# STEP

## Society of Trust and Estate Practitioners

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**DELIVERED BY E-MAIL ONLY**

**TAX LEGISLATION DIVISION**
Department of Finance
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Attention: Ms Annemarie Humenuk

**SOCIETY OF TRUST AND ESTATE PRACTITIONERS ("STEP")**
**COMMENTS AND SUBMISSIONS**
**Re. 2010 Federal Budget ("NRT/FIE Draft Legislation")**

STEP is the professional body for the trust and estate profession worldwide. The Society was formed in 1993 and now boasts over 15,000 worldwide members. In Canada alone, there are over 2,000 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 and a number of members, including the four undersigned, whom have extensive experience in the international area.  STEP (Canada) has been actively involved in making submissions with respect to the introduction of the Non-Resident Trust (“NRT”) and Foreign Investment Entity (“FIE”) draft legislation (the “Draft Legislation”) since these proposed amendments were first introduced by way of draft legislation on June 22, 2000.  We have had an opportunity to review the measures contained in Budget 2010 affecting NRTs and FIEs and although it is difficult to comment in a detailed manner until we have had an opportunity to review the legislative language that will accompany such proposals, we felt it prudent to provide our general and specific comments prior to the May 4, 2010 consultation cut-off date, in the hopes that such comments will be considered when the legislation is finally drafted.

First, we commend the efforts of the Department of Finance in its attempt to streamline these rules in order to address a number of concerns that had arisen over the years in regard to the effective operation of the proposed rules.  The proposed measures contained in Budget 2010 offer a degree of optimism that we may be getting closer to a workable solution to these complex problems.

## GENERAL COMMENTS

Before specifically commenting on the FIE and NRT proposals, STEP felt it appropriate to raise certain general concerns relating to the international tax area.  These concerns have been expressed in previous submissions by STEP and other parties, however to date, measures have not been adopted to address such concerns.  We have attempted to include recommendations below in an effort to work with the Department of Finance in making the international tax area more workable and practicable.

### Foreign Disclosure Rules - Penalties

The current provisions of the *Income Tax Act (Canada)* (the “Act”) require the completion of certain foreign reporting forms (sections 233.2 to 233.7) and the imposition of penalties for failure to comply.  Consideration needs to be given to reducing the penalties for failing to file certain foreign reporting forms.  The applicable penalty is routinely $2,500 for each failure to file the requisite form, provided the omission is not deliberate.  This penalty is particularly harsh for the failure to file Form T1135 (Foreign Income Verification Statement), in that, the vast majority of Canadian resident taxpayers, whose tax affairs are well organized and compliant, do not appreciate the broad scope of what needs to be reported on this form.  For example, the majority of Canadians owning U.S. currency, U.S. stocks or U.S. bonds, held in a Canadian brokerage account, the income from which is reported on T5 slips, would not appreciate that this is “specified foreign property” and therefore subject to disclosure.  We would further contend that many professional advisors would not appreciate this requirement. This is just one particular example of the complexities of the disclosure reporting system.

It is recommended that a comprehensive review of all of the penalties involved with filing forms T1134, T1135, T1141 and T1142 be undertaken.  A penalty should be seen as a deterrent to prevent a person acting in an inappropriate manner (in this case, failure to file the required forms). A penalty should not be a punishment of a magnitude disproportionate to the mischief it is seeking to prevent. Since the foreign disclosure penalties (and possibly the penalties prescribed in subsection 162(7)) apply to each filing for each taxation year, multiple penalties can arise for a year, and the penalties can be applied repeatedly, year after year, in respect of each year that there is a filing deficiency; even where the failure to file is for the same incident. For example, if a taxpayer had an interest in ten foreign companies, and failed to file forms for ten years, there could be 100 penalties applied. Furthermore, if the shares of these same foreign companies were owned by a family of four, for example, there would now be the potential for 400 penalties to be applied, with an aggregate total penalty of $1,000,000. This multiple application of penalties (for arguably the same incident, merely repeated) is entirely inappropriate for inadvertence. The application of these penalties needs to be considered in order to bring fairness and balance into the international reporting system.

