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NRT ALERT: FINANCE RELEASES REVISED NON-RESIDENT TRUST LEGISLATION

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On August 27, 2010, the Department of Finance Canada released for public consultation[1] a package of draft legislation (Draft Legislation) to implement various tax measures announced in the 2010 federal budget as well as several previously announced tax initiatives, including tax rules relating to non-resident trusts (NRT) and foreign investment entities (FIE). Since their first introduction in 2000, the draft rules applicable to NRT and FIE have been controversial. The proposed rules now included in the Draft Legislation represent the seventh version of these rules.

In broad terms, it appears that the Draft Legislation was intended to revise the NRT and FIE proposals to reflect much of the criticism and submissions that the Canadian government had received from various business organizations and other interested parties. In particular, the legislation confirms, as announced in the 2010 federal budget, that the previously proposed FIE rules have been abandoned in favour of retaining the current offshore investment fund property rule found in section 94.1 of the *Income Tax Act* (Canada) (Act) with certain modifications. On the other hand, the proposed NRT rules, which last appeared in 2008, remain substantively intact with limited proposed changes. Thus, it may be questioned whether the Canadian government has been successful in making "substantial modifications meant to simplify the outstanding [NRT] proposals and to better target arrangements that seek to avoid paying the appropriate amount of Canadian tax".[2]

Nevertheless, the purpose of this Bulletin is to review some of the key highlights of the latest legislative proposals and to examine some of the common planning strategies that may be affected by the Draft Legislation.

OVERVIEW OF THE REVISED CANADIAN TAX RULES APPLICABLE TO NRT

The basic framework of the NRT rules in the Draft Legislation remains unchanged from the 2008 version of the draft legislation contained in former Bill C-10, and is intended to replace existing section 94[3] of the Act with effect from January 1, 2007.[4] The cornerstone of the NRT rules is found in proposed subsection 94(3) of the Act.

According to this provision, a NRT will be caught by the rules if, at a "specified time"[5] in the taxation year of the NRT, the following two conditions are met:

[1] The deadline for providing comments on the draft legislative proposals to the Department of Finance was September 27, 2010.

[2] Department of Finance Canada, "Budget 2010: Leading the Way on Jobs and Growth" (Ottawa: Department of Finance Canada, March 4, 2010), page 372.

[3] As currently enacted, section 94 generally provides that a NRT will be subject to tax under Part I of the Act if at any time in the taxation year of the NRT two conditions are met: (a) a person beneficially interested in the NRT is a person resident in Canada, a corporation or trust with which a person resident in Canada was not dealing at arm's length, or a controlled foreign affiliate of a person resident in Canada; and (b) the NRT or its controlled foreign affiliate (if the NRT were treated as a Canadian resident) acquired property directly or indirectly from (i) a person beneficially interested in the NRT or certain relatives of such person, where such person or relative has been resident in Canada for the past 18 months and has resided in Canada for more than 60 months; or (ii) a trust or corporation that acquired the property directly or indirectly from a person described in (i) with whom it was not dealing at arm's length.

[4] A NRT may elect to have proposed section 94 apply to taxation years ending after 2000 and before 2007 if it was established in one of those years.

[5] For an *inter vivos* trust that is not terminated during a taxation year, the "specified time" is December 31 of the relevant calendar year. If an *inter vivos* trust is terminated during a taxation year, the "specified time" is the time that is immediately before the termination.

1. there is a "resident contributor" to, or "resident beneficiary" under, the NRT; and
2. the NRT does not qualify as an "exempt foreign trust".

These conditions are discussed in more detail below. If both conditions are satisfied, the NRT will be deemed to be a resident of Canada for various purposes of the Act[6] and will be subject to Canadian tax on its worldwide income. To avoid an overlap between the NRT rules and the rules in section 94.1 applicable to certain interests in non-resident entities[7], a NRT that is caught by new section 94 will not be considered to be a "non-resident entity" for the purposes of revised section 94.1. In addition, to bolster the position of the Canadian government that a NRT that is deemed by section 94 to be a resident of Canada should also be treated as such for purposes of applying an applicable tax treaty, and likely as a response to such recent cases as *Garron Family Trust (Trustee of) v. The Queen*[8] and *Antle v. The Queen*[9], the Draft Legislation also proposes to amend the *Income Tax Conventions Interpretation Act* to achieve that objective. It will be interesting to see if Canadian courts will agree with this position in determining the residency of a NRT for purposes of an applicable tax treaty.

