

## Budget 2010: foreign investment entity/non-resident trust rules revisited

On March 4, 2010, Canadian Finance Minister Jim Flaherty tabled the federal Government's 2010 Budget. While the Budget did not propose broad-based personal or corporate tax changes, the Government did act upon a pledge made in the 2009 Budget to review, and potentially revise, the complex set of proposed amendments to the *Income Tax Act (Canada)* (the "Tax Act") relating to the taxation of non-resident trusts and so-called "foreign investment entities" (the "FIE/NRT Proposals"). The FIE/NRT Proposals were first unveiled by the federal Government in its 1999 Budget and have been the subject of much heated debate over the past decade. The most recent version of the FIE/NRT Proposals, contained in Bill C-10 that was before the 2nd session of the 39th Parliament, came close to being enacted, but "died on the order paper" when Parliament was dissolved as a consequence of the 2008 federal election. New proposals contained in Budget 2010 are intended to replace the historical FIE/NRT Proposals and are expected to form the basis for revised legislation that will be released for public comment in the future.

### background

The broad objective of the proposed "foreign investment entity" and non-resident trust rules was to prevent Canadian taxpayers from using foreign intermediaries to defer or avoid the payment of Canadian tax in a manner that the federal government considered to be inappropriate.

### new "foreign investment entity" proposals

In Budget 2010, the Government effectively indicated that it is withdrawing its historical proposals relating to the taxation of "foreign investment entities". In place of such past proposals, the Government has proposed limited changes to certain existing taxation rules as a means of satisfying its stated policy objectives. Specifically, the existing rules relating to the taxation of "offshore investment fund property" will be modified to increase the calculated rate for the deemed income inclusion attributable to the holding of such property under certain circumstances. The scope of existing section 94 of the Tax Act (which relates to the taxation of non-resident trusts) will also be broadened.

In addition to replacing the historical FIE/NRT Proposals with more limited proposals, the Government will increase the amount of information required to be provided to the CRA by taxpayers, along with the time period in which the CRA will be permitted to reassess a taxpayer's returns under certain circumstances. Budget 2010 proposes to extend by three years the normal reassessment period in respect of interests in "offshore investment fund property" and trusts captured by existing section 94 of the Tax Act. The Government has also proposed to expand the existing "specified foreign property" reporting obligations by requiring the submission of more detailed information on the foreign property holdings of taxpayers.

## new non-resident trust proposals

In contrast to the Government's abandonment of the "foreign investment entity" proposals, Budget 2010 proposes to retain many of the Government's historical proposals relating to the taxation of non-resident trusts. However, the Government announced its intention to substantially modify such proposals to "simplify the outstanding proposals and to better target arrangements that seek to avoid paying the appropriate amount of Canadian tax".

At the most basic level, each of the Government's historical proposals relating to the taxation of non-resident trusts worked by deeming certain trusts that would otherwise not be considered to be resident in Canada for tax purposes to be Canadian residents under certain defined circumstances. The deeming rules contained in such proposals required the determination of whether the non-resident trust at issue (i) has "resident beneficiaries" or "resident contributors" and (ii) is an "exempt foreign trust". The historical proposals also contained certain provisions that could operate to make the "resident beneficiaries" or "resident contributors" of a trust that is deemed to be resident in Canada jointly and severally liable for certain of the Canadian tax-related liabilities of the non-resident trust.

Budget 2010 contains proposals intended to simplify and limit the scope of the historical non-resident trust proposals, including the following:

- A special exemption will be introduced to make it clear that Canadian tax-exempt entities that invest in a non-resident trust will not be considered to be a "resident beneficiary" or a "resident contributor" for the purposes of the proposed non-resident trust rules;
- Refinements to the legislative proposals will be introduced to ensure that bona fide non-resident commercial trusts are not deemed to be resident in Canada for Canadian tax purposes;
- The concept of "restricted property", which has been relevant to the operation of the historical proposals, will be narrowed; and
- The historical proposals will be revised to ensure that conventional loans made by a Canadian financial institution to a non-resident trust in the ordinary course of the institution's business will not inadvertently result in the financial institution being considered to be a "resident contributor" to the trust.

## taxation of a deemed resident trust

In Budget 2010, the Government acknowledged that its policy objectives do not require that all of the income earned by a particular trust that is deemed to be resident in Canada should be subject to Canadian taxation. Accordingly, the Budget proposes that the property of a trust deemed to be resident in Canada be divided into a “resident portion” and a “non-resident portion”. The “resident portion” will consist of property of the trust that is connected to contributions from residents and certain former residents of Canada (and any property substituted for such property). The “non-resident portion” will consist of any property that is not part of the “resident portion” of the property of the trust.

Budget 2010 proposes to exclude most income arising from property that is part of the “non-resident portion” of a trust’s property from the trust’s income for Canadian tax purposes. Special rules will be introduced to determine how income retained or distributed by a trust that is deemed to be resident in Canada will be allocated between the two types of trust property for Canadian tax purposes. Special provisions will also be introduced to deal with (i) the application of Part XIII withholding tax to distributions made by a deemed resident trust, and (ii) the payment of foreign taxes by a deemed resident trust.

## trust income attribution

Budget 2010 proposes the introduction of special attribution rules to address concerns that “resident contributors” to a trust may be held liable for tax on the income of the trust that has no connection to the property contributed to the trust by the “resident contributor”. Specifically, under the new proposals, “resident contributors” to a deemed resident trust will be directly subject to tax on a proportionate share of the trust’s income for each taxation year. However, such contributors will not be jointly and severally, or solidarily, liable for the other income tax liabilities of the trust.

The relevant reassessment period for income in respect of trusts subject to the revised non-resident trusts provisions will be extended by three years.

## date of application

Budget 2010 proposes that the new measures that will replace the historical “foreign investment entity” proposals will apply for taxation years that end after March 4, 2010. Special measures will be enacted to provide relief to taxpayers who voluntarily complied with the historical “foreign investment entity” proposals in the past.

Budget 2010 proposes that the updated proposed measures regarding the taxation of non-resident trusts apply in respect of the 2007 and subsequent taxation years. However, the attribution of income to “resident contributors” will only apply to taxation years that end after March 4, 2010.

## public consultation process

Budget 2010 proposes a multi-stage process for the review, and possible future enactment, of the latest version of the non-resident trust provisions and the measures that will replace the historical “foreign investment entity” proposals. The relevant proposals contained in Budget 2010 will be open for public comment until May 4, 2010. A panel consisting of respected tax practitioners and representatives of the Department of Finance will review such comments and make recommendations on draft legislation to implement the revised proposals. It is expected that such draft legislation will thereafter be released for further public comment.

## future implications

Budget 2010 reflects a material change in the manner in which the Government intends to address the policy concerns previously targeted by the FIE/NRT Proposals. The historical “foreign investment entity” proposals appear to have been replaced by a more modest set of proposed legislative amendments. Similarly, the proposed legislative changes relating to the taxation of “non-resident trusts” also indicate that the Government has seriously considered many of the technical and policy-oriented concerns previously raised by interested stakeholders. Nevertheless, the updated proposals, particularly those relating to the taxation of non-resident trusts, remain complex. The new proposals relating to the taxation of non-resident trusts introduce several new technical concepts, including specialized tracing and ordering rules that will require careful consideration.

Taxpayers with interests in foreign entities would be well advised to carefully consider the new proposals reflected in Budget 2010 to determine how they may apply in light of their own circumstances. Taxpayers with unique or specialized concerns may wish to take advantage of the ability to submit formal comments to the Department of Finance on the new proposals.

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### a cautionary note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted. © McMillan LLP 2010.