***Recommendations***

Where a non-filing or late filing occurrence was due to inadvertence, the penalty for non-filing of one or more T1135s should be a maximum of $250 for the first instance, and $500 for any subsequent instances. For all other foreign disclosure forms, the penalty levied should be $500 and $1,000 respectively.

**Subdivision i – Shareholders of Corporations Not Resident in Canada**

Part I, Division B, Subdivision i (comprised of sections 90-95) has been part of the Act for almost 40 years. These provisions deal with non-resident trusts, foreign investment funds, foreign affiliates and controlled foreign affiliates, including the exempt and taxable surplus systems, and the foreign accrual income property income (FAPI) rules. STEP has three ongoing concerns in general with these rules.

1) Our first concern relates to the ever increasing overall complexity of these rules, beyond what can reasonably be expected of taxpayers, most professional advisors and tax administrations. For a country such as Canada to have rules of this level of complexity is inappropriate and unproductive. The rules, in general, lie as a trap for the unwary, and a quagmire of complexity for professional advisors, tax administrations and taxpayers. This level of complexity does not assist anyone. It is detrimental to taxpayers, who do not and cannot understand the effect of the rules, thereby making compliance impossible. It is detrimental to professional advisors, who suffer from the same difficulties in understanding the rules and ensuring that their clients comply. Even if the advisors are sufficiently capable of dealing with the rules, there is the question of the cost involved. We must remember that we are living in a global economy and it is no longer only the largest public companies that have an international presence. In fact, it is government policy to encourage the expansion of Canadian interests beyond Canadian borders.

Lastly, it is detrimental to the Canada Revenue Agency ("CRA") in its attempt to enforce these rules. It is no surprise that tax auditors experience the same difficulties with these complex rules as do clients and professional advisors alike.

2) Our second concern is in regard to Canada's attempt to extend the Canadian tax reach to foreign entities with no ongoing connection to Canada. Canadian residents are subject to Canadian tax on worldwide income, while non-residents are subject to Canadian tax only on their Canadian source income, not on foreign source income. If a Canadian person establishes an international trust, say for the benefit of his/her children who reside in a foreign country, and if that trust subsequently earns non-Canadian source income and ultimately distributes this income to non-resident Canadians, there is no reason why Canadian tax should be paid. Attempting to tax this income, pursuant to the provisions of section 94, 94.1 or any other existing or proposed provision in the Act is inappropriate. If Canada moves forward with such measures, the manner in which Canada taxes non-resident trusts would be unusual in the world of international tax, in that it levies tax directly on a foreign entity over which it has no legal jurisdiction. By extending this taxation to foreign income paid to non-residents of Canada, it is quite possible that Canada is overstepping its jurisdiction. We have a concern, therefore, that rather than extending Canada's tax base to cover appropriate situations where erosion could otherwise occur, this change may in fact weaken Canada's ability to tax by opening the door for international criticism, and possibly a legal challenge as to jurisdiction.

3) Our third concern is the fact that CRA has never published a comprehensive interpretation bulletin or guide concerning these rules in the near 40 years since they were first published in the Act. CRA has issued excellent guides on numerous areas, and published well over 1,000 forms to assist taxpayers in complying with the provisions of the Act. Yet in the area of FAPI, foreign affiliates, taxable and exempt surplus, etc., there are no practice aides to assist clients, tax practitioners or CRA auditors.

***Recommendations***

In regard to STEP's first and second concerns, rather than proceed with round after round of technical amendments, we suggest that consideration be given to simplifying these rules in an attempt to make them more readily understandable and user friendly. It was our understanding that this was also the original mandate and subsequent recommendation of the Advisory Panel on Canada's System of International Taxation, however we have not heard anything further following this Panel's publication of its report in December, 2008.