One of the key changes made by the Draft Legislation to the proposed NRT regime is the introduction of the concepts of "resident portion" and "non-resident portion" in describing the property of a NRT that is caught by proposed subsection 94(3). The importance of the distinction between these two categories of property is made apparent by proposed paragraph 94(3)(f) which permits a NRT to exclude from Canadian taxation certain passive income and taxable capital gains[10] generated from the "non-resident portion" of its assets. By default, the NRT will be subject to Canadian tax on the remainder of its income, including income generated from the "resident portion" of the assets of the NRT, unless some or all of that income has been attributed to a "resident contributor" of the NRT pursuant to proposed subsection 94(16) of the Act (as discussed below), or to the extent that such income has been made payable to a beneficiary of the NRT and is deductible to the NRT.

The "non-resident portion" of the NRT consists of any property held by the NRT that is not part of the "resident portion". The "resident portion" is defined in proposed subsection 94(1) essentially as property acquired by the NRT by way of contributions from Canadian residents and certain former residents[11], property substituted for such property, and property derived directly or indirectly from such property. Such derived property would include, but not be limited to, income accumulating and capitalized in the NRT and income earned on such accumulating income, the tax-free portion of capital gains, 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 NRT.

As a result of these proposed changes, trustees of NRT caught by proposed subsection 94(3) will not only face the challenge of computing income of the NRT based on Canadian tax principles but will also need to track carefully the two categories of property of the NRT. While it may be relatively easy for trustees to initially determine whether trust contributions should form part of the resident or non-resident portion of a NRT, tracking may become more challenging as income of the NRT is accumulated or further assets are acquired by the NRT through leverage.

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[6] For example, a NRT is deemed to be a resident of Canada for the purposes of determining its obligation to file certain reporting forms under section 233.3 and section 233.4 in respect of specified foreign property and interests in foreign affiliates, respectively.

[7] See the discussion below regarding the proposed revisions to section 94.1 of the Act.

[8] 2009 TCC 450, 2009 DTC 1568 (TCC) (under appeal to FCA). In *Garron,* the Tax Court of Canada held that two Barbados trusts were resident in Canada for purposes of the *Canada-Barbados Income Tax Convention* based on the facts and its finding that the test for determining the residence of a trust should be consistent with the central management and control test in the corporate context. As such, the trusts were not entitled to the benefit of the treaty capital gains exemption on the sale of Canadian corporate shares.

[9] 2009 TCC 465, 2009 DTC 1732 (TCC), 2010 FCA 280 (FCA). In *Antle*, the Tax Court of Canada held that a Barbados trust involved in a series of transactions known as a "capital property step-up strategy" was not properly constituted, with the result that corporate shares were never legally transferred by the taxpayer to the trust and, thus, the gain realized on the share sale was attributed to the taxpayer and subject to Canadian tax. The Federal Court of Appeal upheld the Tax Court's decision and also concluded that the trust was a sham based on the Tax Court's findings of fact.[7] See the discussion below regarding the proposed revisions to section 94.1 of the Act.

[10] It seems odd that proposed paragraph 94(3)(f) does not exclude business income from Canadian taxation. It is unclear whether this was a deliberate policy choice by the Department of Finance or merely an oversight.

[11] The starting point is typically contributions made by "resident contributors" and "connected contributors" to the NRT, both concepts which are specifically defined in subsection 94(1). In addition to contributions made by Canadian residents, under proposed subsection 94(10), a contribution made by a non-resident who would otherwise not be regarded as a connected contributor and who becomes resident in Canada within 60 months after making the contribution will form part of the resident portion.

Proposed subsection 104(7.01), which is unchanged from the prior draft, limits the deduction otherwise available to a NRT for distributing Canadian-sourced income to non-resident beneficiaries of the NRT in a manner that creates additional tax for the NRT and essentially uses the NRT to collect Part XII.2 tax or Part XIII Canadian withholding tax that would otherwise be payable. Similarly, for a NRT earning income from foreign sources, proposed subparagraph 94(3)(a)(ix) facilitates the application of Part XIII withholding tax on such income distributed to non-resident beneficiaries of the NRT.[12] Under the Draft Legislation, a NRT will be able to claim a foreign tax credit for income taxes paid to another country that treats it as a resident of that country for income tax purposes up to a maximum of the Canadian tax rate and without regard to the limits under subsection 20(11).

