# STEP TECHNICAL COMMITTEE

## Society of Trust and Estate Practitioners

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November 24, 2000

**DELIVERED BY REGULAR MAIL**

**TAX LEGISLATION DIVISION**
Department of Finance
140 O'Connor St.
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Attention: Mr. Wally Conway

**SOCIETY OF TRUST AND ESTATE PRACTITIONERS**
**COMMENTS AND SUBMISSIONS**
**Re. JUNE 22, 2000 LEGISLATIVE PROPOSALS ("Draft Legislation")**

By way of introduction, the Society of Trust and Estate Practitioners ("STEP") is the professional body for the trust and estate profession worldwide. The Society was formed seven years ago, and now boasts over 8,000 members. In Canada alone, there are over 600 STEP members from the legal, accountancy, corporate trust, banking, insurance and related professions, involved at a senior level in the planning, creation, management of and accounting for trust and estates, executorship administration, and related taxes. Members of STEP include the most experienced and senior practitioners in the fields of trusts, estates and taxation. STEP's mission statement is "to be recognized and accepted as the principal professional body for trust and estate practitioners worldwide". The STEP Technical Committee has been organized to comment and provide submissions on legislative proposals that impact, either directly or indirectly, upon trusts and their beneficiaries as well as related trust, estate and tax matters. Attached as Schedule "A" is a list of the current members of the STEP Technical Committee (hereinafter referred to as the "Committee").

Due to the overall complexity of the Draft Legislation, combined with the Committee's desire to provide input in a timely fashion, this letter provides an outline of our most significant

concerns. We would, however, be pleased to provide further detail if need be or to meet with your committee to discuss our concerns in greater detail.

The following comments represent the Committee's main concerns regarding the Draft Legislation and are presented in no particular order:

## A. NON-RESIDENT TRUST RULES

### 1. Definition of "Arm's Length Transfer"

The definition "arm's length transfer" (subsection 94(1)) is an integral part of the Draft Legislation in determining the taxation of non-resident trusts. However, the definition is such that transactions that one would normally consider to be arm's length, due to the transfer price and the nature of the transaction, may not be considered to be an arm's length transfer for these rules. The following example illustrates this concern.

**Example**

1. A U.S. Bank (the "Bank") provides trustee services for a discretionary trust (the "Trust") established and managed under the laws of the United States.

2. All of the beneficiaries of the Trust and the Contributor to the Trust are residents of the United States for income tax purposes. This would be a typical U.S. living trust structure.

3. The Bank, as trustee, wants certain exposure to Canadian currency and purchases a Treasury Bill from a branch of its Canadian subsidiary (the "Canadian Bank").

**Result**

1. The sale of the Treasury Bill by the Canadian Bank would be considered a "contribution" by the Canadian Bank (see definition "contribution" in subsection 94(1)) unless it was an arm's length transfer as defined in subsection 94(1).

2. As a result of the relationship between the Bank and the Canadian Bank and in accordance with the definition "arm's length transfer" (subsection 94(1)), it may be difficult to conclude, "one of the reasons for the purchase was not the relationship between the Bank and the Canadian Bank". Although it seems clear that the intention of the arm's length test definition is to provide a "safe haven" for commercial transactions, the addition of paragraph (b) in the definition creates considerable uncertainty.

In the above example, the Canadian Bank may be deemed to be a "resident contributor" and will have a joint and several liability for the Canadian tax liability associated with the

worldwide income of the trust. Additionally, as a "resident contributor" the Canadian Bank will have a reporting obligation under section 233.2 of the Act.

The Draft Legislation creates uncertainty for transactions, such as the above, which we do not believe, from a tax policy perspective, were intended to be subject to these rules.

## 2. Definition of "Non-Resident Time"

The definition "non-resident time" contained in the definition "connected contributor" (subsection 94(1)) currently reads as follows:

> a "non-resident time" of a person means a particular time at which the person is non-resident, where the person was non-resident or not in existence throughout the period that began 60 months before the particular time (or, where the particular time is before June 23, 2000 or the trust arose on and as a consequence of the death of the person, 18 months before the particular time) **and** ends 60 months after the particular time.

