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Tax Bulletin

October 31, 2003

Trick or Treat?

Finance Delivers Fourth Version of FIE Rules in Time for Halloween

The candy bags of tax advisors were filled to the brim a day early as the Minister of Finance released 156 pages of draft legislation and 204 pages of explanatory notes relating to the new Foreign Investment Entity ("FIE") and Non-Resident Trust rules to be added to the *Income Tax Act*. The FIE rules have been on the government's agenda since the 1999 Federal Budget. Yesterday's release is the fourth version of the detailed legislative proposals to be made public. There are some important changes embedded in the newest version of the FIE rules (the "Halloween Rules"), which make their debut a little more than a year after the October 11, 2002 version of the rules was released.

The broad objective of the FIE rules is to bring any investment by a Canadian resident in an offshore investment vehicle into the Canadian income tax net. The earlier drafts of the FIE rules have used a variety of methods to accomplish this goal. Like a brochure for a new-model automobile, the Halloween Rules offer taxpayers lots of options as to how they will be taxed.

There are now three methods of accounting for FIE interests. In the absence of an election, the Halloween Rules require taxpayers to establish a "designated cost" of their FIE interests against which a prescribed interest rate will be applied to calculate any required income inclusions. The Halloween Rules allow taxpayers to elect to have gains in the value of their FIE interests be taxed on a mark-to-market basis or, alternatively, to have their "share" of an FIE's income, computed using Canadian income tax rules, included in their income for the taxation year (the accrual method). The accrual method last appeared in the 2001 version of the FIE rules and was reintroduced in the Halloween Rules to provide taxpayers with a larger range of compliance options.

The other substantive changes to the FIE rules are more technical, but may have a significant potential impact on investors and offshore investment structures. Some highlights gleaned from our first read through the material:

Designated Cost to Recognize Accrued Losses

A taxpayer whose FIE investment is subject to tax under the prescribed rate regime must establish a "designated cost" of their FIE interests for purposes of calculating any potential income inclusion. Generally, if the value of a FIE investment acquired before 2003 has declined to less than its original cost, the Halloween Rules will reduce the "designated cost" by the amount of such accrued, but unrealized, loss determined at the end of the last taxation year before 2003 (December 31, 2002 for individuals). The previous version of the rules did not automatically recognize such losses in value.

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Multi-Tier Foreign Funds Get Relief

Under the previous rules, an offshore fund of funds was caught by the complex "tracking interest" rules. The tracking interest rules require investors in an offshore tiered fund structure to use the mark-to-market method of reporting FIE income. The Halloween Rules correct this unintended result by making it clear that an FIE interest will be a tracking interest only if the prescribed rate rules do not apply, by default, to the interest. Investors in foreign fund of funds can now choose which of the three methods of reporting to use.

Canadian GAAP - or something similar

Not everything has been fixed by the latest release. Commentators had complained that previous versions of the FIE rules only recognized accounting conventions adopted in the United States and EU member states as being substantially similar to Canadian GAAP for the purposes of calculations performed under the rules. This left taxpayers that invested in entities that used other accounting conventions unsure whether the conventions would be considered sufficiently similar to Canadian GAAP to allow investors to rely upon the entity's financial statements when applying the FIE rules. The Halloween Rules do not expand the category of accounting conventions that are deemed to be similar to Canadian GAAP.

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There are countless wording changes, provision reorderings and language tinkerings in the Halloween Rules. Any product structuring or investment decision should be completed only after a comprehensive review of the technical fine tuning that has made its way into the Halloween Rules. Members of the McMillan Binch tax and structured funds groups would be pleased to assist you as you sort through the bumper crop of FIE goodies.

FIE Rules Apply for 2003

Slowly, ever so slowly, the FIE rules have evolved. Four years have passed and four drafts of the complex rules have been unveiled since the FIE beast was conceived by the architects of the Income Tax Act. It is not surprising that rules as detailed and voluminous as these have taken this long to gestate. Will the Halloween Rules be the version that comes to life in Parliament? Whether or not that is the case, we know that the FIE rules will apply to the 2003 taxation year.

As noted elsewhere in this bulletin, elections must be made for the first taxation year the FIE rules apply to any participating interest in a foreign investment vehicle. That would be 2003 for most investments currently held by Canadian individuals. Fortunately, the Halloween Rules do provide relief for such elections if the rules are not brought into force in 2003. A special provision will deem elections to have been filed on a timely basis if they are filed by the tax filing due date for the taxation year that includes the day the FIE rules come into force.

Given that there are only 61 days left in 2003 and a host of other measures appear on Parliament's schedule, it is a good bet that the FIE rules will come into force in 2004 (or later). As a result, investors have lots of time to plan which of the three reporting methods is best for any particular FIE investment.

Extra! Extra!
Cash Settled Options and Derivatives Not Subject to FIE Rules

The publication earlier this year of a CCRA (Canada Customs and Revenue Agency) Technical Interpretation dealing with the FIE Rules and cash-settled options put the proverbial cat among the tax community pigeons. In a letter, dated April 24, 2003, the CCRA expressed the opinion that a cash-settled option on a basket of securities of non-resident entities was a "participating interest" in a foreign investment entity (FIE). CCRA reached this conclusion despite the fact that the holder of the option had no right to receive the underlying foreign property. CCRA stated that "the option right is a property that confers a right to acquire directly a property (Canadian funds) the fair market value of which is determined primarily by reference to the fair market value of an interest (securities and other financial products) in the non-resident entities".

Submissions to the CCRA and the Department of Finance were fast and numerous. The letter simply had to be wrong. The foreign property in question was solely a yardstick, a measuring standard to determine how much Canadian currency would be paid on the exercise of the option. Many derivative-based investment structures had been implemented on this reading of the standing version of the FIE Rules (the October 2002 version). While Finance officials agreed with those who objected, the division of responsibility (Finance drafts legislation, while the CCRA interprets and enforces it) meant that the pesky letter would not be sent to the litter box. Rather, the CCRA stuck to its guns.

The release of the October 30, 2003 version of the FIE Rules settles the controversy. The definition of "participating interest" has been revised to expressly carve out contractual rights that are settled by the delivery of money. This should make it clear that cash-settled options and other cash-settled derivatives based on underlying foreign reference property are outside the scope of the FIE Rules.

We can all thank the CCRA for this rare beam of clarity in the morass of words that is the FIE Rules. If we had not weathered the last six months of uncertainty occasioned by the Technical Interpretation, tax advisors would likely still be wrestling with the ambiguity of the previous definition of a "participating interest".

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.

This Bulletin was authored by David Wentzell and Michael Friedman 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.

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