdiction should be reviewed by competent local tax counsel.

Jurisdiction Where the Trust Is Established

The Cayman Islands, the Turks and Caicos Islands, and the Bahamas impose no income taxes. The other jurisdictions suggested below as being appropriate jurisdictions for the establishment of offshore trusts—that is, the Cook Islands, Belize, Cyprus, Gibraltar, and Mauritius—exempt from domestic income tax trusts made by and for non-residents.

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[53] Liability to another jurisdiction's income tax rules may occur in several circumstances. In effect, under the common law tax concept of "residence," an individual may reside in two or more jurisdictions simultaneously. Furthermore, liability to worldwide income tax in many jurisdictions is based on other criteria. For example, in addition to residence, an individual is rendered liable to worldwide income tax in the United States on the basis of citizenship and a number of substantial presence tests.

[54] These rules are provided in sections 671 to 679 of the US Internal Revenue Code of 1986, as amended.

The tax legislation, if any, of the offshore jurisdiction under consideration should be carefully reviewed. If there is any doubt about the application of such legislation, an opinion of competent local tax advisers should be obtained to ensure that the establishment of the trust will not give rise to unforeseen tax liabilities.

Jurisdiction Where the Trust Assets Are Situated

Consideration should be given to the impact, if any, that withholding taxes imposed by the source country on the gross amounts of certain investment types of income such as interest, dividends, rents, and royalties may have on the overall tax scheme. For example, where Canadian non-resident withholding tax is imposed under part XIII of the Act on payments made to a non-resident trust to which section 94 of the Act does not apply, the trust's Canadian-resident beneficiaries will not be entitled to claim a foreign tax credit in respect of those withholding taxes when the trust's income is distributed to them.[55] Accordingly, double Canadian taxation would result on the same Canadian source income. In addition, most "tax haven" countries are not parties to international conventions for the avoidance of double taxation. As a result, trusts resident in such jurisdictions generally will not benefit from the reduced rates of withholding taxes usually applicable to investment income under such agreements. Where it is anticipated that significant trust assets are to be located in a jurisdiction that impose high withholding tax rates, such as Canada or the United States, consideration may be given to establishing the trust in a jurisdiction with which the source country has a tax treaty that reduces withholding tax rates without incurring substantial domestic tax liabilities.[56]

CHOICE OF TRUST JURISDICTION, TYPE OF TRUST, AND TRUSTEES

Choice of Trust Jurisdiction

The first step in setting up an offshore trust is the determination of the applicable law. In general, the law of the place where the trust is established will govern the administration of the trust. Alternatively, the law governing the administration of the trust may be expressly specified in the trust instrument. In this case, the trust instrument will generally have a clause providing that it will be governed by the law of the particular offshore jurisdiction and will be subject to the courts of that jurisdiction with respect to any matter affecting the interpretation, enforcement, or

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[55] In effect, subsection 104(22), which provides that for the purposes of computing the foreign tax credit available to a trust and its beneficiaries, the foreign source income of the trust, as well as the foreign tax paid thereon, may be imputed to the trust and to the beneficiaries in amounts designated by the trust in its income tax return for the year, applies only to trusts resident in Canada throughout a taxation year.

[56] Examples of countries that have tax treaties with Canada and that may offer full or partial exemptions from local income tax for trusts with non-local beneficiaries include Barbados, Singapore, Cyprus, Ireland, and Malta.

administration of the trust. The "administration" of a trust refers to all aspects of the application and execution of the trust deed and includes, for example, the appointment and removal of trustees, trustees' powers and duties, the investments that trustees are authorized to make, liability for breach of trust, and the life span of the trust.

It is beyond the scope of this article to compare the differences in trust law among the various jurisdictions in which offshore trusts are commonly established. However, the determination of the principal characteristics that the foreign law should have in order to satisfy estate-planning or asset protection objectives is essential for any successful planning. It goes almost without saying that before any trust is established in an offshore jurisdiction, the advice of a competent local trust expert should be obtained upon a review of the proposed trust instrument and all other material facts and documents.

Of primary importance for the Canadian recognition of the validity of offshore trusts, the jurisdiction must have clearly received or adopted the common law of trusts, rather than introduced the trust concept by statute. Furthermore, the local trust law must have "variation of trusts" legislation that permits the variation of the trust instrument in order to allow its restructuring in anticipation of future legislative changes in the governing trust or tax laws.

