STEP TECHNICAL COMMITTEE

Society of Trust and
Estate Practitioners

Please reply to:

Paul R. LeBreux
Harris & Harris - 180 Attwell Drive, Suite 400
Toronto, Ontario, M9W 6H8
Tel. (416) 798-2722 Fax (416) 798-2715
E-mail: paullebreux@harrisandharris.com

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DELIVERED BY E-MAIL AND REGULAR MAIL

TAX LEGISLATION DIVISION
Department of Finance
140 O'Connor St.
Ottawa, Ontario
K1A 0G5

Attention: Mr. Wally Conway

SOCIETY OF TRUST AND ESTATE PRACTITIONERS
COMMENTS AND SUBMISSIONS
Re. August 2, 2001 LEGISLATIVE PROPOSALS ("Draft Legislation")

The following comments are in relation to the Legislative Proposals on Taxation of Non-Resident Trusts and Foreign Investment Entities released August 2, 2001 (the "August Draft") and are in addition to our initial submissions, forwarded to you by letter dated November 24, 2000 (the "Initial STEP Submission").

We have now had an opportunity to review the August Draft in detail and are pleased and encouraged by the fact that a number of our initial submissions were considered, thereby resulting in certain amendments to the original June 22, 2000 Draft Legislation (the "June Draft"). These amendments not only addressed certain of our major concerns, but also have gone a long way to add clarity and exactness to a number of the more complex provisions.

However, a number of the Committee's concerns have not been addressed and continue to be quite problematic. Furthermore, the August Draft introduces new provisions, new definitions and terms and in certain cases even new tax policy.

Given the extremely short time frame allotted for further submissions, we have isolated our comments to the provisions as they relate to the taxation of non-resident trusts and as such, the following submissions relate only to this portion of the August Draft. The submissions that follow are presented in no particular order. Where appropriate we have attempted to augment our comments with specific examples of hardship that may result should the August Draft be proclaimed as law in its current form.

1. Implementation Date (January 1, 2002)

We remain concerned that the provisions of the August Draft will become operative (i.e. January 1, 2002) prior to the legislation actually being proclaimed as law. This is of even greater concern given the significant amendments to the June Draft, as proposed in the August Draft, combined with the inevitable reality that the August Draft will also undoubtedly undergo further revisions prior to being presented in Bill form.

The difficulty and uncertainty created for taxpayers, not to mention their professional advisors, as a result of this premature implementation is readily apparent. Undoubtedly significant time and money will be expended by Canadian taxpayers to address the concerns created by the legislative proposals. Such expense is potentially futile if the legislative proposals are further amended prior to enactment. Proposing an implementation date prior to the enactment of such complicated legislation, not to mention legislation whose application is retrospective in nature, is clearly prejudicial to the taxpayer and ill advised.

The existing provisions of the *Income Tax Act (Canada)* (the "Act") that tax non-resident trusts (primarily section 94 of the Act) have remained virtually unamended in the Act since 1976. Although we do not intend to enter into a debate with the Department of Finance as to the necessity of these legislative proposals, it would only seem reasonable to delay the implementation date until the legislative proposals have actually been proclaimed as law. Surely, a further delay after nearly 25 years should not be seen as prejudicial in any way to the Department of Finance or Canada Customs and Revenue Agency ("CCRA").

2. Deemed Transfer or Loan - Acquisition of Shares (par. 94(2)(g))

We reiterate our original concerns, as set out in the Initial STEP Submission, regarding the application of proposed subparagraph 94(2)(g)(i) of the Act. To deem a non-resident trust which acquires shares of the capital stock of a corporation resident in Canada (i.e. previously unissued shares from treasury) to be a Canadian resident for the purposes of Part I of the Act and, thereby taxable on its worldwide income will undoubtedly render Canada a less attractive environment for foreign investment.

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. Thomas has decided to capitalize the company by purchasing shares in the capital of the company, arguably the most common method to capitalize a start-up entity.

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, regardless of the fact that the bulk of the assets of the non-resident trust have absolutely no connection to Canada.

Such a result must be seen as over reaching. In the event that Thomas can not find an alternative to capitalizing the Canadian company with proceeds from the non-resident Trust it is likely that Thomas will choose to establish the business elsewhere. Canada potentially loses 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 (i.e. the non-resident Trust). In the alternative, should Thomas decide to still proceed with an investment in Canada, it is likely that Thomas will employ even more aggressive strategies to avoid the effect of paragraph 94(2)(g).

Although the policy to tax the growth on the shares owned by the non-resident Trust in the capital of the Canadian corporation may be appropriate, it is clearly not appropriate to subject all of the income earned by the Trust (i.e. income that is in no way connected to Canada) to Canadian tax. We would suggest that the legislative proposals be amended to deem the non-resident Trust subject to taxation in Canada only on the income generated by the property transferred or loaned to the non-resident Trust by a "resident contributor" or a "connected contributor" as the case may be. We would suggest that this should be the case not simply for the purposes of paragraph 94(2)(g) but for all contributions to non-resident Trusts. Is this not the policy of the new legislative proposals (i.e. to subject income earned on property to

taxation in Canada in the event that the income earned on the property would have otherwise been taxable in Canada had the property not been transferred to a non-resident Trust)?

3. Definition of "Arm's Length Transfer"

The definition "arm's length transfer" (subsection 94(1)) is an integral part of the August Draft in determining the taxation of non-resident trusts. We recognize that this definition has been amended extensively reducing some of the ambiguity that existed previously in the June Draft. We note that for the purposes of the foreign reporting rules (amended subsection 233.2(2)) the arm's length transfer exemption is a basis upon which an exemption can be claimed from the reporting requirements. However, reliance on the type of transaction set out in paragraph (e) of the definition to avoid the transfer being classified as a "contribution" would not permit such an exemption. Unfortunately, the scenario set out in paragraph (e) is the one that will most likely be relied upon to avoid a transfer being deemed a "contribution" given the narrow application of the preceding paragraphs (a) – (d). The requirement to comply with the foreign reporting rules in a situation that is clearly arm's length, but only as a result of the exemption contained in paragraph (e), is impractical and unrealistic and will result in the needless generation of more paperwork.