According to the summary in tabular form found in the explanatory notes prepared by the Department of Finance (the "Explanatory Notes"), it appears that the tax policy for this concept of "non-resident time" is to ensure that persons who cease to be Canadian residents for a continuous period of at least 60 months should be permitted to establish non-resident trusts having Canadian resident beneficiaries without subjecting such trusts to proposed subsection 94(3). However, the present language used in the definition of "non-resident time", creates an administrative and assessing problem directly resulting from the fact that a condition precedent must be fulfilled in order for such a non-resident trust to be exempt from Canadian taxation.

The "particular time" referred to the in the definition above is the time of the contribution. Obviously, it is straightforward to determine at the time of the contribution as to whether the person was a non-resident of Canada throughout the period of 60 months before the "particular time". However, it is impossible to state at the time of the contribution as to whether the person would be a non-resident of Canada or not be in existence throughout the period of 60 months ending after the "particular time". The use of the conjunctive "and" requires that this latter test be met before a contribution can be said to have been made at a non-resident time. This latter test cannot be satisfied at the time of the contribution since it cannot be said that the person made the contribution at a "non-resident time" without retrospection. It is this retrospection requirement that causes the administrative/assessing problem.

As a corollary comment regarding the policy of requiring persons departing Canada to be a non-resident of Canada for 60 months or more before they can establish offshore trusts with Canadian beneficiaries and to exclude such trusts from proposed subsection 94(3), it is submitted that the time period of 60 months is unreasonably too long. Since the administrative position of the CCRA and case law would suggest that there is a presumption that a taxpayer has severed his ties with Canada if he does not return to Canada for 24 months, it is submitted that the time period of 24 months be used in the definition of "non-resident time" for reasons

of consistency with prevailing practice and law. Furthermore, given the administrative/assessing problem referred to above, amending the time period from 60 months to 24 months would assist in limiting the degree and extent of such retrospection.

**3. Deemed Transfer (Paragraph 94(2)(b))**

It is not clear what the actual purpose of paragraph 94(2)(b) is. Unfortunately the Explanatory Notes provide only two examples and both examples fall within the parameters of paragraph 94(2)(a). Interestingly, paragraph 94(2)(a) considers a "fair market value" test in relation to the property being transferred, however paragraph 94(2)(b) does not make reference to this. Although it would seem that paragraph 94(2)(b) is directed at an indirect transfer in which there is "inadequate consideration" this is far from clear. In addition, it should be noted that while proposed paragraph 94(2)(a) has an exclusion for arm's length transfers, proposed paragraph 94(2)(b) does not. We would assume that this is because a relationship must exist between the transferor and certain parties related to the trust itself, although this is also unclear. We would appreciate any direction or assistance that you could provide to assist in interpreting the purpose and effect of paragraph 94(2)(b).

**4. Deemed Transfer or Loan - Acquisition of Shares**

As a result of the application of proposed subparagraph 94(2)(g)(i) of the Act, a non-resident trust which acquires shares of the capital stock of a corporation resident in Canada from that corporation (i.e. previously unissued shares from treasury) will be deemed to have had property transferred to it from that Canadian corporation. This, in turn, will mean that the trust will have a "resident contributor", and, as such, the trust will be liable to Canadian taxation under proposed subsection 94(3).

The utilization of trusts internationally has become quite prevalent and is often seen as the investment entity of choice for many foreign persons. Such trusts more often than not will be utilized to purchase equity interests in Canadian companies. Most of these trusts have absolutely no ties to Canada other than their ownership interest in certain Canadian entities.

**Example**

1. Thomas is a wealthy Asian investor and is a non-resident of Canada. Several years ago Thomas established a trust (the "Trust") in his home jurisdiction for business and personal reasons with no planning designs for Canada.

2. All of the Beneficiaries of the Trust are members of Thomas' family and are not residents of Canada within the meaning of the Act. To date, Thomas has been the only contributor of funds to the Trust and it is not anticipated that any other party will contribute any funds to the Trust.

3. Thomas has decided to establish a new active business in Canada. It is recommended that a new company be incorporated to carry on the business. To avoid any issues regarding "thin capitalization" rules, Thomas has decided to capitalize the company by purchasing shares in the capital of the company.