To provide the Canadian government with a mechanism to collect its taxes from a NRT, the proposed rules place joint and several liability for such taxes on both resident contributors to, and resident beneficiaries of, the NRT. Under previous versions of the draft tax rules, unless a resident contributor or resident beneficiary, as the case may be, met specified conditions to limit liability to the "recovery limit"[13], the person's liability could be unlimited. Although the Draft Legislation retains these concepts and potential consequences, it also introduces new subsection 94(16) to limit the exposure of a taxpayer to the tax obligations of a NRT caught by subsection 94(3).

In particular, proposed subsection 94(16) permits a resident contributor (but not a resident beneficiary) who satisfies certain conditions to elect in writing so that a proportionate share of the income of the NRT (associated with the contribution made by the contributor) will be attributed to, and will be taxed in the hands of, such contributor for Canadian tax purposes. Where a valid election is made[14], the resident contributor will not be jointly and severally liable for the Canadian income tax obligations of the NRT. Moreover, the electing contributor will be excluded from the application of the income attribution rule in subsection 75(2) of the Act, which provides generally for the attribution of income derived from certain trust property to a Canadian resident person where the property was received by the trust from that person and can either revert to that person or pass to other persons determined by that person.[15]

Whether or not this election should be made by a particular resident contributor will depend on the particular circumstances, including the combined federal and provincial income tax rate applicable to income attributed to the resident contributor as well as the amount of the contribution made by the resident contributor to the NRT. In certain cases, it may not be beneficial for a resident contributor to make the election since the attributed income will be deemed to be income from property notwithstanding its actual source.[16]

CONDITION 1 – "RESIDENT CONTRIBUTOR" OR "RESIDENT BENEFICIARY"

A "resident contributor" to a NRT at a specified time under proposed subsection 94(1) is essentially a person who:

- is not an "exempt person";
- has made a "contribution" to the NRT;
- is resident in Canada at that time;

[12] The Draft Legislation appears to be flawed in this regard. Specifically, income associated with the non-resident portion of a NRT would appear to be subject to Part XIII tax as a result of subparagraph 94(3)(a)(ix) if the income is distributed in the same year as it is earned even though such income is not subject to tax under Part I of the Act. The application of Part XIII tax in these circumstances appears to be inappropriate since Canada has already made a tax policy decision not to tax such income under Part I of the Act. In other words, if it is not abusive for such income to escape Canadian taxation by first being capitalized at the end of the taxation year during which the income was earned and then being distributed as capital in a subsequent taxation year to a non-resident beneficiary of the NRT, it should not be abusive if such income is distributed in the year that it is earned to a non-resident beneficiary of the NRT.

[13] "Recovery limit" is defined in proposed subsection 94(8). For most resident beneficiaries of a NRT, the recovery limit for that beneficiary will be the amount received or enjoyed by the beneficiary from the NRT or from a disposition of an interest in the NRT. However, for resident contributors to a NRT, the recovery limit may be much greater than the amount that such person actually contributed to the NRT depending on whether the contribution was made as part of a series of transactions whereby there was a transfer of property to the NRT (see, for example, proposed subsection 94(9)) and whether other amounts have been contributed by persons not dealing at arm's length with the resident contributor (see, for example, proposed subsection 94(7)).

[14] Once this election is made, it does not appear that it can be revoked and the election applies for all subsequent taxation years of the resident contributor as well.

[15] As discussed later in this bulletin, an individual who is a contributor to an immigrant trust will also be exempted from the application of subsection 75(2), but only where the individual has not been a resident of Canada for more than 60 months.

[16] For example, a NRT could distribute capital gains to the resident contributor (assuming the contributor is also a beneficiary) and if the NRT designates the amount pursuant to subsection 104(21) of the Act, the character of the amount as capital gains will be preserved in the hands of the resident contributor. This may be useful particularly where the resident contributor has unused capital losses that can be applied to offset such capital gains.

- is not an individual who has yet to reside in Canada for more than 60 months (other than an individual who, before that time, was never non-resident)[17]; and
- is not an individual who was involved with the NRT before 1960.

An "exempt person" is a new defined phrase in the Draft Legislation and includes a person whose taxable income is exempt from Part I tax under subsection 149(1) (e.g., pension funds, Crown corporations and registered charities), a Canadian or provincial government pension or workers compensation trust or corporation, and a Canadian resident trust, a Canadian resident corporation or a partnership which is wholly owned by tax-exempt persons. Exempt persons are excluded from being resident contributors and connected contributors under proposed section 94.

