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Non-Resident Trusts and Offshore Investment Fund Properties

I. Introduction

Since the early 1980’s the taxation of non-resident trusts (referred to colloquially as “offshore trusts”) has received significant scrutiny from both the Department of Finance (“Finance”) and the Canada Revenue Agency (the “CRA”). This scrutiny has resulted in considerable legislative changes to the provisions in sections 94 and 94.1 of the Income Tax Act (the “Act”), which address the taxation of non-resident trusts and non-resident investment funds.

Currently, non-resident trusts are taxed on their Canadian-source income and foreign accrual property income (“FAPI”) under section 94 of the Act. Section 94.1 is intended to prevent taxpayers from avoiding or deferring Canadian tax by investing in offshore investment funds that are resident in low-tax jurisdictions. Both sections have been the subject of extensive proposed amendments that were first announced in the 1999 Federal Budget. Since that announcement, the proposed amendments have been before Parliament on multiple occasions but have not been passed into law.

Prior to the 2010 Federal Budget, the proposed amendments were most recently set out in Bill C-10, which died on September 7, 2008 when the October 14, 2008 federal election was called. The proposed amendments in Bill C-10 were to apply to a wider range of non-resident trusts than existing section 94 and would have required those trusts to pay tax on their worldwide income (and not just their Canadian-source income and FAPI). In the case of offshore investment funds, it was proposed that existing section 94.1 be replaced by proposed sections 94.1, 94.2, 94.3 and 94.4, which contained extensive rules governing the tax treatment of foreign investment entities (the “FIE Rules”).

I would like to acknowledge the assistance provided by Brent Pidborodchynski of Thorsteinssons LLP in updating this year’s version of the paper.

2 RSC 1985, c.1 (5th supp.), as amended. Unless otherwise stated herein, all statutory references are to the Income Tax Act and the regulations thereunder (the “Regulations”).

3 Prior to this, the amendments were set out in Bill C-33 which died when Parliament was prorogued on September 4, 2007.
The proposed rules in Bill C-10 were subsequently criticized by the Advisory Panel on Canada’s System of International Taxation (the “Panel”) in its report to Finance. The Panel concluded that those proposed amendments should be reconsidered in order to reduce overlap and complexity.

In response to the Panel’s recommendations, the government announced new proposed amendments as part of the 2010 Federal Budget. These proposed amendments were ultimately set out in draft legislation released by Finance on August 27, 2010. With respect to the non-resident trust rules in section 94, the proposed amendments are based on, and substantially modify, the rules that were contained in Bill C-10. Regarding section 94.1, the government announced that it will abandon its proposal to implement the FIE Rules and, instead, the rules in existing section 94.1 will remain in force, subject to relatively minor amendments.

Note, the draft legislation released on August 27, 2010 is still subject to public consultation and further revisions. Once enacted, these rules are generally intended to apply to 2007 and subsequent taxation years. However, certain proposals that were not in Bill C-10 will only apply to taxation years that end after March 4, 2010.

This paper will describe the existing sections 94 and 94.1. It will also describe the proposed amendments to those sections as outlined in the August 27, 2010 draft legislation. For the time being, these proposed amendments remain the best indication of how non-resident trusts and offshore investment funds will be taxed in the future. Obviously, taxpayers and their advisors will need to review the status of any amendments to sections 94 and 94.1 prior to implementing a transaction that could be affected by those rules.

The multiple proposed amendments to section 94 and 94.1 can give rise to some confusion of terminology. For the purposes of this paper, a reference to the “Existing Rules” means the rules in sections 94 and 94.1 that are currently in force. A reference to the “Proposed Rules” means the amendments that were set out in the August 27, 2010 draft legislation.
II. Existing Non-Resident Trust Rules

1. Common Law Test For Residency Of A Trust

A Canadian-resident *inter vivos* or testamentary trust is generally subject to tax on its undistributed taxable income. In contrast, a non-resident *inter vivos* or testamentary trust is generally only subject to Canadian tax on its income earned in Canada (absent the application of section 94). Therefore, the starting point in determining which regime applies is a determination of whether the trust is resident in Canada for the purposes of the Act.

Subject to specific deeming rules in the Act, the legal residence of a trust for Canadian tax purposes is determined by reference to common law principles. Canadian tax practitioners were traditionally of the view that the residence of a trust should be determined primarily by reference to the place where the trustee resides. This principal was stated in *Thibodeau Family Trust v. The Queen.* In that case, the Federal Court-Trial Division was required to determine whether the Thibodeau Family Trust was a resident of Canada or Bermuda for the purposes of the Act. The trust was a discretionary trust that required a majority decision of the trustees on all matters of trustee discretion (two of three trustees were residents of Bermuda). The Court held that because a majority of the trustees were resident in Bermuda, and because the trust document required majority decisions on all matters of trustee discretion, the trust was a resident of Bermuda.

However, in the recent decision of *St. Michael Trust Corp. et al. v. The Queen,* the Court held that the residence of a trust should be determined according to the “central management and control test” used to determine corporate residence.

The *St. Michael Trust* case involved an estate freeze that included two Barbados trusts. The freeze was carried out in respect of shares of a Canadian resident corporation in the automotive industry,

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4 78 DTC 6376 (F.C.T.D.).
5 2010 DTC 5189 (F.C.A). At the Tax Court of Canada, this case was known as “Garron Family Trust”.
6 The central management and control test was set out in *De Beers Consolidated Mines Ltd. v. Howe,* [1906] A.C. 455 (H.L.). The test looks to “where the central management and control actually abides”.
PMPL. Prior to the freeze, the shares of PMPL were held 50% by Mr. Dunin and 50% by Mr. Garron. As part of the freeze, trusts were established for the benefit of Garron and his family and Dunin and his family, respectively. The sole trustee of both trusts was St. Michael Trust Corp., a licensed and regulated trust company resident in Barbados. Garron and Dunin froze their respective interests in PMPL by exchanging their common shares for preferred shares of PMPL. New common shares of PMPL were then issued for nominal cash consideration to two Canadian holding corporations that had been incorporated by the Barbados trusts. At the time of the freeze, the common shares of PMPL were valued at approximately $50,000,000.

Two years after the freeze, the Barbados trusts sold the majority of their shares of their respective holding corporations for approximately $532,000,000. The trusts made remittances required under section 116 of the Act in respect of the dispositions, then sought a return of those funds on the basis that the trusts were exempt from Canadian tax pursuant to the Canada-Barbados Income Tax Treaty. The Minister disagreed and assessed the trusts accordingly.

The Tax Court of Canada held that the “central management and control test” is the appropriate test for determining the residence of a trust, with such modifications as are necessary to make the test work in the trust context. The Federal Court of Appeal upheld the Tax Court of Canada’s decision and stated that applying the central management and control test in the trust context entails determining where the powers and discretions of the trustee are “really” being exercised. The Court also stated that central management and control would typically abide with the trustee of a trust even in cases where beneficiaries put strong recommendations to the trustee, provided that the trustee is free to decide how to exercise the powers and discretions under the trust. However, central management and control will not abide with the trustee if the powers and discretions are exercised by an outsider in such manner that the appointed trustee has been “displaced”. On which side of the line a case falls is a question of fact that can be answered only after considering the evidence in its totality.