4. For a number of business and personal reasons, it is not practical for the Trust, which holds the bulk of Thomas' net worth, to distribute either capital or income and, therefore, it is recommended that the Trust acquire the shares in the capital of the company.

**Result**

1. The combined effect of paragraph 94(2)(g) and subsection 94(3) will deem the Trust to be resident in Canada and subject to tax on its worldwide income unless the acquisition of the shares of the Canadian company is considered to be an arm's length transfer as defined in subsection 94(1).

A similar issue could arise if a dividend were paid on the shares of the Canadian company to Thomas' offshore trust. The application of subsection 94(3) to these types of situations is not considered to be an intended result of these rules. The result, if subsection 94(3) applied would be that not only would the Trust be subject to taxation on the income earned by the company, if any, but also on its worldwide income regardless of where such income was earned. Under the proposed rules the Canadian corporation will also have disclosure obligations under section 233.2 of the Act. In the event that Thomas cannot find a more suitable way to make an investment into Canada, it is probable that Thomas will look elsewhere than Canada to establish his active business. Canada will lose Canadian employment, corporate tax on the income that would have been generated by the new Canadian corporation and any withholding taxes associated with dividends paid by the Canadian corporation to the non-resident shareholders. This is clearly an example of a no-win scenario for either Thomas or Canada.

## 5. Reporting Rule For Quasi-Trusts

Proposed subsection 233.2(4.1) of the Act should be deleted and replaced with the following:

> Where a contribution (within the meaning assigned by subsections 94(1) and 94(2) if the reference to "trust" were replaced by a reference to "non-resident entity") has been made at a particular time by a person to a particular non-resident entity (other than a corporation or a trust), for the purpose of this section and sections 162, 163, and 233.5, the person's obligations under subsection (4) (except to the extent that they are waived in writing by the Minister) shall be determined as if the contribution were a contribution to which paragraph (4)(a) applied, the non-resident entity were a trust not

> resident in Canada throughout the calendar year that includes that time and the taxation year of the entity were that calendar year.

Since proposed subsection 233.2(4.1) of the Act is intended to be a corollary provision to subsection 233.2(4) of the Act and to ensure that proper reporting be made regarding "quasi-trusts", the language of proposed subsection 233.2(4.1) should be consistent with the main provision, being subsection 233.2(4) of the Act. Accordingly, it seems more appropriate to link the application of subsection 233.2(4.1) to the new concept of "contribution" which has been defined extensively as opposed to using more vague concepts of direct and indirect transfers and loans. Since the definition of "non-resident entity" contained in proposed subsection 94.1(1) of the Act encompasses non-resident corporations, it is necessary to exclude these corporations from the definition for purposes of proposed subsection 233.2(4.1) to avoid unnecessary costs and compliance by taxpayers. Since taxpayers do report their interests and investments in foreign corporations pursuant to either section 233.3 or 233.4 and such reports contain extensive and detailed information, it would be redundant and burdensome to require the same taxpayers to file similar information on another form made pursuant to proposed subsection 233.2(4.1).

In addition to the foregoing comments, if the definition of "non-resident entity" for the purpose of proposed subsection 233.2(4.1) of the Act is not amended to exclude corporations, there will likely be many unintended results from the application of this new provision. For example, assume that a U.S. individual, Mr. X, who has never resided in Canada owns all of the issued and outstanding shares of a U.S. corporation. The sole asset of this corporation is comprised of a small business operated wholly in the U.S. for a number of years. This business has no connection to Canada (i.e. no assets situated in Canada, no Canadian employees, etc.). Over the years, Mr. X has transferred property or loaned funds to this U.S. corporation on a non-arm's length basis, (i.e. made interest-free loans, contributed assets without receiving full consideration, etc). Assume further that Mr. X sells the U.S. corporation to an arm's length party who is another U.S. resident person and the sale occurs on normal commercial terms. Mr. X then decides to move to Canada to retire and becomes a Canadian resident for purposes of the Act.