It is evident that for a person to be a "resident contributor", the person must exist at the specified time in order to be a Canadian resident at that time. Furthermore, the person must have made a "contribution" to the NRT at or before that time. If a NRT has a "resident contributor" at the specified time, the NRT could be subject to proposed subsection 94(3) even where the NRT does not or cannot have any Canadian resident beneficiaries. This result is a marked departure from existing section 94 where a Canadian resident person (or another non-arm's length person) must be beneficially interested in the NRT to trigger the application of the rule.

In comparison, for a NRT to have a "resident beneficiary", the Draft Legislation requires the NRT to have:

- a beneficiary[18] under the NRT that is not a "successor beneficiary"[19] or an "exempt person" and that is resident in Canada; and
- a "connected contributor" to the NRT.

In simple terms, a "connected contributor" to a NRT means a person (including a person who has ceased to exist) who has made a contribution to the NRT and who has resided in Canada for more than 60 months and whose contributions were not made at a "non-resident time".[20] Unlike the definition of "resident contributor" which requires that the contributor be resident in Canada at a particular time, the definition of "connected contributor" contains no similar requirement and, thus, is a broader concept. Furthermore, the definition of connected contributor specifically includes persons who have ceased to exist. Therefore, a person will not avoid being a "connected contributor" by either dying or terminating.

It is apparent from the definition of "resident beneficiary" that a NRT must have a "connected contributor" before this definition can be satisfied. In other words, without a connected contributor to the NRT, it will not be possible for the NRT to satisfy the definition even if all of the beneficiaries of the NRT are residents of Canada. In this regard, the concept of resident beneficiary seems to be counter-intuitive in that a NRT may have Canadian resident beneficiaries without necessarily being subject to tax under proposed subsection 94(3). Similarly, if a NRT has a connected contributor but all of its beneficiaries are non-residents of Canada, the definition of resident beneficiary will not be satisfied and the NRT will not be caught under proposed subsection 94(3). As such, an individual who has resided in Canada for more than 60 months before becoming a non-resident of Canada for purposes of the Act could establish a NRT within 60 months of departing Canada for the benefit of only non-resident persons without the NRT having a resident beneficiary within the meaning of proposed subsection 94(1).

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17 The Department of Finance Canada was apparently concerned that NRT could be established by Canadian resident infants who would presumably avoid the definition of "resident contributor" if the exclusion was not added. It is this part of the definition of "resident contributor" that provides the legislative basis for the NRT that are commonly referred to as "immigrant trusts". Since the contributor may reside in Canada for up to 60 months before he or she becomes a "resident contributor" to the NRT, the immigrant trust will enjoy a Canadian tax holiday for up to 60 months.

18 The definition of "beneficiary" in proposed subsection 94(1) is broader than the definition of "beneficially interested" in subsection 248(25) and attempts to include, among other persons, shareholders of a corporation as beneficiaries of a trust where the corporation is a beneficiary of the trust.

19 A "successor beneficiary" is defined in proposed subsection 94(1) to mean a beneficiary whose right to income or capital is dependent upon the death of the contributor to the NRT or to a person related to such contributor. Under the Draft Legislation, it is proposed that a person related to a contributor will now be expanded for this definition to include an uncle, aunt, niece or nephew of the contributor. The beneficiary will cease to be a successor beneficiary upon the death of the relevant person.

20 In general terms, "non-resident time" is defined in proposed subsection 94(1) to mean the period of time beginning 60 months before the time of the contribution to the trust and ending 60 months after such time and throughout which the contributor is either non-resident or not in existence. The beginning portion of this period is modified to 18 months if the trust arose upon the death of an individual or the contribution was made before June 23, 2000.

"Contribution"

From the foregoing discussion, it is evident that the concept of a "contribution" to a NRT is fundamental to both the definition of "resident contributor" and "resident beneficiary". A "contribution" by a particular person to a trust in proposed subsection 94(1) means:

- a transfer or loan (other than an arm's length transfer) of property to the trust by the particular person; and
- a transfer or loan (other than an arm's length transfer) of property to the trust by another person if the transfer or loan (other than an arm's length transfer) of property (or the obligation to do so) by the particular person was part of a series of transactions[21] that included the transfer or loan of the other person and to the extent that the transfer or loan of the other person can reasonably be considered to have been made in respect of the transfer or loan (or the obligation to do so) by the particular person.