Example

> A publicly traded Canadian corporation (i.e. Nortel Networks) declares and issues a stock dividend. Unfortunately a stock dividend is not deemed to be an arm's length transfer pursuant to paragraph (a) of the definition arm's length (paragraph (a) exempts a transfer that is a dividend but not if the transfer is a transfer described in paragraph 94(2)(g) [which would include a stock dividend]). Although the declaration of the stock dividend would clearly result in a transfer that is arm's length in nature, this will only be as a result of the operation of paragraph (e). Additionally, there is no practical manner for the publicly traded corporation to be assured that a non-resident trust is not a beneficial owner in some way of its shares and, therefore, the completion and filing of a foreign reporting form will always be necessary in such an instance.

We understand that the refusal to grant an exemption from the foreign reporting rules in a situation where the party is relying on the exception set out in paragraph (e) is designed to ensure that CCRA has an opportunity to review such transfers, however, in the case where the transferor is a public corporation, we believe such a transferor should not be required to comply with the foreign disclosure rules and would recommend that an exemption from this requirement be provided for publicly traded companies.

4. "Non-Resident Time" and "Connected Contributor"

The policy of the legislative proposals is to deem a transfer to a non-resident trust to have occurred during a non-resident time provided the contribution is made 60 months after such contributor is no longer a resident of Canada. Based on this policy, an entity that has

contributed to a non-resident trust within the 60 month period of becoming a non-resident of Canada should clearly be deemed a "connected contributor", however, once the entity has been a non-resident of Canada for more than 60 months it would seem that from a policy perspective the entity should, as of this date, no longer be deemed a "connected contributor". It seems onerous to forever deem an entity to be a "connected contributor" because the entity may have miscalculated the 60-month period or because of other extenuating circumstances making it practical to establish the non-resident trust within this 60-month period. What rationale can there be for exempting a non-resident trust from the application of new subsection 94(3) where the entity made a contribution 61 months after becoming a non-resident while simultaneously taxing a non-resident trust in Canada where the entity made the contribution 59 months after becoming a non-resident of Canada, but has now been outside of Canada for the appropriate 60 month period.

5. "Non-Resident Time" and "Resident Contributor"

Given the policy that a contribution made during a non-resident time should not be considered as a "contribution" for the purposes of the definition "connected contributor" it seems only reasonable that this same exemption should also apply with respect to the definition "resident contributor".

Example

> Mr. Jones, a former resident of Canada, has been a non-resident of Canada for a considerable period (i.e. 20 years). Ten years ago Mr. Jones established a non-resident Trust for the benefit of his children, who still reside in Canada. Pursuant to the provisions of current section 94 this Trust would not be taxed as a resident of Canada. Pursuant to the provisions of new section 94, this Trust would not be taxed as a resident of Canada, since the contribution by Mr. Jones was made during a "non-resident time" (we are assuming that Mr. Jones does not return to Canada as a resident within five years of contributing to the Trust).
>
> However, should Mr. Jones return to Canada as a resident (i.e. ten years after contributing to the Trust), Mr. Jones will be defined as a "resident contributor", thus subjecting the Trust to the provisions of subsection 94(3). This result seems to fly in the face of the policy that a "contribution" should be ignored if it occurred during a non-resident time. Given that it may be impractical or even prohibited for the Trust to either be terminated or for the assets to be distributed to the beneficiaries, we question why such a Trust should immediately become subject to Canadian taxation upon the return to Canada of the contributor.

We would recommend that the definition "resident contributor" be revised to provide as follows:

> "resident contributor" to a particular trust at any time means an entity that is, at that time, resident in Canada and a contributor to the particular trust

but does not include

(a) an individual (other than a trust) who has not, at that time, been resident in Canada for a period of, or periods the total of which is, more than 60 months (other than an individual who, before that time, was never non-resident); or

(b) an entity that would not be a contributor to the trust at the particular time if

(i) the transfers and loans referred to in paragraph (a) of the definition "contribution" made by the entity at a non-resident time of the entity were not taken into account, or

(c) an individual, if ….

6. "Resident Contributor" and Paragraph 94(2)(g)

We note that the previous "grand fathering" provided in paragraph 94(2)(g) of the June Draft has now been removed in the August Draft. We are concerned that this will result in an untenable result in the event that a non-resident trust, prior to June 22, 2000, acquired shares in the capital of a Canadian corporation from treasury (obviously without any indication that this would be the subject of proposed legislation) and subsequently disposed of such shares, again prior to June 22, 2000. One can only imagine how many Canadian corporations would fit within this scenario. To deem such a Canadian corporation to be a "resident contributor" of the non-resident trust in such a scenario is perverse. Furthermore, any third party acquiring the shares in the capital of the Canadian corporation at some future point would have no ability to complete the appropriate due diligence in order to determine that the Canadian corporation would carry the unenviable distinction of being a "resident contributor" to some unknown non-resident trust. Clearly, the legislative proposals should not intend to create such a result when it would be virtually impossible to determine whether an entity was or was not a "resident contributor".

We would suggest that paragraph 94(2)(g) be revised to add the following wording immediately following clause (v):

provided the entity that has acquired the property as set out above in clauses (i) – (v) still held an interest in the property as of ANNOUNCEMENT DATE.

We believe that this limited "grand fathering" is appropriate and reasonable given the policy of the legislative proposals.

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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