Based on the broad language of proposed subsection 233.2(4.1) of the Act, it would appear that Mr. X would, subject to section 233.7, be required to report the U.S. corporation after he becomes a resident of Canada for purposes of the Act for all future taxation years (after 2001) even though he no longer owns the U.S. corporation. In particular, this proposed provision requires that where property is at any time transferred or loaned by a person (i.e. Mr. X) to be held by a non-resident entity (i.e. the U.S. corporation) that is not a trust, exempt trust, or exempt foreign trust, and the transfer or loan would not be an arm's length transfer or exchanged for certain property, Mr. X would be required to report the U.S. corporation on the basis that all of his transfers or loans to the corporation were treated as contributions to a non-resident trust. This result is clearly inappropriate in the circumstances and beyond the apparent legislative intent of the provision as stated in the Explanatory Notes to proposed subsection 233.2(4.1).

## 6. Trust For Charitable Purposes

We do not understand the reasons behind requiring a trust, which has been established exclusively for charitable purposes to have more than 20 contributors in order to be classified as an "exempt trust". We believe that in many cases this may not be practicable or even possible and may potentially detract from a number of legitimate charitable intentions.

**Example**

1. Sergei is a European citizen residing in Canada. Sergei is a professional hockey player.

2. Sergei has established a Trust in Europe for the exclusive benefit of certain underprivileged members of his hometown. The Trust has been established exclusively for charitable purposes, however, the Trust does not always distribute all of its current income in each year, for a variety of reasons.

3. Sergei has been able to convince a number of other professional athletes to contribute to the Trust. Some of these athletes reside in Canada, while others reside outside Canada. There are currently only 10 contributors to the Trust.

**Result**

1. The Trust will not be classified as an "exempt trust" subject to the definition in subsection 94(1).

2. As a result of Sergei's contribution to the Trust, the Trust will be subject to tax in Canada on its worldwide income. Additionally, if the Trust fails to pay the income tax owing, Sergei and any other contributor to the Trust, will be personally responsible for the taxes owing.

We believe this is another example of the Draft Legislation extending too far. Again, we would agree that there may be certain abuses of the Canadian tax system that may involve the establishment of foreign charitable trusts, however, the attempt to prevent such abuses should not detrimentally affect legitimate tax and charitable giving. Such abuses must be seen as the exception to the general rule and not the cause for a new rule.

## 7. Grandfathering of Pre-June 22, 2000 Trusts

Under any self-assessment system of income taxation, taxpayers have the basic right to know what the rules are and to plan their affairs based on such rules. As stated by the court in *Phillips v. Eyre* (1820), 6 L.R. 1 (Q.B.):

> Retrospective laws are, no doubt, prima facie of questionable policy, and contrary to the general principle that legislation by which the conduct of mankind is to be regulated ought, when introduced for the first time, to deal

> with future acts, and ought not to change the character of past transactions carried on upon the faith of the then existing law. (at 23)

According to subsection 10(2) of the Draft Legislation, the legislative proposals contained in subsection 10(1) of the Draft Legislation are stated to apply to taxation years of trusts that begin after 2000 with limited exceptions. Although the press release of September 7, 2000 has extended the effective date of the new rules to the 2002 and later taxation years, the fundamental problem remains. That is, the legislative proposals will apply to trusts established before June 22, 2000 and hence, have retrospective effect. As a result, taxpayers who planned their affairs based on the existing law before June 22, 2000 may be adversely affected by the Draft Legislation. For example, consider a non-specified foreign trust that was established before June 22, 2000. Under existing subsections 94(1) and 248(25), an offshore trust established by a Canadian resident person for the benefit of solely non-resident persons (i.e. no Canadian resident person is beneficially interested in the trust) is not subject to Canadian tax pursuant to Part I of the Act on its foreign-sourced income. This result makes sense from a tax policy perspective in that Canada would similarly not tax foreign-sourced income earned in the hands of the non-resident beneficiaries if the trust assets were held directly by such beneficiaries. Since neutrality is a desirable criterion in the design of any tax system this result should be encouraged.

Unfortunately, the legislative proposals contained in the Draft Legislation remove this element of neutrality under the existing Act by subjecting the trust in the foregoing example to Canadian tax under Part I of the Act. That is, proposed subsection 94(3) of the Act and the press release would apply to the above trust for the 2002 and later taxation years since the offshore trust has a "resident contributor" at the end of the relevant taxation year. This result is patently unfair to the Canadian resident person who established the trust according to the existing Act. To address this inequity and yet give effect to any change in tax policy, it is submitted that the Draft Legislation should only apply to trusts formed on or after June 22, 2000.