In regard to STEP's third concern, this criticism is certainly not original to this submission, however to date CRA has seemingly concluded that it has no intention to develop this material. We therefore recommend that the Department of Finance consider exerting such influence as it may have on the CRA to direct that a comprehensive programme be established to provide forms and bulletins in the international area to augment compliance.

## SPECIFIC COMMENTS

### FIE Rules – Proposed Changes

The comments in Budget 2010 in regard to the FIE rules indicate that the Department of Finance has made the decision to abandon the FIE draft legislation, although it is not easy to determine exactly what is being proposed with regard to amending existing section 94.1. Our understanding is that existing section 94.1 will be maintained, substantially in its current form, with three specific changes:

1) It is proposed that the prescribed rate applicable in computing the income inclusion for an interest in an offshore investment fund property be increased to the three-month average Treasury Bill rate plus two percentage points.

2) The measures proposed effectively broaden the application of the rules contained in section 94 which currently require certain beneficiaries of a non-resident trust that is deemed resident in Canada to report income on a modified foreign accrual property income basis. Although we do not understand what exactly is being proposed in this regard, we remain strongly opposed to any legislative change that would tax beneficiaries on an accrual basis in respect of their interest in a "personal" or "testamentary" trust. Our concern stems from a significant change in tax policy which was introduced at a late stage in the development of the FIE rules (introduced as part of Bill C-10), wherein the Department of Finance was seemingly looking to require Canadian resident beneficiaries to include in their income for the year an amount calculated under the "imputed income" method, regardless of any actual receipt. STEP and numerous other bodies, made it clear at the time of this policy change that this proposed rule was arbitrary, unfair, excessively punitive in its result, and failed to honour the principle from the Carter Commission upon which arguably the current Act is based, which is "a buck is a buck is a buck". It taxed a beneficiary of a trust on amounts that he or she may never receive, and which bear no relationship to that person's entitlement to income or capital, or the receipt of same.

3) The relevant reassessment period in respect of interests in offshore investment fund property and interests in trusts described in the previous paragraph be extended by three years.

***Recommendations***

With respect to the first change, STEP has no issues with the proposal to increase the prescribed rate.

With respect to the second change, STEP is strongly opposed to a tax policy shift that would attempt to tax a beneficiary's interest in a foreign trust, which trust is a personal or testamentary trust. Such trusts and their beneficiaries should only be taxable in accordance with the operation of section 94. Section 94.1 should not be used as a charging section for such beneficial interests. STEP is, however, sympathetic to the need for anti-avoidance rules to be put in place to control tax avoidance through the use of international structures. Accordingly, if that is the intention, then we have no objection to an anti-avoidance rule in section 94, which can be backed up, potentially, by the general anti-avoidance rule as well.

Finally, with respect to extending the reassessment period, STEP does not agree that this extension is warranted. Subsection 152(3.1) defines the normal reassessment period. This period was established as reasonable by policymakers when originally implemented taking into consideration a number of factors such as what would be a reasonable period for the administration of a taxpayer's tax return and the need to provide a taxpayer certainty over their tax affairs. To extend the normal reassessment period arbitrarily strays from the original policy intent of subsection 152(3.1) and is inappropriate. We also believe that an extension of three years has the ill effect of shifting CRA's focus away from its efforts to enhance compliance, which should be the first order of business.

**FIE Rules – Definition of Offshore Investment Fund**

If, in fact, the originally proposed amendments to section 94.1 are truly to be abandoned in favour of maintaining existing section 94.1, subject to the three changes referenced above, we query whether the fundamental definition of offshore investment fund property will be maintained, such as it is in current section 94.1. We have a concern that at the present time the test of whether an entity is an offshore investment fund property is a subjective test, requiring an analysis of the taxpayer's motives. Where one can argue that none of the reasons for the taxpayer acquiring, holding or having the interest in the property is to derive a benefit in a manner that the taxes paid are less than they would have been had the income actually been received directly by the Canadian resident person, section 94.1 is inapplicable. This introduces a degree of subjectivity into the rules, which may not be appropriate. If this anomaly is to be addressed, as was the attempt with the proposals to amend existing section 94.1, then one must consider what is the appropriate manner in which to define an offshore investment fund property. STEP and numerous other professional bodies had concerns with previous attempts to do this, in that they were unduly complex, and inadvertently seemed to include corporate groups which, in substance, carried on an active business but, in accordance with the rules previously proposed for one of several reasons were deemed not to have carried on an active business.