Where asset protection is one of the objectives in setting up the offshore trust, the settlor should choose a foreign jurisdiction whose laws provide extensive and specific debtor protection against claims of future creditors in respect of the settlor, the trust, and, if it is a non-discretionary trust, the beneficiaries thereunder. For example, the enforcement of foreign judgments in the jurisdiction without the filing of a new action should be restricted. Limited, if any, recognition should be accorded foreign bankruptcy court orders in the jurisdiction. Furthermore, a creditor should be unable to proceed against assets held by a trust created in the foreign jurisdiction or against its trustee if the claim relates to a matter governed or to transfers protected by the law of the foreign jurisdiction. For example, a creditor may be required to prove not only the fraudulent intent of a settlor, but also that the settlor was rendered insolvent as a result of his transfer of assets to the trust. In addition, no creditor whose claim arose after the transfer of assets into the trust should be able to recover against or otherwise challenge the trust. Accordingly, such a trust may effectively shield the trust assets from creditors, even where a Canadian court has found the creation of the trust to be fraudulent as to the creditors of the settlor. At the very least, a creditor (or a trustee in bankruptcy) will find it very difficult, and presumably expensive, to attack an asset protection trust created and administered under foreign laws with such features.

An example of an offshore jurisdiction that provides especially favourable trust legislation for asset protection trusts is the Cook Islands. Under its law, only creditors existing at the time of settlement are protected against a fraudulent transfer to an "international trust" under Cook law, and the claim of the creditor must be proved beyond a reasonable doubt. The statute-of-limitations period is two years or less for all matters involving credit claims based on a fraudulent transfer.

It should be noted, however, that the trust assets might not benefit from the protective laws of the offshore trust jurisdiction if they are situated outside its territory. For example, if the assets remain in Canada, it is possible that a Canadian court would permit the execution of a judgment against the offshore trust, notwithstanding the protection afforded by the applicable law of its jurisdiction. Therefore, in order for the offshore trust to be effective in protecting assets from the settlor's creditors, not only must the trust be governed by an appropriate offshore law, but the trust assets must also be situated offshore.

As a general rule, the offshore trust is usually created and made resident in a "tax haven" jurisdiction. In effect, even if the desired use of the trust is not tax-motivated, the absence of local taxes reduces the possibility of double taxation.

It has been suggested that the following jurisdictions, which appear generally to satisfy all of the above criteria, should ideally be used for the establishment of offshore trusts for tax-deferral or tax-reduction and asset protection purposes: the Cook Islands, the Bahamas, Belize, the Cayman Islands, Cyprus, Gibraltar, Mauritius, and the Turks and Caicos Islands.[57] All of these jurisdictions were at one time colonies of England, and their previously existing law regarding fraudulent conveyances and settlement transactions was the received law of England or a local variation thereof.[58] Other jurisdictions, even certain high-tax jurisdictions such as the United Kingdom, may function as "tax havens" or otherwise be more suitable for certain trusts involving foreign settlors, beneficiaries, and assets. Needless to say, expert local tax advice is essential where the planning relies on foreign tax rules or exemptions.

Finally, convenience and political stability are important practical factors to consider. Accordingly, the jurisdiction should have an internationally competitive infrastructure including international banks, experienced trust officers, highly trained attorneys and accountants, and sophisticated communication systems. Since a client will normally visit the jurisdiction from time to time, and will often need to communicate with trustees situated there, it should also be accessible and, preferably, in the same time zone. As a result of these considerations, an otherwise ideal jurisdiction such as the Cook Islands may be impractical because of its location (in the South Pacific).

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[57] See, inter alia, Norman C. Tobias, "The Uses and Abuses of Foreign Asset Protection Trusts," in the 1993 Corporate Management Tax Conference, supra footnote 19, 14:1-42; and Jack Bernstein, "Asset Protection Trusts" (April 1993), 3 *Tax Profile* 301-8.

[58] Tobias, supra footnote 57, at 14:3.

Type of Trust and Trust Provisions

Trustees generally hold trust property for the benefit of beneficiaries who are either

- specifically identified and entitled to a specified portion of the trust income or capital (commonly referred to as a "strict trust"); or
- members of a specified class of beneficiaries who may be chosen to receive all or any portion of the trust income or capital (commonly referred to as a "discretionary trust").

The discretionary trust is generally used in the establishment of offshore trusts because it is flexible and because the interests of the beneficiaries have no value, thereby affording additional protection from creditors and resulting in less taxation on the death of the beneficiaries. The trustees under such trusts are usually afforded complete discretion to distribute income or capital to any beneficiary in a defined class or group, to the exclusion of any other beneficiary. Thus, in the event that a potential beneficiary subsequently becomes insolvent or declares personal bankruptcy, the trustees may decline to exercise their discretion in favour of that beneficiary during the period of insolvency or bankruptcy.