## B. FOREIGN INVESTMENT ENTITY ("FIE") RULES

### General Comments

In the 1972 tax reform, Canada introduced a series of rules to tax Canadian shareholders in respect of income earned in foreign corporations. The principal thrust of these rules was to allow Canadian taxpayers to realize business income in foreign jurisdictions but to require Canadian taxpayers to report or accrue investment income earned by the foreign corporation where that foreign corporation was controlled by the Canadian taxpayer. These rules eliminated the tax advantage that would otherwise arise if investment income were earned by these offshore corporations. The rules resulted in essentially the same Canadian tax being realized whether the offshore investment income were earned in Canada or offshore. There was (and is) no tax penalty for earning such investment income offshore.

If the foreign corporation was not controlled, then the rules allowed the return of business income free of Canadian tax if the Canadian taxpayer was a corporation and if the business

income was earned in a treaty country. Otherwise income (business or investment) was taxed only when received by the Canadian taxpayer. Again, there was no tax penalty for earning investment income in the offshore corporation.

The tax policy behind the proposed foreign investment entity ("FIE") rules also appears to ensure that Canadian taxpayers not be required to accrue or report on an mark-to-market basis income earned by offshore entities which principally earn business income. This statement is based upon the definition of FIE which defines a FIE to essentially be an entity where more than half of its assets are investment properties. One concern with the proposed FIE rules as presently drafted is that the rules can apply to entities that primarily earn business income. In addition, unlike the controlled foreign affiliate rules, there is a tax disadvantage for investing in a FIE. These results are considered to be contrary to the tax policy for the introduction of these rules. Also, considering that in recent years the Department of Finance has relaxed several provisions to permit Canadian residents to invest a greater percentage of their wealth outside Canada it is strange that the FIE rules would have the opposite effect.

It has been indicated that the reason for the proposed changes to existing section 94.1 was due to concern that the rule was ineffective in ensuring that Canadians cannot earn investment income outside of Canada and thereby eliminate or defer Canadian tax. This is somewhat indicated in the Explanatory Notes issued with proposed new section 94.1 where it states "a taxpayer's investment motives are no longer relevant". It is submitted that many taxpayers did not invest in offshore funds in tax haven countries due to the possible ineffective nature of existing 94.1. It is further submitted that these "aggressive" taxpayers that invested in such entities and did not include income amounts under existing section 94.1 could have had their filing positions challenged by the CCRA. It does not appear that the CCRA challenged those aggressive taxpayers and that should neither be the basis for the complete redraft of the existing legislation nor the determination that the existing legislation is ineffective.

Considering that existing section 94.1 was enacted in late 1984 and that there have been no cases with respect to that section would lead one to believe that the rule must have been effective for some period of time. It would also lead one to believe that it has only been in recent years that the rule may not have been effective or as effective for certain more aggressive taxpayers. It is unclear why the CCRA has not pursued these aggressive taxpayers in the courts to deal with the issues. It is submitted that a better approach may be to propose amendments only to those parts of existing section 94.1 in respect of which the CCRA had difficulty in assessing taxpayers. The Committee would be pleased to assist the Department with these matters.

It is also submitted that many taxpayers will be subject to these new rules whose offshore investments were not tax motivated and would not have been subject to existing 94.1 (such as acquiring investments in a jurisdiction such as the United States). Being subject to these rules will result in the tax incurred being different than what the taxpayer would have expected when the investment was acquired before the introduction of these rules (i.e. gains fully taxable instead of being taxed as a capital gain). It is submitted that this is a significant change in the tax treatment associated with investments that would not have been subject to tax under existing 94.1. If the new rules as drafted are to apply to such investments then it is

submitted that the new rules should only apply to interests acquired after the Announcement Date.