***Recommendations***

In the event that a new definition of offshore investment fund property is to be drafted, we recommend that you seek to avoid any definition change that would deem an otherwise active business income earning company to have earned passive income in the examples below:

1) Particular types of businesses which in normal usage would be considered active businesses (such as real estate companies, licensing companies, etc.), but which under the proposed FIE rules were not considered active.

2) Corporate groups, which were foreign affiliates, but which did not meet the ownership percentage test for the shares of the company to be considered non-portfolio, and the underlying assets to be considered in lieu thereof. This created numerous problems, because it brought otherwise active corporate groups of foreign affiliates within the proposed FIE rules, which was inappropriate.

**FIE Rules – 60 Month Immigration Exemption**

One of the proposed measures to be adopted within the FIE rules, was to extend the 60 month exemption provision for new immigrants to Canada, as contained in section 94, to the application of the FIE rules. This proposed change was a welcome addition to the existing framework for taxing a new immigrant's ownership interest in an offshore investment fund property.

***Recommendations***

If section 94.1 is to operate without amendment, other than the three changes referenced above, STEP would recommend maintaining the exemption provided in earlier versions of the FIE rules to exempt from the FIE rules a person who has not been resident in Canada for 60 months. This is keeping with the exemption provided under the non-resident trust rules

**NRT Rules – Proposed Changes**

We understand, broadly speaking, that the tax policy behind the non-resident trust rules is to put a non-resident trust to which a Canadian resident person has made a contribution on an equal footing with a Canadian domestic trust. This is done by deeming the trust to be Canadian resident, such that it is taxable on its worldwide income. In addition, non-resident withholding tax would be levied on trust distributions, which is analogous to what would occur if a Canadian resident trust made such distributions. STEP appreciates the need for anti-avoidance rules to be put in place to control tax avoidance through the use of non-resident trusts, but continues to believe that the attempts to do this to date are unworkable and misguided. The mischief that the Department of Finance seems to hope to address with the NRT proposals occurs in situations where Canadian residents are seemingly not entitled to a benefit under the terms of a trust; however through a variety of complex machinations ultimately receive a benefit in one form or another: a benefit which often escapes the Canadian tax net.

***Recommendations***

We are sympathetic to this challenge, however we do not agree that the level of changes proposed are necessary to deal with this. There are ways to ensure that this concern is more accurately targeted without the need for wholesale changes which obviously lead to further challenges and issues, as evidenced by the last ten years of debate over these proposals. STEP would be pleased to meet with the Department of Finance to discuss more targeted options to address this concern, such as a re-draft of subsection 248(25) to ensure the ability to determine whether, in fact, a Canadian resident will ultimately benefit from the income earned within a foreign trust.

**NRT Rules – "Resident" – "Non-Resident" Portion**

The new measures contained in Budget 2010 provide for the income of the trust to be divided into three basic categories: the non-resident portion of the income, the Canadian resident portion, and a residual portion (which may be nil in many circumstances depending upon the quantum of distributions made and the level of income earned). Overall, we applaud the attempt to address the unfairness and inappropriateness inherent in deeming an otherwise foreign trust, which has received the vast percentage of its assets from a non-resident, to be resident in Canada and taxable on its entire income, solely as a result of a Canadian resident person having made a nominal contribution to the trust, whether such contribution was actual or deemed in accordance with the new provisions contained in proposed subsection 94(2). That said, and in furtherance to our general comments above in regard to the overall complexity of the legislation in the international tax area, we are concerned that the measures proposed, although welcome, will not assist in simplifying the rules unless an attempt is also made to address the overall complexity of the rules aimed at taxing non-resident trusts. In fact, we are concerned that the division of property in this manner may have the opposite effect and create an even greater degree of complexity making the application of the rules virtually impossible. For example, the combined effect of proposed subsection 94(2) (deeming rules for contributions) and the new measures aimed at classifying and valuing resident and non-resident contributions for purposes of calculating taxable income for Canadian tax purposes, potentially will lead to widespread non-compliance, be it purposeful or inadvertent.