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7 Garron’s interest in PMPL was held indirectly through a corporation, GHL, the shares of which were held by Garron, his spouse and the Garron Family Trust.

8 In particular, Article XIV(4) of the Canada-Barbados Income Tax Treaty provides that gains from the alienation of property may only be taxed in the contracting state of which the alienator is resident.
The Federal Court of Appeal accepted the Tax Court of Canada’s finding that the trustee was not exercising the main powers and discretions under the Barbados trusts, and that those powers and discretions were really being exercised in Canada by Dunin and Garron. Accordingly, the Federal Court of Appeal upheld the Tax Court of Canada’s decision that the trusts were resident in Canada for the purposes of the Act.

It must be noted that leave has been sought to appeal the St. Michael Trust case to the Supreme Court of Canada. It remains to be seen whether that Court will grant leave to appeal and, if so, whether that Court will agree that the central management and control test is the correct test for determining the residence of a trust under the Act.

2. **Conditions for the Application of the Existing Non-Resident Trust Rules**

Section 94 is an important element of the FAPI regime set out in the Act and operates to tax certain non-resident trusts on their passive income. In this manner, section 94 imposes Canadian tax on investment income earned outside Canada by certain non-resident trusts. Very generally, the non-resident trust rules in existing section 94 will apply to non-resident trusts where there is both a Canadian-resident beneficiary and a Canadian-resident contributor.

One of the preconditions to the application of existing section 94, which is outlined in paragraph 94(1)(a), is that a trust must have a Canadian resident who is “beneficially interested” in the trust. This precondition will be met where a person resident in Canada is “beneficially interested” in a trust either directly or indirectly through a corporation, trust or controlled foreign affiliate (“CFA”) of the person at any time in the taxation year of the trust. The definition of “beneficially interested” has been amended several times in recent years to try to expand its scope. However, Finance still believes that there is room for abuse and they have eliminated this requirement in the proposed legislation, which is discussed below in detail.

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9 “Beneficially interested” is defined in subsection 248(25) to include a person entitled to any right to income or capital of a trust whether immediate or future, whether absolute or contingent or whether conditional on the exercise of any discretion. Further, pursuant to paragraph 248(25)(b), a person is deemed to be beneficially interested in a trust if the trust acquired property from that person (or any non-arm’s length party or foreign affiliate) and the trust includes a power to appoint new beneficiaries.
Paragraph 94(1)(b) imposes a second precondition to the application of the existing non-resident trust rules which requires that the trust (or a non-resident corporation that would be a CFA of the trust if the trust was resident in Canada) has acquired property, directly or indirectly, from a person who:

(i) was (or was related to) the Canadian-resident beneficiary referred to in paragraph 94(1)(a), or was an uncle, aunt, nephew or niece of that Canadian-resident beneficiary;

(ii) was resident in Canada at any time in the previous 18 months (or at any time during the 18 month period preceding the contributor’s death); and

(iii) has been resident in Canada for a period or periods totalling 60 months.

Additionally, the requirement in paragraph 94(1)(b) will also be met if the interest in the trust was purchased by a Canadian-resident beneficiary or acquired by way of a gift, inheritance or the exercise of a power of appointment from a person that would have met the Canadian-resident contributor test outlined above. Thus, generally, the test for a Canadian-resident contributor in paragraph 94(1)(b) will be met when a trust acquires property, directly or indirectly, from a Canadian resident or when a Canadian resident purchases an interest in a trust.

Under the existing section 94, a non-resident can establish a non-resident trust for the benefit of a Canadian resident without attracting liability under section 94 (assuming the trust does not otherwise acquire property from a Canadian resident). A Canadian resident can also establish a trust for the benefit of non-residents without section 94 applying. As a result, section 94 currently only applies when a Canadian resident transfers property (either directly or indirectly) to a non-resident trust for the direct or indirect benefit of a Canadian beneficiary.

10 The following trusts are expressly excluded from this element of the test for a Canadian resident contributor: (i) an inter vivos trust created before 1960 by a person who was a non-resident at that time; (ii) a testamentary trust that arose as a consequence of the death of an individual whose death occurred before 1976; and (iii) a trust governed by a foreign retirement arrangement.

11 Subsection 94(6) deems the trust to have acquired property from any person who has given a guarantee on the trust’s behalf, or from whom it has received any other financial assistance whatever.

12 Pursuant to clause 94(1)(b)(i)(B) the test for a Canadian resident contributor will be met whether the trust acquires property from a person or entity meeting the criteria established in clause 94(1)(b)(i)(A) or from a non-arm’s length trust or corporation that acquired the property from such person or entity.

13 The requirement that the person from whom the trust has acquired property be resident in Canada for 60 months allows immigrating non-residents to avoid Canadian tax on investment income generated from property contributed to a non-resident trust for up to five years. These structures are commonly referred to as “immigration trusts”.
3. *Application of the Existing Non-Resident Trust Rules*

As discussed above, under the Existing Rules, a non-resident trust will be subject to tax in Canada under section 94 if the trust has a Canadian-resident beneficiary who is related to (or is the uncle, aunt, nephew or niece) of a Canadian resident who has contributed property to the trust. However, the tax payable by the trust will differ depending on whether the trust is a discretionary or non-discretionary trust.

(a) Discretionary Trusts

A discretionary non-resident trust that has a Canadian-resident beneficiary and a Canadian-resident contributor will be subject to the rules outlined in paragraph 94(1)(c). Paragraph 94(1)(c) deems such a trust to be a resident of Canada for the purposes of Part I of the Act and provides that the trust is subject to tax on its Canadian-source income and on its FAPI.\(^\text{14}\) The trust’s Canadian-source income is the income on which it would otherwise be subject to Canadian tax as a non-resident calculated in accordance with section 115 of the Act. In addition, a discretionary trust subject to tax under section 94 is required to include all of its FAPI in its income. There is no mechanism to reduce the trust’s tax based on the relative interests of resident and non-resident beneficiaries. However, pursuant to subsections 104(6) and 94(3), to the extent that a portion of the trust’s income or FAPI has been distributed in the year or has become payable to a beneficiary in the year, the trust is entitled to deduct such amount from its income.

The definition of FAPI found in section 95(1) is expanded by paragraph 94(1)(c) for the purposes of calculating the FAPI of a non-resident discretionary trust. Paragraph 94(1)(c) operates to include in FAPI all dividends received by a non-resident trust (including dividends received from a foreign affiliate) and all gains realized by a non-resident trust (including gains on the sale of shares of foreign affiliates engaged in active business). The expansion of the definition of FAPI was introduced to counter a planning opportunity that was previously available to non-resident trusts. Specifically,

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\(^\text{14}\) This article is not intended to outline the elements of FAPI. These issues are addressed elsewhere at this conference.
because a trust has the ability to convert income to capital, if a non-resident trust was not taxed on dividends and gains in the year of receipt, the trust was able to distribute such income or gains by way of a tax-free capital distribution to Canadian beneficiaries in a subsequent year.