Another concern with the FIE rules is with respect to taxpayers that do not use professionals to assist them in determining their tax liabilities. This is usually because the amount of tax involved does not warrant the use of professional help. The FIE rules have a wide application and would require many taxpayers to assess their tax liability under these complex rules. We submit that taxpayers that do not utilize professionals to determine their liability will have difficulty in understanding and applying these rules.

**Specific Issues**

**1. Exempt Interests**

One rule that can result in Canadians being taxed with respect to foreign entities that primarily carry on business is paragraph (b) of the definition of "exempt interest" in section 94.1. It seems clear that the intention of this paragraph is to exclude investments in foreign public corporations that primarily carry on business. However, the proposed rules, as drafted, do not achieve this intention.

Many publics companies are structured with a "top" holding company with many operating subsidiaries being owned by that top company. Such a structure requires the public company to satisfy the "qualifying corporation" definition in section 94.1. One requirement to be a qualifying corporation is that its subsidiaries must be wholly owned (or the shares not owned must be owned by related companies). Accordingly, minority interests could cause this requirement not to be met. Another requirement is that the 50% investment property test becomes an all or substantially all (or 90%) test. It is unclear why a corporation should fail the qualifying corporation test, but would qualify to be an exempt interest if all of its operations were carried on by the top company. Failing to satisfy the qualifying corporation test and, therefore, the exempt interest test then requires the Canadian taxpayer to determine if the offshore company is a FIE. It may be difficult, if not impossible, for taxpayers to obtain the non-consolidated financial information necessary to determine if the foreign public corporation is a FIE particularly for large public corporations.

**2. Filing of Election re. Mark-to-Market Rules**

If a taxpayer who has an interest in a FIE wishes to be taxed under proposed section 94.1 for the initial year in which the FIE rules apply to that interest, the taxpayer is obligated to file an election by the "filing due date" for that particular year. Furthermore, a timely election must be filed for each subsequent year to be able to continue to be taxed under section 94.1. The Draft Legislation has no provision for late filing such elections. Accordingly, because of failure to file the election on time, many taxpayers will be required to use the mark-to-market basis for taxation, regardless of whether the taxpayer would be in a position to avoid this. This failure may simply result from the fact that the taxpayer and/or his or her professional

advisors were unaware that the entity in question in which the taxpayer held an interest was a FIE.

## 3. Determination of Market Value

The FIE rules are silent on providing any assistance in terms of determining the market value of a specific interest in a FIE. One of the most common concerns would be in relation to an interest in a private company, a company that does not offer a quoted market value for an individual's interest in it, or an entity that holds assets that cannot be readily valued (i.e. real estate). Taxpayers will be required to hire valuation experts to assess the value of their interests or otherwise determine the value based upon the information available to them. For those taxpayers with substantial assets, determining fair market value or hiring someone to determine fair market value should not be much of a concern. However, for the general taxpayer, the taxpayer will be concerned as to whether he has determined the appropriate fair market value amount and thereby remitted the appropriate amount of tax in a given year.

## 4. Taxation of Active Business Income

If a share of the FIE's income is taxable in the hands of a Canadian resident under section 94.1, such taxation is based on all of the FIE's income for tax purposes, not just investment income. This is a departure from the tax policy in the international tax area as discussed above. It means that Canadians holding an interest in a FIE will be subject to a tougher tax regime than those holding an interest in a "controlled foreign affiliate". Similarly, if the mark-to-market rules apply, unrealized appreciation in value of the interest in the FIE, even if derived from underlying assets used in an active business, will be subject to taxation each year. It is submitted that there will be situations where the amount required to be included in income under proposed sections 94.1 or 94.2 would exceed the distributions received by the taxpayer. While this result would be appropriate for those offshore entities that accumulate investment income, in many cases, the offshore entity (particularly those that also carry on a business) annually distributes an amount equal to or greater than the investment income earned. It is not considered to be appropriate for entities that annually distribute an amount equal to or greater than their investment income to be subject to these rules since there has not been a deferral of Canadian tax. In addition, it is inappropriate in these circumstances to cause all income, including business income or unrealized gains, to be taxable in Canada.

