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PROPOSED FOREIGN INVESTMENT ENTITY RULES TO TAKE EFFECT JANUARY 1, 2003

Canadians holding offshore investments should take note of new “foreign investment entity” rules (FIE Rules) tabled in the House of Commons on October 11, 2002. The pending legislation would replace and toughen-up the existing “offshore investment fund property rules” in the *Income Tax Act*. The proposed FIE Rules extend well beyond existing law and will significantly affect many Canadian taxpayers investing in foreign corporations, trusts, partnerships, funds and other entities. The new FIE Rules are intended to apply to taxation years beginning after 2002.

CURRENT RULES

The current offshore investment fund property rules require Canadian taxpayers to include in their income a calculated annual return on “offshore investment fund property”. This provision applies only where a “main reason” for the investment was the reduction or deferral of Canadian tax that would have arisen if the offshore investment income had been earned directly by the Canadian investor. It has proven to be difficult for the Canada Customs and Revenue Agency to satisfy the “main reason” test and the offshore investment fund property rules have rarely been applied. The FIE Rules will give CCRA a more easily applied tax collection tool because the tax avoidance motive has been eliminated for many types of offshore investment.

HOW THE FIE RULES WORK

Canadian taxpayers holding a participating interest in an FIE will be required to either:

- include in taxable income an amount calculated by multiplying their cost of the FIE investment by a prescribed interest rate (the “Designated Cost Method”); or
- mark-to-market their investment at the end of each taxation year and include the full amount of any increase in value in taxable income (any decline in value would be treated as a loss from property deductible only to the extent of income already included as a result of the FIE Rules) (the “Mark-to-Market Method”).

The Mark-to-Market Method will be available only to the extent the taxpayer elects to have it apply and the FIE has a readily obtainable fair market value. A taxpayer can only elect into the Mark-to-Market Method in either the first year the FIE Rules apply or the year in which the interest in the FIE is first acquired. An election will apply to all identical FIE properties. The rules will not allow a taxpayer to move between the Designated Cost and Mark-to-Market Methods.

The Mark-to-Market Method may result in a comparatively larger income inclusion where the increase in the net asset value of the FIE exceeds the prescribed interest rate. Amounts determined using the Mark-to-Market Method would generally be taxed as ordinary income and not as capital gains. Capital gains taxation will be available if the FIE itself is a capital account investor. This would not be the case for a fund with a high portfolio turnover for example.

The FIE Rules will include special provisions to prevent avoidance with the creation of “tracked interests” in entities that are not FIEs or through the creation of an interest in an FIE that would otherwise be exempt.

WHAT INVESTMENTS WILL BE CAUGHT BY THE FIE RULES?

The legislation which details the FIE Rules is complex - more than 50 pages of definitions, application rules and taxing provisions. This is both a sign of the serious approach the government is taking to the perceived abuses of Canadians harbouring their investments offshore and an indication of “legislative overkill”. Needless to say, determining whether an investment is subject to the FIE Rules can be complicated.

As a starting point, all non-Canadian entities will be treated as FIEs unless an exemption or carve-out is available. The most significant carve-out is for a foreign entity whose investment property represents less than one-half of the carrying value of all of its properties. A foreign entity whose principal business is not an investment business will also be exempt from the FIE Rules. Other interests which are excluded from the FIE Rules include employee stock option rights in foreign entities, partnership interests, controlled foreign affiliates, mark-to-market properties of financial institutions, and property held by most tax exempt entities. An investment in an offshore fund that is listed on a recognized foreign stock exchange, has at least 150

unitholders, and the units of which are available for purchase by the general public will not be subject to the FIE Rules if the investor has no “tax avoidance motive”. A similar exemption will apply to widely held and actively traded securities of a foreign fund that is formed under the laws of, and resident in, a country with which Canada has a bilateral tax treaty. A specific rule will deem there to be no tax avoidance motive where an investor holds a Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT) formed in the United States if the investor includes in income any amounts that are payable by the fund in a taxation year. Other than in the cases of widely held funds described above, the FIE Rules will apply to non-exempt investments even though the investor has no tax avoidance motive.

THE AGE OF FIE APPROACHES

All Canadian taxpayers (both individual and corporate) holding foreign investments must consider the potential effect of the FIE Rules. Considerations will include an analysis of whether to elect into the Mark-to-Market Method. For the first quarter of 2003 the prescribed interest rate for the Designated Cost Method is 5%. An investor using the Designated Cost Method may wish to sell and reacquire an FIE interest that has an accrued loss. This would reduce the initial cost amount used in calculating the annual income inclusion. Investors with foreign investment assets are strongly encouraged to obtain advice from a tax professional familiar with their personal circumstances.

This Bulletin was authored by David Wentzell and Mark Lobsinger who are members of our Structured Products Group. The McMillan Binch Structured Products Group is one of the largest groups in Canada dedicated to specialty products and funds offered in the Canadian marketplace. From compliance issues to the creation and implementation of exchange listed structured funds, our Structured Products Group services the needs of a broad range of market participants including securities dealers, market intermediaries, hedge funds and other money managers.

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.

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