Because paragraph 94(1)(c) deems certain non-resident trusts to be persons resident in Canada for the purpose of Part I, non-resident trusts are subject to provisions of the Act that would otherwise only apply to Canadian-resident trusts. Like a Canadian-resident trust, an *inter vivos* non-resident trust is taxed at the highest marginal rate, whereas a non-resident testamentary trust is taxed at the marginal rates applicable to individuals. Non-resident trusts that are deemed to be resident in Canada for the purposes of Part I are also subject to the 21-year deemed disposition rule in subsection 104(4).

Subparagraph 94(1)(c)(ii) clarifies that for the purposes of the foreign tax credit available under section 126, a non-resident discretionary trust’s FAPI is deemed to be income from a source in the country other than Canada that the trust would be resident in but for subparagraph 94(1)(c)(i). Any income or profits tax paid by the trust (other than pursuant to section 94) that may reasonably be regarded as having been paid in respect of this income is deemed to be non-business income tax paid by the trust to the government of that country. As a result, such trusts are able to utilize the foreign tax credit available under section 126.

It should be noted that paragraph 94(1)(c) only operates to deem non-resident trusts to be Canadian residents for the purposes of Part I. Therefore, payments to a non-resident discretionary trust are subject to the withholding tax required by Part XIII of the Act. However, provided the income precipitating the withholding under Part XIII is included in the trust’s taxable income, the trust will be entitled to a tax credit in respect of its Part XIII tax.

Under subsection 94(2), Canadian-resident beneficiaries and contributors to a non-resident trust are jointly and severally liable for the unpaid taxes, penalties and interest of the trust. This liability is limited to the total of amounts paid to them by the trust, amounts in respect of which they are entitled to enforce payment and any proceeds of disposition received in respect of an interest in the trust.

A non-resident discretionary trust is also deemed to be a Canadian resident for purposes of sections 233.3 and 233.4. Sections 233.3 and 233.4 impose the reporting obligations in respect of “specified
foreign property”. Where a trust is deemed to be a Canadian resident by virtue of section 94 and it owns “specified foreign property” with a cost in excess of $100,000 or holds an interest in a foreign affiliate, the trust will be required to comply with the reporting requirements under sections 233.3 and 233.4 of the Act.

(b) Non-Discretionary Trusts

If existing section 94 applies to a non-discretionary non-resident trust, paragraph 94(1)(d) operates to deem the trust to be a corporation for any beneficiary whose beneficial interest in the trust is not less than 10% of the aggregate fair market value of all beneficial interests in the trust. As a result, any beneficiary holding a beneficial interest that has a fair market value of 10% or more of all of the beneficial interests in the trust will be subject to the FAPI rules as though the trust were a corporation. A beneficiary holding an interest in a non-resident non-discretionary trust that is less than the 10% threshold will not be subject to tax under existing section 94, although existing section 94.1 could apply to such an interest.

III. Proposed Non-Resident Trust Rules

1. Introduction

To address perceived abuses of the non-resident trust rules in existing section 94, Finance has proposed certain amendments to that section. As noted at the beginning of this paper, the Proposed Rules released on August 27, 2010 have not yet been enacted and are still subject to public consultation and further revisions.

The Proposed Rules, if enacted in their current form, would significantly broaden the scope of existing section 94. As discussed, the Existing Rules apply to non-resident trusts where there is both a Canadian-resident beneficiary and a Canadian-resident contributor to the trust. The Proposed Rules would no longer include a requirement that there be both a Canadian-resident beneficiary and a Canadian-resident contributor to the trust. Instead, the Proposed Rules focus on taxing non-resident
trusts that have received contributions from Canadian residents regardless of whether any Canadian resident is beneficially interested in the trust.

2. **Conditions for the Application of the Proposed Non-Resident Trust Rules**

Proposed subsection 94(3) deems certain non-resident trusts to be resident in Canada for the purpose of computing liability for tax under the Act. Proposed subsection 94(3) applies where a non-resident trust (other than an “exempt foreign trust”, which is discussed in more detail below) has either a “resident contributor” or a “resident beneficiary”.

A “resident contributor” is defined in proposed subsection 94(1) to be a “contributor” who is resident in Canada at that time and has been a resident of Canada for periods that total at least five years. A “contributor” is a person or partnership (other than an “exempt person”) that has made a “contribution” to the non-resident trust. The meaning of “contribution” is discussed in greater detail below, but very generally includes any transfer or loan (other than an “arm’s length transfer”), directly or indirectly, of property to a trust. Thus, in contrast to the Existing Rules, proposed section 94 will apply where a Canadian-resident person contributes property to a trust exclusively for the benefit of non-resident persons. From a tax policy perspective, it is not clear why the rules have been expanded to apply in this circumstance, since the establishment of a non-resident trust benefiting only non-residents is analogous to giving the property to a non-resident, a situation that would not otherwise attract Canadian tax after the initial gift.

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15 The definition of “resident contributor” does not include an individual that has made a “contribution” to a trust established before 1960 by a person that was a non-resident at that time, provided that the individual has not made any “contributions” to the trust after 1959. In addition, the immigration trust exception is preserved because the definition of “resident contributor” requires the contributor to have been resident in Canada for at least 60 months.

16 A “person” includes any word or expression that is descriptive of a person, and specifically includes a corporation.

17 The definition of “exempt person” in proposed subsection 94(1) includes certain tax-exempt entities, including (i) Her Majesty in right of Canada or a province; (ii) persons exempt from tax under subsection 149(1); (iii) federal or provincial pension funds; (iv) certain trusts or corporations established in connection with a workers compensation program; (v) a trust resident in Canada all of the beneficiaries of which are exempt persons; (vi) a Canadian corporation all of the shares of which are held at by exempt persons; (vii) a Canadian corporation without share capital all of the property of which is held for the benefit of exempt persons; and (viii) a partnership all the members of which are exempt persons.
A “resident beneficiary” is defined as a person (other than a “successor beneficiary”\textsuperscript{18} or an “exempt person”\textsuperscript{19}) that is a Canadian-resident beneficiary of the trust, where at that time there is a “connected contributor” to the trust. A “connected contributor” is defined as a contributor that has made a contribution to the trust, other than a person that has only made contributions to the trust at a “non-resident time”.\textsuperscript{20} In addition, if the person is an individual (other than a trust) the “connected contributor” must have been resident in Canada for periods totalling five years.\textsuperscript{21} Thus, the term “resident beneficiary” is somewhat misleading, as the definition generally requires not only a beneficiary that is resident in Canada, but also a contributor that was a resident of Canada within five years of the time of the contribution (either before or after). Therefore, if a non-resident person settles a non-resident trust for the benefit of a Canadian at a non-resident time, proposed section 94 will not apply, provided no additional contributions are made to the trust by residents of Canada.\textsuperscript{22}

(a) Meaning of “Contribution”

As noted above, proposed section 94 generally requires that a “contribution” be made by a person or partnership that is either currently a resident of Canada or was a resident of Canada within five years of the time of the “contribution”. Thus, the determination of whether a person has made a “contribution” is a key element in the application of proposed section 94.