An entity may be classified as a FIE even if 100% of its assets are used in an active business and 100% of its income is derived from an active business. This will be the case for entities that own real estate, since all real estate is classified as "investment property", even if used in an active business. Accordingly, in cases where more than 50% of the carrying value of an entity's assets consists of real estate, the entity will generally be a FIE. Accordingly, non-resident entities that operate a hotel, theater, or nursing home business, to name just a few, may be classified as FIEs as a result of their heavy real estate component. Although an election to treat the FIE as a "controlled foreign affiliate" may solve the problem in many cases, this election is only available where the FIE is a "foreign affiliate" and in which the taxpayer has a "qualifying interest" as defined in paragraph 95(2)(m). This election will not

be available where the FIE is a trust or where the shareholdings in a corporate FIE do not meet the requirements for a qualifying interest in a foreign affiliate or it is not a foreign affiliate.

## 5. Death of an Individual with an Interest in a FIE

On the death of an individual taxpayer holding an interest in a FIE that is subject to the mark-to-market rules, there will be a deemed disposition at fair market value, and any positive "deferral amount" will have to be recognized as income. A concern arises if the interest in the FIE passes to the taxpayer's spouse or spousal trust. The Draft Legislation contains no exception under which a "spousal rollover" would be allowed for the "deferral amount". This is clearly inconsistent with the general scheme of the Act.

## 6. What is a "Foreign Investment Entity"?

The new definition in the Draft Legislation of a "foreign investment entity" supersedes the term "offshore investment fund" in the existing legislation. The purpose of the existing definition being to target Canadian residents investing in certain offshore mutual funds. The scope of the Draft Legislation, however, goes far beyond what one would commonly refer to as a "fund". In a number of cases it will be nearly impossible to determine, with any degree of certainty whether a Canadian resident has an investment in a FIE. We are concerned that if the Draft Legislation were to be enacted intact, the all-encompassing nature of the definition "foreign investment entity" will result in significant inequities and undue hardships.

**Example**

1. John, a Canadian resident has purchased a foreign Index Participation Unit ("IPU"). Each year the IPU has paid out to its unit holders the income, dividends and capital gains generated throughout the year. The unrealized gains, however, would be tax deferred.

**Result**

1. In the event that John is required to use the mark-to-market method, the unrealized gains of the foreign IPU will now be taxable as income.

The investment in Index Participation Units and a variety of exchange-traded funds (ETFs) have proven extremely popular in the past several years for Canadian residents. The Draft Legislation will potentially destroy these investments as viable investment vehicles for Canadian residents.

## 7. Investment Business

The definition of investment business in subsection 94.1(1) excludes a business that is in the development of foreign resource properties. However, it would appear that if a foreign corporation were to be in the development of both Canadian and foreign resource properties than that foreign corporation's business could be an "investment business" and thereby not be an exempt interest and be subject to the FIE rules. It is not considered to be appropriate for a foreign corporation to be subject to the FIE rules simply because part of its business is developing Canadian resource properties and foreign resource properties.

## 8. Capital Dividend Account and Exempt Surplus

For capital properties held on June 22, 2000 that are subject to the mark-to-market rules, accrued gains to January 1, 2001 will be included in the "deferral amount". This deferral amount is included in the taxpayer's income when the property is sold (or in the case of a gain, if the taxpayer elects to include it in income). The amount included in income is two-thirds of the accrued gain at January 1, 2001. However, this amount is not a capital gain and therefore if the taxpayer is a Canadian-controlled private corporation of a foreign affiliate of a taxpayer, then the non-taxable portion of the deferral amount is not included in the taxpayer's capital dividend account or exempt surplus. It is submitted that the non-taxable third should be included in the capital dividend account and in exempt surplus otherwise taxpayers that hold these investments in Canadian-controlled private corporations or in foreign affiliates will be at a tax disadvantage in comparison to those who hold the investments directly.