The second part of the definition is broad in scope and appears to be an indirect contribution rule aimed at covering certain related transactions where they are part of the same series of transactions that includes a contribution of property to the NRT. For example, if A transfers property to B in a transaction that cannot be regarded as an "arm's length transfer" and, as part of the same series of transactions, B transfers property to C so that C could transfer property to a NRT in a transaction that would not be regarded as an arm's length transfer, both A and B will be regarded as having made a contribution to the NRT to the extent that the transfer made by C to the NRT could reasonably be considered to have been made in respect of the transfers made by A and B as part of the series of transactions.

Supplementing this broad and complex definition of contribution are several rules in proposed paragraphs 94(2)(a) to (u) that deem certain events to be transfers of property, contributions, or not contributions to a trust. For example, proposed subparagraph 94(2)(d) deems the provision of a guarantee or financial assistance to be a transfer of property.

A significant change found in the Draft Legislation is the deletion of the rule formerly contained in proposed paragraph 94(2)(c), which deemed an entity to have transferred a property to a trust if it transferred or loaned property (other than by way of an arm's length transfer) to another entity and, at or after that time, the trust held property the fair market value of which was derived in whole or in part, directly or indirectly, from property held by the other entity. Instead, the Draft Legislation now seems to rely on paragraph 94(2)(a) to supplement the indirect contribution rule described above. According to this provision, a person or partnership will be deemed to have transferred, at any time, a property to a trust if at that time it transfers or loans property (other than by way of an arm's length transfer) to another person or partnership and, because of that transfer, the fair market value of one or more properties held by the trust increases, or a liability or potential liability of the trust decreases, at that time.

As announced in the 2010 Federal Budget, the Draft Legislation contains a new rule[22] that deems a loan made by a specified financial institution not to be a contribution to a trust if the loan is made on arm's length terms and conditions and in the ordinary course of the business carried on by the specified financial institution. This new rule is intended to allow a NRT investing in Canadian assets to access conventional financing from Canadian financial institutions without triggering the application of proposed section 94.

"Arm's Length Transfer"

The concept of "arm's length transfer", as defined in proposed subsection 94(1), is critical in excluding certain transactions from the ambit of the definition of "contribution". However, in basic terms, a transaction will qualify as an arm's length transfer only if:

- the property transferred or loaned is not "restricted property" (basically, shares or indebtedness of closely-held corporations issued as part of a corporate reorganization unless excluded under proposed subsection 94(14));
- it is reasonable to conclude that none of the reasons for the transfer is the acquisition by any person of an interest as a beneficiary under a NRT; and

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[21] Subsection 248(10) expands the concept of a series of transactions by including any related transactions or events completed in contemplation of the series.

[22] Paragraph 94(2)(c).

- the terms and conditions of the transaction are similar to those that would be entered into by arm's length parties.

Since the 2010 Federal Budget announced that the definition of "restricted property" would be "narrowed and better targeted", it is interesting to note from the definition found in the Draft Legislation that a share or indebtedness (or rights to either property) of a closely-held corporation will qualify as "restricted property" only if such property were acquired by a person or partnership as part of a transaction or series of transactions in which "specified shares" (generally, shares with fixed entitlement rights) of a closely-held corporation were acquired by any person or partnership, and only if the specified shares were acquired at a tax cost that is less than their fair market value. Furthermore, other property the fair market value of which is derived in whole or in part, directly or indirectly, from such shares, indebtedness, or rights will also be regarded as "restricted property" only if that other property was acquired by the person or partnership as part of that series of transactions. However, the definition of restricted property has also been broadened to include not only indebtedness in the circumstances just described, but also other obligations of closely-held corporations.

In many cases involving NRT established for high net worth families, a transfer or loan of property is unlikely to qualify as an arm's length transfer because the transaction either involves restricted property or a reason for the transfer can be linked to the identity of certain beneficiaries of the NRT. Thus, in practice, the "arm's length transfer" exception can seldom be relied upon to avoid a "contribution" to these NRT.

CONDITION 2 – "EXEMPT FOREIGN TRUST"

Even if a NRT has either a resident contributor or a resident beneficiary at the specified time, the NRT will not be subject to proposed subsection 94(3) if the NRT constitutes an "exempt foreign trust". The definition of exempt foreign trust identifies nine specific categories of trusts, which include a NRT established for non-resident individuals who are mentally or physically infirm, a NRT established as a consequence of a marital breakdown for the benefit of non-resident children attending school, and a NRT established for charitable purposes with 20 or more arm's length contributors.