In the proposed amendments to subsection 94(1), a particular person or partnership will be considered to have made a “contribution” to a trust where that person or partnership has: (i) made a transfer or loan to the trust; (ii) made a transfer or loan as part of a series of transactions or events

\textsuperscript{18} The definition of “successor beneficiary” includes a beneficiary whose interest is solely contingent on the subsequent death of an individual that is a contributor, or is related to a contributor.

\textsuperscript{19} Supra note 17.

\textsuperscript{20} Pursuant to the definition of “non-resident time” in proposed subsection 94(1), a transfer made by an entity within five years of becoming, or ceasing to be, a resident of Canada will not be considered to have been made at a “non-resident time”. Further, pursuant to proposed subsection 94(10), the definition of “non-resident time” will be applied with retroactive effect, such that a person will be considered to have made a contribution at a time other than a non-resident time if that person becomes resident in Canada within five years of making such a contribution. A special 18-month time period applies to a trust created by, or contributions arising on, the death of an individual. Therefore, a non-resident who dies more than 18 months but less than 60 months after leaving Canada and upon whose death a trust is created will not be considered to be a “connected contributor” to the trust.

\textsuperscript{21} As such, the immigration trust exception is preserved (i.e., there will not be a connected contributor to the trust until the immigrant has been a Canadian resident for 60 months).

\textsuperscript{22} This has often been colloquially referred to as a “granny trust” (i.e., a non-resident grandparent settles a trust for the benefit of Canadian resident grandchildren). Under the Proposed Rules, a trust created in this manner will still not fall within section 94.
that includes a transfer or loan by another person or partnership to the trust where the transfer by that other person or partnership can reasonably be considered to be in respect of the transfer by the particular person or partnership; or (iii) become obligated to make a transfer or loan as part of a series of transactions or events that includes a transfer or loan by another person or partnership to the trust where the transfer to the trust by that other person or partnership can reasonably be considered to be in respect of the particular person or partnership’s obligation. However, the definition of “contribution” specifically excludes an “arm’s length transfer”. Thus, the definition of “contribution” includes direct and indirect transfers or loans to a trust, other than “arm’s length transfers”.

Proposed subsection 94(2) contains a number of rules which significantly expand the scope of the definition of “contribution”. For example, where a trust has made a contribution to another trust, paragraph 94(2)(n) deems each contributor to the original trust to have made a contribution to the other trust. Paragraph 94(2)(o) deems a partnership and the members of that partnership to have made a contribution to any trust to which the partnership has made a contribution. Paragraph 94(2)(q) deems the acquisition of a “specified fixed interest” in a trust from a third party, or a right to acquire a “specified fixed interest” in a trust, to constitute a contribution directly to the trust.

As noted above, in order to have a “contribution” there must be a “transfer or loan”, directly or indirectly, of property to a trust, other than an “arm’s length transfer”. The meaning of both of these terms is discussed below.

(b) Meaning of “Transfer or Loan”

The terms “transfer” and “loan” are not defined in the Proposed Rules. However, proposed subsection 94(2) deems a number of events to constitute a transfer or loan for the purpose of proposed section 94. These deeming rules clarify and significantly broaden the scope of what constitutes a transfer or loan. Proposed subsection 94(2) deems the following to be transfers or loans of property:

(i) a transfer or loan to another person or partnership (other than an “arm’s length transfer”) where the fair market value of the trust’s assets increase or the trust’s liabilities decrease as a result of the transfer (paragraph 94(2)(a));
(ii) the provision of a guarantee or financial assistance to another person or partnership (paragraph 94(2)(d));

(iii) the provision of certain services after June 22, 2000 (other than “exempt services”) (paragraph 94(2)(f));

(iv) the acquisition of shares of a corporation, interests in a trust or partnership or debt owing by another entity from that corporation, trust or partnership (paragraph 94(2)(g)(i) to (iv));

(v) the acquisition of rights to acquire or be loaned property after June 22, 2000 (paragraph 94(2)(g)(v); and

(vi) an obligation to do an act that would if done otherwise constitute a transfer or loan (paragraph 94(2)(i)).

Proposed paragraph 94(2)(k) applies to bring certain third party transfers within the meaning of transfer or loan. Where a person or partnership has made a transfer or loan to a trust, the transfer or loan is made at the direction (or with the acquiescence) of another person or partnership and it is reasonable to consider that one of the reasons the transfer or loan is made is to minimize the liability of any person or partnership that would have arisen as a result of the application of proposed section 94, then the contribution is deemed to have been made jointly by both persons or partnerships.

Note, under the draft proposals contained in Bill C-10, a loan made by a Canadian financial institution to a non-resident trust could potentially have been viewed as a contribution to that trust. However, proposed paragraph 94(2)(c) now ensures that loans made by a Canadian financial institution to a non-resident trust on arm’s length terms and in the ordinary course of the financial institution’s business will not result in the financial institution being considered to have made a contribution to the trust.

The effect of proposed subsection 94(2) is to broaden the scope of the meaning of transfer or loan, such that the term would appear to include almost any transaction whereby value is created for the benefit of a trust, with the exception of an “arm’s length transfer” (discussed below).
(c) Meaning of “Arm’s Length Transfer”

A transfer or loan to a trust will not be considered to be a “contribution” if it is an “arm’s length transfer” as defined in proposed subsection 94(1). The definition of “arm’s length transfer” generally includes an arm’s length return on investment and a return of paid up capital.

A transfer will only qualify as an “arm’s length transfer” if:

(i) it is reasonable to conclude that none of the reasons for the transfer is the acquisition at any time by any person or partnership of an interest as a beneficiary under the trust;

(ii) the amount of the transfer is not more than the amount that the transferor would have been willing to make if an arm’s length relationship existed between the transferor and transferee; and

(iii) the property transferred is not “restricted property”. 23

The definition of “arm’s length transfer” is very narrowly drafted. The requirement that none of the reasons for the transfer is the acquisition at any time by any person or partnership of an interest as a beneficiary in the trust would appear to catch many transactions which are otherwise based on arm’s length terms. For example, where a Canadian resident (the “Lender”) loans money to a non-resident trust benefiting his children, even if arm’s length terms are included in the loan, it may be difficult to conclude that none of the reasons for the loan is the acquisition of an interest in the trust by his children at the time the trust was established. Presumably, one of the reasons the loan is being made is because the non-resident trust benefits the Lender’s children. Thus, an “arm’s length transfer” requires not only arm’s length terms, but also a situation analogous to an arm’s length relationship.