Asset protection trusts often contain what is commonly referred to as a "spendthrift" clause that prohibits the transfer or assignment of any interest in the trust, either by voluntary or involuntary acts of the beneficiaries or by operation of law, and limits the liability of the trust with respect to the debts, liabilities, contracts, or other obligations of any beneficiary of the trust. Alternatively, a "protective" trust may arise under the common law when the trust document provides that a beneficiary will cease to have an income interest in a trust upon his or her bankruptcy or upon the attempted alienation of his or her interest in the trust. Either a "spendthrift" or a "protective" clause is found in most "strict" offshore trusts in which the beneficiaries' interests are fixed, even those whose primary objective is not the protection of assets. However, an alternative to either type of trust would be a discretionary family trust, under which no beneficiary has a right to acquire trust property unless and until the trustee exercises its discretion to make a distribution to him or her. Under this type of trust, the beneficiaries' interests are worthless until the distribution.

Furthermore, the asset protection trust must be irrevocable; otherwise, the power of revocation may be exercised by the settlor, upon an order issued by a court of the jurisdiction of his domicile at the instance of judgment creditors, or by a trustee in bankruptcy, as the legal representative of the bankrupt settlor.

Choice of Trustee

Because it is imperative that the settlor have no control over the trust property and its devolution, it is necessary that the trustee be entirely trustworthy, hence the origin of this title. A trust company situated and operating in the offshore jurisdiction of choice is usually contracted to be the trustee of an offshore trust. The settlor may choose between a large trust company, which is generally owned by an international bank, and a small trust company owned by one or more individuals. The larger and more international the corporate trustee is, the greater will be the security offered against the incompetence or dishonesty of trust officers.

If one of the purposes of the offshore trust is to protect assets from creditors, the trustees also should be offshore. Otherwise, a Canadian court might order the trustees to exercise their powers in order to distribute assets to a settlor or a beneficiary debtor. If the trustees refuse, they might be fined (or, if the trustees are individuals, jailed) for contempt of court, and a court might even proceed to exercise their powers in their names.[59]

In anticipation of the possibility of political instability, adverse trust or tax law changes, or other factors that would render the trust's legal jurisdiction inappropriate, it is common to find an export or "flee" clause in the trust deed. Such a clause provides for the automatic destitution of the trustees and the appointment of trustees residing in another jurisdiction on the occurrence of certain predetermined events.

Often, the settlor appoints one or more individuals to serve as "protectors" under the trust. The protectors may advise the trustee concerning the making of investments in excess of a given dollar amount and the exercise of its discretionary powers over distributions. The protectors may change the governing law and the situs of trust administration, and, under specified circumstances, may remove a trustee and appoint a successor trustee. It should be kept in mind, however, that if too much power is given to the protectors, the administration of the trust will become too ponderous. The protectors are generally relatives or close acquaintances of the settlor. Because of the possible influence of the protectors over the management of the trust, the protectors—or at least a majority of them—should not reside in Canada.

The settlor may also present the trustee of a discretionary trust with a "letter of wishes" indicating the preferred devolution of the trust property among the beneficiaries. However, the trustees must not be legally bound by such a letter in order to preserve the discretionary nature of the trust and to ensure its non-residence for Canadian tax purposes.

EXAMPLES OF USES OF NON-RESIDENT TRUSTS

Hereunder are descriptions of possible methods of setting up and using non-resident trusts in order to make gifts for estate-planning and asset protection purposes involving Canadian residents. It should be noted that, in practice, each estate or asset protection plan must be established on the basis of the particular circumstances at hand. The tax practitioner should have a thorough knowledge of his clients' wishes and assets, a general understanding of the legal, tax, and political regimes of the suitable offshore jurisdictions, and good working relationships with local professionals with whom the setting up and management of the trust structure would be coordinated.

59 Ibid., at 14:25.

Estate Planning

Gifts and Bequests by Non-Residents

Where a non-resident of Canada wishes to make a gift of property to or for the benefit of a resident of Canada, and the gifted property is expected to be invested rather than immediately spent, Canadian income taxes may be deferred until such time as the Canadian resident receives the gift, by making the gift through an offshore trust resident in a "tax haven" jurisdiction. Moreover, it is possible to structure a foreign trust to escape Canadian tax indefinitely. In effect, if the settlor does not reside and has never resided in Canada, and if the trust does not reside in Canada, the income earned by the trust from foreign sources will escape all Canadian taxation. Indeed, since the trust will not be resident in Canada, it will not be subject to Canadian income tax under the normal rules. Furthermore, it was demonstrated above that section 94 of the Act will not apply to include the income of the trust in the income of the Canadian-resident beneficiary if the settlor is not, never has been, and never will be a resident of Canada. Section 94.1 of the Act also should not apply in the same circumstances.