After receiving considerable criticism regarding the potential application of the previous version of the NRT rules to certain non-resident commercial trusts, the Canadian government responded by revising the exemption intended for non-resident commercial trusts contained in paragraph (h) of the definition of "exempt foreign trust". Accordingly, the Draft Legislation now provides an exemption for a NRT (other than a NRT that elects in writing not to be an exempt foreign trust) if the following two conditions are satisfied at the particular time:

- the only beneficiaries who may receive any of the income or capital of the NRT hold "specified fixed interests" in the NRT (essentially, non-discretionary interests); and
- any one of the following conditions applies:
  - there are at least 150 beneficiaries of the NRT each of whom holds specified fixed interests having a total fair market value of at least C$500; or
  - all specified fixed interests in the NRT are listed on a designated stock exchange and were traded on a designated stock exchange on at least 10 days in the immediately preceding 30 day period; or
  - each outstanding specified fixed interest in the NRT was either
    - issued by the NRT for at least 90% of the interest's proportionate share of the net asset value of the NRT's property at the time it was issued; or
    - acquired for fair market value at the time the interest was issued; or
  - the NRT is governed by
    - a Roth IRA (as defined in the U.S. *Internal Revenue Code*); or
    - a plan or arrangement created after September 21, 2007 that is subject to the U.S. *Internal Revenue Code* and that the Minister of National Revenue agrees is substantially similar to a Roth IRA.

While the revised proposals have simplified the exemption from the NRT rules for non-resident commercial trusts, they have also added a new rule to tax Canadians who invest in such trusts. Under proposed section 94.2, if a "resident beneficiary"[23]

[23] Since it is unlikely that many non-resident commercial trusts will have a connected contributor, it is unclear whether section 94.2 will be effective in carrying out the tax policy of the Canadian government. Moreover, the Draft Legislation appears to contain a peculiar transitional rule for section 94.2 as it relates to a NRT that is caught by subsection 94(3) for a taxation year ending before March 5, 2010. The version of section 94.2 that applies in those circumstances does not seem to depend on the NRT being a non-discretionary trust. This result is inconsistent with the existing Act and seems to be contrary to the explanatory notes to this provision.

holds, together with persons not dealing at arm's length, 10% or more of the specified fixed interests in a NRT that is described in paragraph (h) of the definition of exempt foreign trust (and that is therefore excluded from the application of the NRT rules), the resident beneficiary will be required to include in income a participating percentage of the NRT's FAPI under the foreign affiliate rules (determined as if the NRT were a foreign corporation) for taxation years ending after March 4, 2010. In essence, the trust will be treated as a controlled foreign affiliate of the resident beneficiary for Canadian tax purposes.

As confirmed in the explanatory notes to the Draft Legislation, where section 94.2 does not apply in respect of an interest in the NRT that is described in paragraph (h) of the definition of exempt foreign trust, the offshore investment fund property rule in existing section 94.1 could instead apply to require the beneficiary to include an imputed amount in income for each taxation year during which the interest is held.[24]

PLANNING OPPORTUNITIES UNDER THE REVISED NRT PROPOSALS

Based on the Draft Legislation, it appears that the following traditional planning strategies will continue to be available for immigrant trusts, perpetual trusts, departure trusts and real estate trusts.

Immigrant trusts

If an individual immigrating to Canada is the only contributor to a NRT and becomes a resident of Canada for purposes of the Act, the NRT may be exempted from Canadian taxation under the NRT rules for a period of up to 60 months. The reason for this result is that the immigrant would not qualify as a "resident contributor" or a "connected contributor" under the Draft Legislation even though the immigrant is a resident of Canada for purposes of the Act.

A common structure used with immigrant trusts involves employing a foreign holding company[25] in the following manner:

- A NRT would be established by a non-resident individual settling a nominal sum upon a professional trustee for the benefit of the immigrant and his immediate family;
- The trustee of the NRT would use the settled sum to incorporate a foreign corporation (Holdco) having only non-resident directors and the trustee, on behalf of the NRT, would subscribe for all of the issued and outstanding common shares of Holdco for nominal consideration;
- Before arriving in Canada, the prospective immigrant would transfer his/her assets to Holdco in exchange for redeemable and retractable preferred shares of Holdco having an aggregate redemption amount equal to the fair market value of the assets at the time of their transfer to Holdco; and
- Before arriving in Canada, the prospective immigrant would make a gift of the preferred shares of Holdco to the NRT.