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23 “Restricted property” is defined in proposed subsection 94(1) to include shares, indebtedness or other obligations of a closely held corporation (or rights to acquire such a shares, indebtedness or other obligations), if such property was acquired as part of a transaction or series of transactions whereby “specified shares” (generally, any shares, other than ordinary common shares) of a closely-held corporation were acquired by a person or partnership at a cost that was less than fair market value at the time of acquisition.
(d) The “Exempt Foreign Trust” Exemption

As discussed above, proposed section 94 only applies where a non-resident trust, other than an “exempt foreign trust”, has either a resident contributor or a resident beneficiary. Thus, the determination of whether a trust qualifies as an “exempt foreign trust” is a key element in the application of proposed section 94.

The definition of “exempt foreign trust” in proposed subsection 94(1) includes:

(i) a non-resident trust benefiting non-resident physically or mentally infirm dependants (paragraph (a));

(ii) a non-resident trust created to benefit non-resident children upon a breakdown of marriage or common law partnership (paragraph (b));

(iii) a non-resident trust that is an agency of the United Nations, certain non-resident trusts that own or administer a university described in paragraph (f) of the definition “total charitable gifts” in subsection 118.1(1), a non-resident trust to which her Majesty in right of Canada has made a gift in the trust’s current taxation year or at any time in the preceding calendar year, or a non-resident trust established pursuant to the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage (paragraph (c));

(iv) certain non-resident trusts established exclusively for charitable purposes (paragraph (d));

(v) certain non-resident trusts established for the benefit of employees, such as employee profit sharing plans, retirement compensation arrangements, foreign retirements arrangements (paragraph (e)), certain trusts operated exclusively for the purpose of administering or providing employee benefits (paragraph (g)) and certain trusts operated exclusively for the purpose of administering or providing superannuation or pension benefits (paragraph (h)); and

(vi) certain non-resident commercial trusts (paragraph (g)).
Regarding the exemption in paragraph (g) of the definition of exempt foreign trust (referred to as the “commercial trust exemption”), Finance announced in the 2010 Federal Budget that the Proposed Rules are not intended deter investments in bona fide commercial trusts; nor are bona fide commercial trusts intended to be deemed resident in Canada. As a result, the commercial trust exemption has been expanded in the Proposed Rules. Under these rules, a non-resident trust (other than a trust that elects with the Minister not to be an exempt foreign trust for the taxation year in which an election is made and for each subsequent taxation year) will be an exempt foreign trust if:

(i) the only beneficiaries of the trust who may receive any income or capital of the trust hold “specified fixed interests”\(^{24}\) in the trust; and

(ii) any one of the following applies:

(a) there are at least 150 beneficiaries of the trust, each holding specified fixed interests with a fair market value of at least $500;

(b) all specified fixed interests in the trust are listed on a designated stock exchange and were traded on the exchange on at least 10 of the 30 immediately preceding days;

(c) each outstanding specified fixed interest in the trust was either issued for at least 90% of the interest’s proportionate share of the net asset value of the trust’s property or acquired for fair market value; or

(d) the trust is governed by a Roth IRA (as defined in the U.S. Internal Revenue Code) or certain plans that the Minister agrees are substantially similar to a Roth IRA.

Although the rules in proposed section 94 will not apply to a non-resident trust that meets the commercial trust exemption (since such a trust will be an “exempt foreign trust”), resident beneficiaries of such a trust may still be subject to Canadian tax in respect of their interests in the trust under either: (i) proposed section 94.2; or (ii) the offshore investment fund property rules in section 94.1.

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24 As defined in proposed subsection 94(1) as, generally, a non-discretionary interest.
Under proposed section 94.2, if a resident beneficiary holds, together with persons not dealing at arm’s length, 10% or more of the specified fixed interests in a trust described by paragraph (h) of the definition exempt foreign trust, the resident beneficiary is required to include in income a participating percentage of the trust’s FAPI (determined as if the trust were a corporation). Further, if the resident beneficiary, together with persons not dealing at arm’s length, holds less than 10% of the specified fixed interests in such a trust (such that neither proposed sections 94 nor 94.2 apply), then the offshore investment fund property rules in section 94.1 may still apply. The offshore investment fund property rules are discussed in greater detail later in this paper.

3. Application of the Proposed Non-Resident Trust Rules

(a) Taxation of a Deemed Resident Trust

Under proposed subsection 94(3), a non-resident trust subject to proposed section 94 is deemed to be resident in Canada for certain purposes of the Act, including the calculation of its Canadian tax liability.

In order for a deemed resident trust to compute its Canadian tax liability under the Proposed Rules, it must first divide its assets into a “resident portion” and a “non-resident portion” (the meaning of these terms are discussed in more detail below). Under proposed paragraph 94(3)(f), a deemed resident trust is entitled to exclude from Canadian taxation any income from property and taxable capital gains generated in respect of the “non-resident portion” of its assets (except to the extent that such income is derived from Canadian sources upon which non-residents are normally required to pay tax).25 As a result, a deemed resident trust is generally only subject to Canadian tax on income generated from its “resident portion”, subject to any deductions available in respect of amounts made payable to beneficiaries pursuant to subsection 104(6) or amounts allocated to an “electing contributor” pursuant to proposed paragraph 94(16)(f) (as discussed in more detail below).

25 Pursuant to proposed paragraph 94(3)(f), a deemed resident trust will remain subject to Canadian taxation on any income from property or taxable capital gains realized in respect of the non-resident portion of its assets to the extent that such income would have been included in the trust’s income under any of paragraphs 115(1)(a) to (c) if the trust were a non-resident of Canada throughout the year. Also note, it appears that proposed paragraph 94(3)(f) does not exclude from Canadian taxation any business income earned by a deemed resident trust in respect of the non-resident portion of its assets.
The term “resident portion” is defined in proposed subsection 94(1) to include property acquired by the trust from contributions from Canadian residents and certain former residents, any property substituted for such property, and any property derived directly or indirectly from such property. The term “non-resident portion” is defined to mean any property held by the trust that does not form part of the trust’s “resident portion”.

Based on the above, any time that a deemed resident trust receives a contribution, the trustees of the trust will need to make a determination of whether such contribution forms part of the resident portion or non-resident portion of the trust’s property. Further, the trustees will need to track any income earned within the trust in order to determine whether such income should be allocated to the resident portion or non-resident portion. In this respect, in the 2010 Federal Budget, Finance indicated that any accumulated income arising from property that is part of the non-resident portion would not form part of the resident portion, provided that it is kept separate and apart from the property in the resident portion.

(b) Electing Contributors

Proposed subsection 94(16) provides rules regarding the attribution of the income of a deemed resident trust to its “electing contributors”. In particular, any resident contributor in respect of the trust (but not a resident beneficiary) may make an election to be attributed its share of the trust’s

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26 In particular, the “resident portion” will include all property held by the trust in respect of which a contribution has been made by a “connected contributor” or a “resident contributor”. Further, pursuant to subsection 94(10), the resident portion will include all property contributed by a non-resident who becomes resident of Canada within 60 months of making the contribution.