## 9. Life Insurance

There has long been concern as to how immigrants to Canada should treat life insurance policies issued by offshore companies. The rules governing tax-exempt insurance contracts are quite complex and no one would (or could) give an opinion as to whether, for example, a policy issued by a company in Switzerland or even the United States could satisfy the "exempt test" rules currently contained in the Act. The lack of certainty regarding the tax treatment of such policies has proven very frustrating for immigrants to Canada and their advisors. The Draft Legislation governing offshore life insurance policies is, in part, an attempt to provide certainty as to the treatment of such policies. As a result, many immigrants may be inclined to cancel offshore policies upon immigrating to Canada as a result of the Draft Legislation. Such action may well be imprudent; particularly if the individual has had a change of health since the policy was issued (and in any event new insurance coverage would likely be more expensive as a result of the individual being older). The Draft Legislation also attempts to make it much less attractive for Canadian residents to purchase policies from offshore carriers. This is a niche market, but it could well involve substantial dollars and should be the true focus of the new legislation.

The Draft Legislation applies both to Canadian residents who purchase offshore policies as well as to non-residents who acquire such policies within 5 years of immigrating to Canada. This 5-year look back provision may prove impractical and unfair, especially since the policy may have been acquired when the individual had no intention of immigrating to Canada. Further, the cost to an individual of obtaining new insurance coverage may well be

prohibitive (i.e. if the individual has had a change in health status). In this regard, it should be noted that people take out life insurance policies for a variety of reasons (e.g. charitable giving, funding foreign taxes, etc). To apply the new proposed rules at subsection 94.2(10) to immigrants might have serious implications on the estate planning they implemented prior to coming to Canada (and possibly even before contemplating immigrating to Canada).

The Draft Legislation rules impose a strict “mark-to-market” regime, however, there is no “market” in insurance policies. The closest thing there is to a “market” is the policyholder's right to demand the policy's cash surrender value from the issuer of the policy. However, the Explanatory Notes indicate that cash surrender value is not necessarily indicative of market value for purposes of the mark-to-market rules.

The Draft Legislation rules do not allow for any grandfathering relief in respect of policies acquired prior to Announcement Date. In this regard, the Department of Finance has always recognized the unique nature of life insurance and the unfairness of applying new rules to existing policies. This history of grandfathering relief recognizes (1) the long term nature of the life insurance policy (2) the need for certainty regarding such long term contracts, and (3) the increasing cost of obtaining life insurance coverage as an individual ages (as a result of being older and perhaps less healthy). Not extending grandfathering relief to existing policyholders would invite a very negative precedent.

## Conclusion

It remains our opinion that many of the examples and concerns set out above are unintended results, however, they are very real concerns. We do not disagree that the taxation of non-resident trusts and the taxation of “offshore investment funds” may be in need of some revision, however, such a major undertaking is bound to create unintended results. We believe that given the major impact that such legislation will have on Canada’s taxation system especially in relation to foreign investment, that it is imperative that the legislation be proclaimed as law prior to becoming effective. We do not disagree that the Announcement Date should remain June 22, 2000, however we believe it is imperative that taxpayers know exactly what the legislation will be in order to determine the application of the legislation to certain situations.

Additionally, we believe that the need for proper grandfathering provisions must be considered. For example, there are numerous non-resident trusts that have previously been established in the U.S. and other foreign jurisdictions. Such trusts were often created by contributions from Canadian residents at the non-resident beneficiary’s express request. In such cases, the Contributor generally has no ongoing involvement with the Trust. To now require the non-resident trust to pay Canadian tax on all of its undistributed income and furthermore, to make the contributor jointly and severally liable for such taxation is not practical. In fact, in many instances the contributor will not even be aware of the potential tax liability.

We believe that certain amendments are important in order to maintain integrity in our tax system, however, we believe that these amendments need to be given further thought. We

would be pleased to assist the Department of Finance in addressing these concerns and recommending amendments that would address the Department's main concerns while simultaneously ensuring that the Canadian tax system is fair, not only to Canadian residents, but any person carrying on business in Canada.

In conclusion, we realize that certain of the above submissions may be addressed by subsequent amendments to the Draft Legislation, as indicated in Finance Canada's September 7, 2000 Press Release "Finance Minister Extends Consultation Period and Announces New Effective Date for Foreign Investment Entity and Trust Tax Proposals" and we look forward to being able to assist with the drafting of such amendments.

Should you have any questions or concerns with respect to any of our comments or submissions, you may direct them to the undersigned. We appreciate your consideration and attention to this matter.

Yours very truly,

**STEP TECHNICAL COMMITTEE**

Paul R. LeBreux
Chair

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