Accordingly, upon arrival in Canada the immigrant would have no interest in either Holdco or the NRT except as one of the beneficiaries of the NRT. Advantages of structuring the NRT in this manner are that the immigrant's interest in the NRT would not be "specified foreign property" reportable under section 233.3, and it avoids the potential application of the transfer pricing rules. On the other hand, the immigrant would be required to report the NRT pursuant to section 233.2 even though the NRT may not be taxable if the immigrant is a resident of Canada at the end of the relevant taxation year and the year is not the first year during which the immigrant became a resident of Canada.

[24] Under proposed amendments to section 94.1, interests in trusts subject to the NRT rules and trusts described in paragraphs (a) to (g) of the definition of "exempt foreign trust" in proposed subsection 94(1) are excluded from the application of section 94.1, while trusts described in paragraph (h) of the definition of "exempt foreign trust" are excluded from section 94.1 only if they are subject to section 94.2. However, for section 94.1 to apply in respect of an investment in such a trust (or a non-resident trust not subject to the NRT rules), specified conditions must be met, one of which is that it must be reasonable to conclude that one of the main reasons for the investor acquiring, holding or having an interest was to derive a benefit from portfolio investments in specified assets in such a manner that the taxes, if any, on the income, profits and gains from such assets for any particular year are significantly less than the tax that would have been applicable under Part I of the Act if the income, profits and gains had been earned directly by the investor. Where section 94.1 applies, a taxpayer generally will be required to include in income for each taxation year in which the taxpayer owns an interest in the trust the amount, if any, by which an imputed return for the taxation year exceeds any amounts made payable in the year by the trust to the taxpayer as a beneficiary. The imputed return is computed on a monthly basis and is the product of the designated cost of the interest to the taxpayer and the prescribed rate of interest plus two percent.
Although the explanatory notes to the proposed amendments to section 94.1 state that the provision will not apply to an interest in a NRT having no resident contributors, the Draft Legislation itself is deficient in that it contains no such exclusion. Thus, there appears to be a technical problem with the current language of the Draft Legislation.

[25] Some financial institutions and professional trust companies may insist upon the immigrant's assets being held through a holding company to maximize limited liability protection or to minimize potential claims of conflict of interest by the trustee.

If the NRT requires capital, it could simply cause Holdco to redeem some or all of its preferred shares of Holdco. This capital could then be distributed tax-free to the immigrant, as a beneficiary of the NRT, even though the immigrant is a resident of Canada.

Depending on the circumstances, a simpler trust structure may be preferable from a planning perspective. Instead of incorporating Holdco as an intermediary, the NRT may acquire assets directly from the immigrant without adverse tax consequences under subsection 75(2) as a result of the proposed exclusion in paragraph 75(3)(c.3). Under subsection 75(2), if property of a trust is held on condition that it (or property substituted for it) may revert to the person from whom it was received or may not be dealt with except with the consent, or pursuant to the direction, of the person, any income or loss from the property or taxable capital gain or loss from the disposition of the property will be attributed to the person while the person is resident in Canada. Proposed paragraph 75(3)(c.3) contained in the Draft Legislation effectively excludes a NRT from the application of subsection 75(2) during the period in which a contributor to the NRT has yet to reside in Canada for more than 60 months.[26] Accordingly, an immigrant trust will be excluded from the attribution rule in subsection 75(2) for its first 60 months.

Perpetual trusts

As long as all of the contributors to a NRT never reside in Canada for more than 60 months, the NRT will never be taxable under proposed subsection 94(3) as there will never be a "resident contributor" or a "connected contributor" to the NRT. Accordingly, the NRT will enjoy an indefinite tax holiday from the NRT rules as currently proposed. Since Canada does not, in general, impose tax upon distributions of capital from a trust (whether resident in Canada or not), to the extent that such a NRT is able, under the terms of its trust deed, to capitalize its income or gains annually, the NRT will be able to distribute such amounts to a Canadian resident beneficiary as distributions of capital. The distribution of capital will not be taxable in the hands of the Canadian recipient but the recipient may be required to report the distribution in an information return pursuant to section 233.6.

While the proposed NRT rules exclude perpetual trusts from taxation under proposed subsection 94(3), they do not afford similar treatment to "outbound" trusts, i.e., NRT established by persons who have been resident in Canada for more than 60 months but the only possible beneficiaries of which are non-residents of Canada. In contrast to a perpetual trust, an outbound trust would be taxable under proposed subsection 94(3) to the extent that there is a "resident contributor" at the specified time.