27 The Technical Notes to proposed subsection 94(1) suggest that such income would include, but would not be limited to, income accumulating in the trust and income earned on such accumulating income, capital gains (i.e., the tax-free portion of a capital gain), and insurance proceeds in respect of which the insurance premiums were funded in whole or in part by property from the resident portion of the trust.

28 It should be noted, as part of the Technical Notes to the August 27, 2010 draft legislation, Finance provided examples of the computation of the resident portion. However, these examples do not appear to apply the sourcing principles referred to in the 2010 Federal Budget. Instead, the examples simply allocate accumulated income to the resident portion based on the proportion of assets in the resident portion compared to the total assets of the trust. The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants have raised this issue in a submission to Finance dated September 27, 2010.

29 In order for the election to be valid, subsection 94(16) must apply to the contributor for the taxation year in which the election is made and for all subsequent taxation years, and it must be filed with the Minister on or before the electing contributor’s filing-due date for that first taxation year. A valid election must also include evidence that the contributor notified the trust, no later than 30 days after the end of the trust’s taxation year that ends in the first year for which the election is to have effect, that the election would be made.
income,$^{30}$ resulting in that portion of the income being taxable in the hands of the electing contributor.$^{31}$ Pursuant to proposed paragraph 94(16)(f), a deemed resident trust is entitled to a deduction corresponding to the amount included in an electing contributor’s income.

Pursuant to proposed paragraph 94(16)(b), any amount attributed to an electing contributor is deemed to be income from property from a source in Canada. Further, pursuant to proposed paragraph 75(3)(c.2), the attribution rule in subsection 75(2)$^{32}$ will not apply to an electing contributor.

(c) Liability for Tax

Under proposed paragraph 94(3)(d), each resident beneficiary and resident contributor of a trust (other than an electing contributor) is jointly, severally, and solidarily liable for the tax payable by the trust. However, this liability is limited to the contributor’s “recovery limit”, provided that the criteria in proposed subsection 94(7) are met. Subsection 94(7) operates to limit a person or partnership’s liability only if:

(i) the person or partnership is solely liable for tax as a “resident beneficiary” of the trust, or a “resident contributor” that did not contribute more than the greater of $10,000 or 10% of the total contributions made to the trust;

(ii) the trust has filed all information returns required by section 233.2 before that time, unless less than $10,000 has been contributed to the trust; and

(iii) it is reasonable to conclude that each transaction which occurred at the direction of or with the acquiescence of the person or partnership was not designed to limit the person or partnership’s exposure under proposed paragraph 94(3)(d).

$^{30}$ Losses of a trust cannot be attributed to an electing contributor. However, the amount of the income inclusion under paragraph 94(16)(a) is computed by subtracting from the trust’s income the amounts deducted by the trust under section 111 (thus ensuring that electing contributors benefit from their proportionate share of trust losses).

$^{31}$ The amount of an electing contributor’s income is computed by taking the trust’s income (less any amounts deducted by the trust under section 111) and multiplying the result by the proportion that the electing contributor’s share of contributions is of the total amount of contributions made to the trust.

$^{32}$ Subsection 75(2) generally applies to attribute any income or loss realized from trust property to a person resident in Canada where the property is held on condition that the property may revert to the person from whom the property was received.
If these criteria are met, the person or partnership’s liability will be limited to the “recovery limit” as defined in proposed subsection 94(8). The “recovery limit” is generally the total of the amounts received or payable by the trust after 2000 to the person or partnership, amounts received after 2000 upon the disposition of the person or partnership’s interest in the trust, the FMV of the benefits enjoyed after 2000 by the person or partnership from the trust, amounts recoverable from the person or partnership under subsection 94(2) as it read before 2007, and the amount of contributions made by the person or partnership. From this amount, previous recoveries by the CRA are subtracted to determine the person or partnership’s recovery limit. If the conditions in proposed subsection 94(7) are not satisfied, there will be no limit (other than the actual liability of the trust for tax, interest and penalties) to the liability imposed by proposed paragraph 94(3)(d).

(d) Other Consequences of Deemed Residency

In accordance with proposed section 94, a trust is deemed to be a resident of Canada for the purpose of calculating the trust’s foreign tax credits, the “specified foreign property” reporting rules, the 21-year deemed disposition rule, the deduction in computing income found in subsection 104(6),\(^\text{33}\) and for the purpose of determining its liability for tax under Part XIII of the Act in respect of amounts paid to the trust and by the trust.

With respect to the trust’s Part XIII liability, however, because the deeming rule only applies for the purposes of determining the trust’s liability under Part XIII, and not for the purpose of determining the actual amounts to be withheld, Canadian resident payors are still required to withhold and remit pursuant to Part XIII in respect of amounts paid to a non-resident trust which is deemed to be a resident of Canada by virtue of section 94. However, pursuant to proposed paragraph 94(3)(g), any amount withheld is deemed to have been paid on account of the trust’s Part I tax liability for the year to the extent that such amount was included in the trust’s income under Part I for that year.

It should be noted, the 2010 Federal Budget also included a proposal to amend the Income Tax Conventions Interpretation Act (Canada) in order to clarify that a trust that is deemed to be resident

\(^{33}\) However, see also proposed subsection 104(7.01) which restricts the deduction where the trust has non-resident beneficiaries.
in Canada under proposed section 94 would be considered resident in Canada for tax treaty purposes. At the time of the budget announcement, it was unclear whether this proposal would be retroactive. However, the draft legislation released on August 27, 2010 clarified that this proposed amendment would apply only after March 4, 2010.

(e) Exceptions from the Deemed Residency

Proposed subsection 94(4) provides that a trust to which section 94 applies will not be deemed to be a resident of Canada for the purpose of certain provisions in the Act.

The deemed Canadian residency status of a non-resident trust will not apply for the purpose of the rollover provisions in subsection 70(6), subsection 73(1) and paragraph 107.4(1)(c) of the Act. Subsection 70(6) provides a tax-free “rollover” with respect to capital property in respect of a transfer to a trust created on a taxpayer’s death for the benefit of a spouse or common law partner. Subsection 73(1) provides a similar rollover where the taxpayer transfers property to the trust benefiting the taxpayer’s spouse or common-law partner. By virtue of the requirement in subsection 70(6) and subsection 73(1) that the relevant trust be a Canadian resident, it is not possible to transfer assets on a rollover basis to a non-resident trust for the benefit of a spouse or common-law partner despite the fact that the trust may be deemed to be a resident of Canada for other purposes.

Section 107.4 is another rollover provision which applies to certain dispositions where the legal ownership of property changes but its beneficial ownership does not. Paragraph 107.4(1)(c) provides that the rollover does not apply where the transferor of the property to the non-resident trust is a person or partnership resident in Canada or with respect to certain transfers of “taxable Canadian property” to a non-resident.\textsuperscript{34} Accordingly, it will not be possible for a Canadian resident to transfer property to a non-resident trust, or to transfer “taxable Canadian property” on a rollover basis to a non-resident trust, even if the trust is deemed to be a Canadian resident for most purposes of the Act.