To ensure the avoidance of all Canadian tax, the non-resident trust should not hold property that is taxable Canadian property, Canadian resource properties, real property situated in Canada, or property that gives rise to payments that attract part XIII withholding tax.

In addition to deferring Canadian tax by retaining income in a non-resident trust in the circumstances described above, Canadian tax can be permanently avoided where income is accumulated in the trust and is ultimately distributed to the Canadian-resident beneficiary as non-taxable capital. In effect, under the general principles of common law, income that is accumulated by the trustees becomes an accretion to capital. When the capital of a trust is then distributed to a beneficiary who is resident in Canada, it is received as capital and is not subject to tax. To support an argument that accumulated trust income has been "capitalized," it is advisable that trustees reinvest the accumulated income of the trust in income-earning investments and hold those investments for a lengthy period before making any distribution to any beneficiary. Furthermore, the trust instrument should direct the trustees to thus accumulate and "capitalize" amounts received as income. Finally, the trustees should refrain from adopting a practice of distributing, at the beginning of each year, trust income from the previous year.

The assets held by such non-resident trusts would not normally be subject to probate in Canada nor, where they are computed as a percentage of the value of the deceased settlor's assets, to provincial probate fees.

These results are clearly advantageous to those obtained where the non-resident benefactor or testator either gives or bequeaths property to the Canadian-resident beneficiary.

This type of planning is commonly used by non-resident parents or grandparents who wish to make an inter vivos gift or who wish to bequeath property on death to or for the benefit of relatives such as children or grandchildren resident in Canada.

In a variation of this theme, a non-resident corporation in which a resident of Canada holds a minority interest could use part of its retained earnings to settle a non-resident trust for the benefit of the Canadian resident. Since the retained earnings belong to the corporation, it is arguable that the non-resident trust does not acquire property, directly or indirectly, from the Canadian resident. It would have to be demonstrable that the Canadian resident did not suggest, authorize, or approve the transfer.

As another possibility, a resident of Canada could give property to a non-resident, followed by the eventual settling of the property by the non-resident in an offshore trust for the benefit of the Canadian resident's children, for example. This planning would be subject to the application of the general anti-avoidance rule, unless it could be demonstrated that the first gift was in no way related to or contingent on the second.

Similarly, a non-resident could settle property on a trust for a Canadian resident who would then make a gift of equivalent property to the non-resident. The success of this plan would also be subject to the application of the general anti-avoidance rule, unless, again, it could be demonstrated that the settlement of property was in no way related to or contingent on the gift of equivalent property.

Gifts by Canadian-Resident Settlors

Estate Freeze

Since a non-resident personal trust is tax-neutral as compared with a personal trust that is resident in Canada, a non-resident trust may be considered in order to implement an estate freeze in the same way as a resident trust. In effect, common shares of a small business corporation may be converted into fixed-value preference shares pursuant to section 86, and new common shares of the corporation would then be issued for nominal consideration to a non-resident inter vivos trust formed for the benefit of a spouse or children. The trust should use funds borrowed at a commercial rate of interest to subscribe for the shares. If a spouse is a beneficiary of a discretionary trust, a parent rather than the other spouse should be the settlor.[60]

Although the use of a non-resident offshore trust for the implementation of an estate freeze does not usually offer any income tax advantages over the use of a domestic trust, it can be useful in order to combine the estate freeze with a plan to protect assets from creditors or from the possibility of the reintroduction of estate taxes or exchange controls, for example.

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[60] If the spouse of a beneficiary of a discretionary trust is the settlor thereof, regulation 2800(3)(e) of the Act requires that all accumulating income be taxable to the spouse rather than to all discretionary beneficiaries. For further discussion regarding this typical structure, see Jack Bernstein, "Tax Planning for Personal Trusts," in the 1988 Conference Report, supra footnote 3, 40:1-43, at 40:13-16.

Other Uses Resulting in Deferral and Avoidance

Certain very aggressive and complex plans have been suggested for use by Canadian-resident settlors that technically result in the same advantages of indefinite deferral and avoidance that are possible when the settlor is and remains a non-resident of Canada, as described above. Obviously, such plans should be implemented only after the possible application of the general anti-avoidance rule has been carefully considered.