**NRT Rules – Effective Date**

Establishing a retroactive effective date at which time the proposed rules are to be operative has been an issue that STEP has strongly discouraged since the Draft Legislation was originally introduced. The Draft Legislation (NRT and FIE proposals) has been the subject of numerous delays and restatements. The effective date having been deferred on at least four separate occasions has made advising clients virtually impossible and has led to widespread confusion in regard to Canada's international tax framework.

The proposed measures affecting NRTs, combined with the substantial proposals already in draft form, require a Trustee to make calculations requiring information that would be unavailable or impossible to obtain at this time for previous years making retroactive compliance impossible. Adopting a retroactive effective date creates specific challenges as well. For example, what would happen with a foreign trust that was wound up between 2007 and 2010 by way of a distribution to beneficiaries? In such an instance the trustee would no longer hold assets with which to pay any Canadian tax. Under existing section 94, the trust may not have been taxable, possibly by virtue of not having Canadian resident beneficiaries (or the ability to add Canadian resident beneficiaries). In such an instance, would non-resident withholding tax now be collectable and if so, how and at what rate? Following this example, STEP is also concerned with the inequity created by assigning to a Canadian resident contributor third party liability for the tax of the trust in situations where the contribution occurred long before the adoption of the proposed rules. How is the Canadian resident contributor to fund the payment of tax created by virtue of being attributed this income? In practice, this is not a trivial matter, since the Canadian resident contributor may not be a beneficiary under the trust and, in many cases will often be precluded from being able to obtain any benefit under the trust and may also have no ability to compel the trustee and/or a beneficiary to pay the tax due and owing.

There are numerous examples of challenges that a retroactive phase-in date will create.

***Recommendations***

Given the complexity and sheer volume of the NRT proposals it would seem only practical that the legislation only apply for taxation years commencing in the year that the legislation is proclaimed in force. To do otherwise creates confusion and complexity which far outweighs any potential gains associated with an earlier effective date.

STEP continues to be strongly opposed to legislative amendments that have retrospective effect. Trusts that were established prior to March 4, 2010 (the "Announcement Date") of the new measures effecting foreign trusts should only be affected by the legislation that existed at the time such trusts were established. 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)

The legislative proposals, as currently drafted, will apply to all trusts, regardless of when they were established and hence for trusts established prior to the Announcement Date the legislation will have retrospective effect. As a result, taxpayers who planned their affairs based on the existing law in place at the time may be adversely affected by the Draft Legislation, without any ability to revise their planning to adjust to the change in law. For example, consider a non-specified foreign trust that was established before June 22, 2000. Under existing subsections 94(1) and 248(25), a US trust established by a Canadian resident person for the benefit solely of US persons (i.e. no Canadian resident person is beneficially interested in the trust) would not have been subjected to Canadian tax pursuant to Part I of the Act on its foreign-sourced income. The "settlor" of the Trust, as described, would have planned his or her affairs based on the rules in existence at the time. The retrospective effect of the Draft Legislation would render this planning ineffectual since the foreign trust would have 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 taking into account the rules applicable at the time and may now be unable to amend the planning in place. 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 the Announcement Date.