In addition, the deeming rule in proposed subsection 94(3) which deems certain non-resident trusts to be resident in Canada will not apply for the purpose of determining whether a trust is a “mutual fund

\textsuperscript{34} In addition, by virtue of paragraph 94(4)(f), section 94 will not apply to deem a trust to be resident in Canada for the purpose of
trust” or an “exempt foreign trust”. The exception for mutual fund trusts ensures that a non-resident trust cannot qualify as a “mutual fund trust”. The exception for “exempt foreign trusts” prevents any circularity in determining what qualifies as an “exempt foreign trust”.

(f) Becoming or Ceasing to be a Resident of Canada

Proposed paragraph 94(3)(c) and subsections 94(5) and (6) address the taxation of a non-resident trust that is deemed by section 94 to become or cease to be a non-resident trust. The rules generally provide that the provisions in section 128.1 regarding immigration to Canada apply at the beginning of the calendar year in which a non-resident trust is first deemed resident in Canada. The emigration rules in subsection 128.1(4) also apply at the beginning of a calendar year where there is neither a “resident beneficiary” nor a “resident contributor”, provided that there was a “resident beneficiary” or a “resident contributor” in the previous year. The application of subsection 128.1(4) will result in a deemed disposition of the trust’s assets immediately before the trust ceases to be deemed resident in Canada under subsection 94(3).

4. Conclusion / Summary

Compared to the Existing Rules, the Proposed Rules will apply to a broader range of non-resident trusts, including trusts that have no Canadian beneficiaries. The tax imposed in accordance with Proposed Rules will also be significantly different than that imposed under the Existing Rules. Under the Proposed Rules, a deemed resident trust’s property will be divided into a “resident portion” and a “non-resident portion”. The trust will only be taxed on the income accumulated in the resident portion, with deductions allowed for income payable to beneficiaries and income attributed to electing contributors. Any amounts attributed to electing contributors will be taxed in their hands directly. Resident beneficiaries and non-electing resident contributors will be jointly, severally, and solidarily liable for the trust’s liabilities, subject to a recovery limit.

IV. Offshore Investment Fund Rules

the exclusion to the definition of “disposition” in subparagraph (f)(i) of that term in subsection 248(1).
1. **Introduction**

Existing section 94.1 is a provision that is intended to tax taxpayers in respect of interests in investment funds resident outside Canada. The rules generally apply where a taxpayer has an interest in an “offshore investment fund property”, as defined in subsection 94.1(1), and one of the main reasons for holding the investment is to reduce the tax that would otherwise have been payable if the income had been earned directly. Where the rules apply, a taxpayer is deemed to have received notional income from the investment.\(^{35}\)

The existing rules in section 94.1 have had little impact and have largely been ignored by taxpayers and the CRA. In fact, there is only one reported decision involving the application of section 94.1.\(^{36}\) Further, in the 1999 Federal Budget, the government indicated that, in its view, the effectiveness of the provision had weakened over the years. The response was the introduction of the proposed FIE Rules, the latest version of which were included as part of former Bill C-10. As discussed above, these rules were subsequently criticized by the Panel, which recommended that the rules (including the FIE Rules) be reconsidered. In response, as part of the 2010 Federal Budget, it was proposed that the FIE Rules be abandoned and existing section 94.1 remain in force, subject to certain minor amendments (which were contained in the draft legislation released on August 27, 2010).

2. **Application of the Existing Offshore Investment Fund Rules**

Section 94.1 generally applies where the following conditions are satisfied:

(i) A taxpayer holds an interest in a property that is a share of the capital stock of, an interest in, or a debt of, a non-resident entity;

(ii) That interest may reasonably be considered to derive its value, directly or indirectly, primarily from *portfolio investments* of that or any other non-resident entity in, among other things, interests in one or more corporations, trusts, partnerships, organizations,

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\(^{36}\) *John S. Walton v. The Queen*, 98 DTC 1780 (T.C.C.).
funds or entities; and

(iii) One of the main reasons for the taxpayer holding or having an interest in the non-resident entity is to derive a benefit from portfolio investments in such a manner that the taxes, if any, on the income, profits and gains from such assets are significantly less that the tax that would have been applicable had the income, profits or gains been earned directly by the taxpayer.

If each of these questions is answered in the affirmative, then section 94.1 will apply and the taxpayer will be subject to an income inclusion from the investment equal to the product obtained when the taxpayer’s “designated cost” of the investment at the end of each month is multiplied by the appropriate prescribed interest rate plus two percent, 37 divided by twelve. This notional income is reduced by the amount of taxable income (other than capital gains) actually generated by the offshore investment fund property and included in income by the taxpayer.

The “designated cost” of an offshore investment fund property, as defined in subsection 94.1(2), includes the cost to the taxpayer of the property plus amounts made available by a person to another person whether by way of gift, loan, payment for a share, transfer of property at less than its fair market value or otherwise, in circumstances such that it may reasonable be considered that one of the main reasons for making the additional amount available was to increase the value of the property held by the taxpayer that is not otherwise included in the taxpayer’s cost of the property plus the total of all amounts previously included in the taxpayer’s income in respect of the property by virtue of section 94.1. Further, any such amount that is included in income is also added to the taxpayer’s adjusted cost base of the property pursuant to paragraph 53(1)(m).

Prior to the announcements made as part of the 2010 Federal Budget, the proposed FIE Rules were to be effective for years commencing after 2006. Now that the FIE Rules have been abandon, a taxpayer who had voluntary complied with the FIE Rules in previous years (on the basis that the FIE Rules would be enacted) is entitled to have the relevant years reassessed. If a taxpayer who complied with the FIE Rules in such years does not wish to be reassessed, and had more income in those years than would have been the case under existing section 94.1, the taxpayer has the option of deducting

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37 The current prescribed interest rate is the three-month-average Treasury Bill rate (see subsection 4301(c) of the Regulations).
the excess income. This deduction must be claimed by the taxpayer for the first taxation year that ends after the last taxation year of the taxpayer that ends before March 4, 2010.\(^{38}\)

(a) Interest in a Non-Resident Entity

In order for section 94.1 to apply, the taxpayer must hold an interest in a property that is a share of the capital stock of, an interest in, or a debt of, a “non-resident entity” (other than a CFA of a taxpayer,\(^{39}\) a trust to which section 94.2 applies, or a prescribed non-resident entity\(^{40}\)) or an interest in or a right or option to acquire such a share, interest or debt.

The term “non-resident entity” is defined broadly in subsection 94.1(2) to include:

(i) a corporation that is not resident in Canada;

(ii) a partnership, organization, fund or entity that is not resident or is not situated in Canada; or

(iii) a non-resident trust, other than a trust that is described in subparagraph (b)(i) of the definition “resident contributor” in proposed subsection 94(1)\(^{41}\) or a trust that is an “exempt foreign trust” as defined in proposed subsection 94(1) because of any of paragraphs (a) to (g).

The application of this definition is relatively straightforward for corporations and other foreign entities described in items (i) and (ii) above. However, in the context of trusts, although most “exempt foreign trusts” will be excluded from the definition of “non-resident entity”, certain commercial trusts that qualify under paragraph (h) of that definition will be considered non-resident entities and, thus, potentially subject to section 94.1.