Departure trusts

If an individual has been a resident of Canada for more than 60 months and has recently become a non-resident of Canada for purposes of the Act, the individual may establish a NRT without being a "resident contributor" to the NRT since he/she would no longer be a resident of Canada at the specified time. Nevertheless, the individual would still need to be concerned about whether the NRT would have a resident beneficiary. To avoid triggering the "resident beneficiary" condition of the proposed NRT rules, the individual would have one of two basic choices:

- If the individual has not been a non-resident of Canada continuously for more than 60 months since leaving Canada, the individual cannot transfer property to a NRT having Canadian resident beneficiaries without subjecting the NRT to proposed subsection 94(3). However, if the individual establishes a NRT having only non-resident persons as beneficiaries, the NRT would not be caught under proposed subsection 94(3); or
- If the individual has been a non-resident of Canada continuously for more than 60 months, the individual can establish a NRT with one or more beneficiaries who are resident in Canada without the NRT becoming subject to proposed subsection 94(3). On the other hand, if the individual returns to Canada within the 60 month period following his or her contribution to the NRT and the individual becomes a resident of Canada for purposes of the Act, the NRT will be taxable for the taxation year during which the contribution was made as opposed to the taxation year when the individual returned to Canada.[27]

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[26] Without the proposed exclusion, if the immigrant simply transferred property to a NRT of which he/she is a capital beneficiary, there is a material risk that the CRA will attribute any income or taxable capital gain earned or realized by the NRT from the transferred property to the immigrant while the immigrant resides in Canada. If the CRA were successful in arguing its position, the tax advantage for the first 60 months of the NRT would disappear.

[27] See the definition of "non-resident time" in proposed subsection 94(1) and proposed subsection 94(10).

NRT for Real Estate Investments

The basic concept would involve the use of a perpetual trust to invest in Canadian real estate that generates passive income (e.g., income from property). If a non-resident investor established a NRT that qualifies as a perpetual trust[28], the following tax consequences may result:

- The NRT would not be subject to proposed subsection 94(3) since the NRT would not have either a resident contributor or a resident beneficiary.
- The NRT would not be subject to the thin capitalization rules in the Act, which currently apply only to Canadian resident corporations. Accordingly, the non-resident investor would not be limited in the amount of funds that could be lent on an interest-bearing basis to the NRT. To the extent that the interest expense associated with the loans is reasonable in the circumstances, the interest expense should be deductible by the NRT on a current basis.
- If the NRT elects under subsection 216(4) in respect of the rental income received from the Canadian real estate it holds, the NRT would be able to minimize its obligations to pay Canadian non-resident withholding tax under Part XIII of the Act.
- If the loan from the non-resident investor to the NRT is not secured by Canadian real property[29] and the income earned by the NRT does not constitute taxable income earned in Canada[30], the NRT would not be deemed to be a resident of Canada for purposes of Part XIII of the Act. As such, interest on the loan paid by the NRT to the non-resident investor would not be subject to Canadian non-resident withholding tax.

This structure would permit the non-resident investor to receive all or a significant portion of the rental income from the investment in Canadian real estate with little or no Canadian income tax. Moreover, upon a future disposition of the Canadian real estate, the Canadian taxation of any capital gain realized on the disposition will be no worse than if the investor had owned the real estate directly.

CONCLUSION

Although there are a number of technical deficiencies with the language of the Draft Legislation, the latest NRT proposals seem, on balance, to be more favourable for taxpayers and for tax planning than the 2008 version of the rules. In particular, the introduction of the attribution mechanism in proposed subsection 94(16) will help alleviate the exposure of some Canadians contributors to a disproportionate amount of tax liability under the NRT rules. Moreover, the carry-over from the prior draft rules of the requirements to satisfy the definitions of “resident contributor” and “resident beneficiary” will ensure that planning opportunities continue for immigrant trusts, perpetual trusts, departure trusts, and real estate trusts.

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[28] If a bare trustee corporation is used to hold legal title to the Canadian real estate on behalf of the NRT, it would be prudent not to have the NRT incorporate a Canadian company for this purpose. If the Canadian corporation issues shares to the NRT, the corporation would be deemed under proposed subsection 94(2)(g) to have transferred property to the NRT and therefore be a “resident contributor” to the NRT.

[29] See subsection 212(13).

[30] See the proposed amendment to subsection 212(13.2).

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