**NRT Rules – General Comments, Questions and Recommendations**

Over the last decade STEP has prepared and delivered to the Department of Finance a number of submissions, mostly in relation to the NRT proposals. Although we are pleased that many of our suggestions were adopted in subsequent drafts of the rules, STEP remains concerned that there still exist a number of outstanding and unaddressed issues and a number of open questions in regard to the application and effect of these rules. Although it is difficult to comment on the NRT rules with any degree of certainty until we have an opportunity to see the proposed draft legislation, we do have a number of issues and questions that remain unclear and thought best to address them in this submission prior to new legislation being drafted:

1) Are the new measures contained in Budget 2010 simply to be added as an overlay to the existing section 94 amendments (as contained in Bill C-10) or can we expect further amendments to the already existing Draft Legislation to ensure that the Budget 2010 proposed measures complement and not detract from the existing Draft Legislation. If the former, than we are of the opinion that the legislative changes need further refinement.

2) The draft legislation gives rise to many transitional issues, such as whether a step-up in cost base would be granted to a trust which prior to these rules was non-resident, which is now deemed resident. How would this step-up work under the new attribution system? Presumably this step-up would be granted, and the trust assets would be re-valued to market value, as if the trust had become Canadian resident.

3) There are concerns about what would happen when a Canadian resident contributor either dies or ceases to be Canadian resident. We would assume that the previous rule which created potential capital gains in the trust at that time would not apply; on the basis that income which should properly be allocated to the Canadian resident person has been so allocated. Under the previous proposals, this was one of the most far reaching and inappropriate rules, noting that the Canadian resident contributor is most likely not a beneficiary of the trust.

4) We remain concerned with the scope, complexity and vagueness of certain of the provisions contained in the current draft of the legislation, particularly the definitions, and also the rules of application in subsection 94(2).

5) We do not see a policy reason for requiring that a former Canadian resident be restricted from creating a non-resident trust in respect of which there are Canadian resident beneficiaries for a period of 60 months after leaving Canada, and we would suggest that the 18-month period, which has been accepted in the past, be maintained.

6) If the definition of exempt foreign trust is to be retained, we would suggest consideration be given to adding another category of exempt foreign trust, in limited circumstances where all of the beneficiaries of the trust are non-resident individuals and are specifically named and the provisions of the trust do not permit the addition of Canadian resident beneficiaries under any circumstances. The basis for this is that a Canadian resident looking to make estate planning arrangements for non-resident family members should not be prevented from utilizing a trust, for bona fide reasons. If the Canadian resident were to give the property to the non-resident beneficiaries, (say children), then the income subsequently earned on the funds would not be subject to Canadian tax. Similarly, if funds were transferred to a non-resident corporation owned by the non-resident children, the income of that corporation would not be subject to Canadian tax. We fail to see why in these circumstances a trust should be treated separately, simply because the Canadian resident wishes to utilize a trust structure for estate planning reasons. In certain situations, it would be reasonable to utilize a trust, for the long term protection of close family members. We fail to see how a Canadian resident who has parted with the funds absolutely, and can never be added as a beneficiary of the trust, could use such a structure for avoidance of Canadian tax. An anti-avoidance rule could be added to provide that the trust is taxable from inception, or 2010, whichever is later, if the trust failed to meet the conditions for exemption, due to a beneficiary becoming a resident of

Canada or an amendment to the trust deed such that a Canadian person could be added as a beneficiary.

7) We do not see a need for a provision such as previously proposed subsection 104(7.01) restricting the deduction of income in the trust when distributed to non-resident beneficiaries. The attribution of income mechanism will address this issue.

8) If the legislation is going to attribute foreign income to a Canadian resident taxpayer than there has to be a provision that also attributes the foreign tax paid. It is erroneous to conclude that foreign trusts are only set-up in low or zero tax jurisdictions. Many foreign trusts are set-up in high taxing jurisdictions (i.e. the US and the UK).

Should you have any questions or concerns in regard to the issues raised in this submission, we would be happy to address any of the points in greater detail at a mutually convenient time. We appreciate your consideration and attention to this matter.

Yours truly,

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