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\(^{38}\) See subsections 7(5) to (10) of the “Transitional rules for taxpayers that complied with former proposed 94.1-94.4” released as part of the August 27, 2010 draft legislation.

\(^{39}\) Interests in CFA’s are dealt with under the FAPI regime, which is addressed elsewhere at this conference.

\(^{40}\) There are currently no prescribed non-resident entities for the purpose of section 94.1.

\(^{41}\) As a result, an *inter vivos* trust created before 1960 by a person who was non-resident when the trust was created is excluded from the definition of “non-resident entity”.
As noted in the discussion regarding the non-resident trust rules, proposed subsection 94(3) deems any trust to which proposed section 94 applies to be resident in Canada for the purposes of the definition of “non-resident entity” in section 94.1. As a result, section 94.1 will not apply to a trust to which proposed section 94 applies.

Further, although it is not specifically addressed in the Proposed Rules, we understand that Finance has informally indicated that it will add a specific exemption to the definition of a “non-resident entity” to exclude immigrant trusts from the application of section 94.42

(b) Value of a Non-Resident Entity from Portfolio Investments

The second precondition to the application of subsection 94.1 is that a non-resident entity must reasonably be considered to derive its value, directly or indirectly, primarily from portfolio investments of that or any other non-resident entity in:

(i) shares of the capital stock of one or more corporations;
(ii) indebtedness or annuities;
(iii) interests in one or more corporations, trusts, partnerships, organizations, funds or entities;
(iv) commodities;
(v) real estate;
(vi) Canadian or foreign resource properties;
(vii) currency of a country other than Canada;
(viii) rights or options to acquire or dispose of any of the foregoing; or
(ix) any combination of the foregoing.

The term “portfolio investments” is not defined in the Act and its meaning has received no judicial scrutiny in the context of section 94.1. Therefore, the meaning of the term must be determined based

42 Albert Baker and Joyce Lee, “Section 94.1 and Immigration Trusts”, (2010) vol. 18, no. 11 Canadian Tax Highlights
on an examination of the text, context and purpose of section 94.1. In this regard, a term used in a statute and not defined should generally be given the meaning it has among those who are familiar with the term in the context in which it is used in the statute. The subject matter of section 94.1 is offshore investment funds. Accordingly, the meaning of “portfolio investments” should be the meaning that would be applied by people conversant with such funds; generally financiers, investment managers, brokers and accountants. A review of relevant dictionary definitions suggests that “portfolio investments” connotes a collection of passive investments that are managed as a group, as opposed to direct investment or control.\textsuperscript{43}

A further observation regarding the meaning of “portfolio investments” is that it should be viewed as a sub-category of “investments”. The word “investment” is typically used in the Act to refer to properties which are capable of yielding income in the nature of interest, dividends, or rent, and which, when disposed of, will result in capital gains or losses. The term “investment” is generally not used to describe a property forming part of an inventory or stock-in-trade which, when disposed of, will give rise to income rather than a capital gain. In other words, “investments” is generally used as a synonym for “capital property”.

The CRA was asked to provide its interpretation of the term “portfolio investments” at the 1986 Revenue Canada Round Table, where it stated that the term, as used in section 94.1 and former subsection 206(1), has “a very broad meaning”.\textsuperscript{44} Further, at the 1990 Revenue Canada Round Table, the CRA stated that it considered “portfolio investments” not to be limited to passive investments and that it may include property that is used in a business.\textsuperscript{45}

This last statement by the CRA may be intended to mean only that the CRA will consider property to be a “portfolio investments” if it is held for the purpose of earning income from a business as


The Canadian Dictionary of Finance and Investment Terms (Hauppauhe NY: Barron’s Educational Series, Inc., 2000) defines “portfolio investment” as “purchase of shares and bonds made with the objective of realizing income and capital gains, rather than for the purpose of gaining control of a company”.


described in the definition of “specified investment business” in subsection 129(4.1) or “investment business” in subsection 95(1). Since such property would be held on capital account, this position would be consistent with the interpretation of portfolio investments described above. However, if the CRA’s position is that portfolio investments can include active business assets that are held on income account, then it is inconsistent with the interpretation attributed to section 94.1 at the time it was announced. In particular, in the supplementary information to the Notice of Ways and Means Motion tabled with the 1984 Federal Budget, Finance indicated that “investments in non-resident entities whose principal business is a bona fide active business will not be affected by these rules”. Further, the interpretation would be difficult to reconcile with an earlier CRA technical interpretation, regarding the meaning of “portfolio investments” in former subsection 206(1), where the CRA stated that “loans made by a Canadian corporation in the course of carrying on the business of lending money would not be considered to be portfolio investments. Again, however, it would be a question of fact whether a corporation is in the business of lending money or simply investing in debt instruments”.  

(c) Tax Avoidance Motive

Section 94.1 will not apply unless it can be shown that the taxpayer has met the purpose test outlined in subsection 94.1(1). The purpose test requires that one of the main reasons that the taxpayer acquired an interest in the non-resident entity was to significantly reduce the tax which would have been payable had the taxpayer acquired the portfolio investments directly.

Subsection 94.1(1) indicates that this issue must be examined in light of all the surrounding circumstances including those listed in paragraphs 94.1(1)(c) to (e), which are:

(i) 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 (paragraph (c));

(ii) 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

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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 (paragraph (d));
and

(iii) 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 (paragraph (e)).

The purpose test in section 94.1 requires a comparison of the taxes actually payable in respect of the
portfolio investments and the taxes that would have been payable had the taxpayer acquired the
portfolio investments directly. Further, the provision states that taxes payable in respect of the
portfolio investments must be “significantly” less than the taxes that would have been payable
otherwise. It is unclear what is meant by the term “significantly”. However, it appears that if no
Canadian tax would have otherwise been payable in the year by the taxpayer if the taxpayer had held
the portfolio investments directly (for example, because the taxpayer was in a loss position), then the
tax avoidance motive test would not be met.47

Another element of the test is that the tax avoidance motive must be “one of the main reasons” for the
taxpayer acquiring the interest in the non-resident entity. Although this test appears quite broad, this
is one of the traditional shortcomings of section 94.1 (at least from the CRA’s perspective). While
the determination is to be made based on all of the surrounding circumstances, it seems likely that
many taxpayers with offshore investments have taken the position that such investments are held by
them strictly for non-tax reasons (such as access to special fund managers, etc.).

3. **Summary**

Finance’s decision to backtrack from the FIE Rules constitutes a significant reversal of tax policy.
Finance has proposed to discuss the amendments with a panel of tax practitioners and there may be
additional refinements to the offshore investment fund rules once these consultations have been
completed. It will be interesting to see if Finance tries to strengthen these rules since it has

47 This point was made in *Wiener* supra note 35 at page 4.
acknowledged that taxpayers have largely been ignoring them in recent years.
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NON-RESIDENT TRUSTS
AND
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