Planning for Migration

Trust for Immigrant

As indicated above, section 94 of the Act will not apply until January 1 of the year in which the contributor-settlor has resided in Canada for an aggregate of 60 months. Accordingly, an individual who has never resided in Canada may shelter accumulating income from Canadian taxation for the first 60 months of his residence in Canada by using a non-resident trust. Section 94.1 of the Act also should not apply to the trust.

The typical procedure for establishing a non-resident trust for the benefit of a new immigrant may be described as follows:

• the immigrant settles a discretionary inter vivos trust for the benefit of himself and his adult children in an appropriate tax haven jurisdiction with a non-income-producing property such as a gold coin;

• the immigrant incorporates a company in a tax haven jurisdiction and transfers assets to it in exchange for retractable preferred shares; and

• the immigrant acquires Canadian residence and then gifts the preference shares to the trust.

During the 60-month period, the company will pay no dividends to the trust. If the immigrant requires funds, the company shall transfer funds to the trust by redeeming preferred shares, and the trust could distribute the funds to the immigrant as a tax-free capital distribution.[61] Under this trust structure, the attribution rules should not apply to the immigrant or his family.[62]

Trust for Emigrant

An indefinite deferral and avoidance of Canadian income tax could be achieved by a person emigrating from Canada who wishes to give property to members of his family who will continue to reside in Canada. In effect, if the emigrant settles property by inter vivos gift on an offshore

[61] By virtue of subparagraph 104(13)(c)(ii).

[62] For additional discussion on the methods of setting up offshore trusts for immigrants, see Sunny Ngan, "Foreign Trust Structures for Immigrants," Personal Tax Planning feature (1990), vol. 38, no. 5 *Canadian Tax Journal* 1264-83; and Martin Day, "Offshore Trust Planning: The Fifth Year and Beyond," International Tax Planning feature (1993), vol. 41, no. 5 *Canadian Tax Journal* 979-1000.

trust structured and administered so as not to be resident in Canada, and if the emigrant is the sole contributor to the trust, then, as indicated above, section 94 will not apply to impute income to the Canadian-resident beneficiaries of the trust in any calendar year that begins more than six months after the emigrant abandoned his Canadian residence. Furthermore, section 94.1 also should not apply in the same circumstances.

As with the establishment of non-resident trusts by non-residents, discussed above, in order to ensure the avoidance of all Canadian tax, the non-resident trust should not hold property that is taxable Canadian property, Canadian resource properties, real property inventory situated in Canada, or property that gives rise to payments that attract part XIII withholding tax.

Finally, as discussed above with respect to gifts and bequests by non-residents, Canadian tax will be permanently avoided and not just deferred when the trust income is accumulated in the trust and is ultimately distributed to the Canadian-resident beneficiary as non-taxable capital.

It should be noted that, unlike the situation of the non-resident contributor discussed above, the contributor to this type of trust is subject to the deemed fair market value disposition rule in paragraph 69(1)(b) of the Act. Consequently, the contribution of appreciated assets that qualify as taxable Canadian property, and therefore qualify for the exemption from the deemed disposition rules on cessation of Canadian residence,[63] should be avoided if possible.

Asset Protection

A basic creditor-proofing plan would involve the setting up of a discretionary inter vivos trust in an appropriate tax haven jurisdiction that has specific asset protection legislation. The beneficiaries could be the settlor, the settlor's spouse, and the settlor's children. The trust could include, for added protection, a "protective" clause under which a beneficiary will cease to have an income interest in the trust on his or her bankruptcy or on the attempted alienation of his or her interest in the trust. Although this arrangement would protect the assets from future creditors of the settlor, no income tax deferral would be available. In effect, if a beneficiary settled the trust, he would be taxable on all of the income earned by the trust pursuant to the attribution rules.[64]

CONCLUSION

A properly designed and implemented non-resident offshore trust may provide a means of estate planning or of protecting assets against future creditor claims of its settlor that would be tax-neutral or tax-advantageous

[63] Subsection 128.1(4).

[64] Subsection 75(2).

as compared with similar uses of resident trusts or corporations. In particular, the potential tax-deferral and tax-avoidance possibilities offered by the use of non-resident offshore trusts by non-resident donors for the benefit of Canadian-resident beneficiaries render them one of the few remaining tax-planning tools in the tax planner's arsenal against Canada's high taxes.