Canadian Tax Update

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By:
Michael Cadesky FCA, TEP
Grace Chow CA, TEP

Cadesky and Associates LLP
Canadian and International Tax Specialists
Toronto, Canada

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Canadian Tax Update

Topics

- Information exchange agreements and implications
- Mind and management
- Non-resident trust rules
- International structures
- Declining corporate / rising personal tax rates
- Increased focus on tax avoidance

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Canadian Tax Update

Information Exchange Agreements

- Very successful in negotiating TIEA
- 30 completed or being negotiated
- Carrot and stick approach
- Use by CRA of TIEA unknown at present

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Canada has been very successful in negotiating TIEAs with offshore financial centres. A carrot and stick approach has been used to negotiate the tax information exchange agreements. The carrot is that a TIEA country may have access to the exempt surplus system for repatriating dividends from a foreign affiliate to a Canadian parent company tax-free. The stick, on the other hand, is that without a Treaty or a TIEA, commencing in 2014 income of a foreign affiliate (including active income) will be imputed to the Canadian shareholder, whether or not distributed. Normally active income would not be taxed in the hands of a Canadian shareholder until distributed. The diagram on the next page illustrates this.

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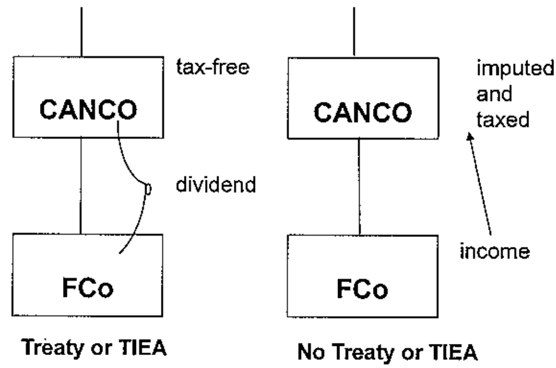
Information Exchange Agreements

Carrot — Tax-free repatriation

Stick — Otherwise FAPI from 2014



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Tax Information Exchange Agreements

In Force

- Anguilla
- Aruba
- Bahamas
- Bermuda
- Cayman Islands
- Dominica
- Guernsey
- Isle of Man
- Jersey
- Netherlands Antilles
- San Marino
- St. Kitts and Nevis
- St. Vincent and the Grenadines
- Turks and Caicos Islands

Signed but not yet In Force

- Costa Rica
- Saint Lucia

Under Negotiation

- Antigua and Barbuda
- Bahrain
- Belize
- British Virgin Islands
- Brunei
- Cook Islands
- Gibraltar
- Grenada
- Liberia
- Liechtenstein
- Montserrat
- Panama
- Uruguay
- Vanuatu

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Mind and Management

- Common law concept derived from U.K. case law
- Used in Garron Case for trust with Barbados trustee found to be Canadian resident
- Treaty claim by Barbados trust for exemption on capital gains failed
- Upheld by Supreme Court
- Mind and management concept applies to trusts
- Applicable in non-treaty countries (i.e. Bahamas)
- Deems entity resident in Canada (trust or corporation)

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Mind and management is a common law concept adopted from U.K. case law. In the past, the main application was to corporations. The concept has now been extended by the courts to trusts as well. Under the mind and management concept, a corporation or trust which has its mind and management in Canada will be Canadian resident, and therefore taxable on its world income (both Canadian and foreign).

The mind and management concept was used successfully to negate the benefits of a tax plan involving a Barbados trust and a treaty exemption claim. The decision to deny treaty benefits was based on the trust being factually Canadian resident even though trustee was in Barbados. The decision is upheld by the Supreme Court. It is now likely that CRA will take a much more aggressive approach to examining mind and management in both corporate and trust scenarios.

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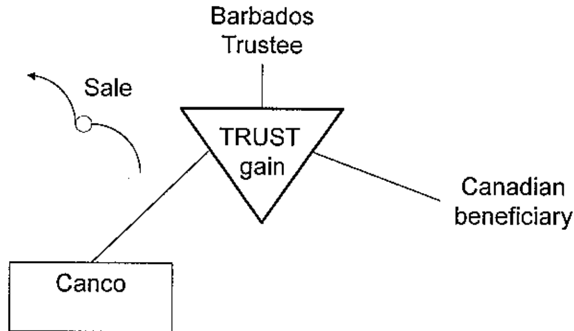

Trust considered factually resident in Canada as "mind and management" in Canada.

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A trust which is appropriately managed by trustees in a foreign jurisdiction, with no reserved powers held by any person in Canada (settlor, protector or beneficiaries) should not have an issue with its mind and management being in Canada. However, reserve powers held by Canadian persons, and situations where a trustee merely follows instructions in a pre-defined sequence of transactions devised by Canadian advisors may cause the mind and management of the trust to be considered to arise in Canada.

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Do's and Don'ts for Trustees

Do not

- give Canadian resident persons reserved powers
- have Canadian protector
- blindly follow instructions of Canadian settlor, beneficiaries or advisors
- make decisions in Canada (especially relevant to Canadian institutions with foreign trust companies)
- simply follow orders
- hide behind special company status

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The list of do's and don'ts is not exhaustive but should act as a reasonable guideline to make sure that mind and management is not in Canada. These should be self explanatory.

The mind and management concept was originally believed not to be applicable to trusts, and it was thought that if the trustees (or at least the majority) were resident in a foreign jurisdiction, then the trust would be resident in that jurisdiction. However, the case law has changed this view.

The cases which have been taken to court thus far, Garron and Antle involved claims under an international tax treaty for exemption from Canadian tax, overriding Canadian law. The plans could be viewed as aggressive arrangements designed to produce a tax benefit not justified in tax policy terms, but the concept is nevertheless applicable potentially to all foreign trusts. These would involve inbound or granny trusts and also immigrant trusts. While such arrangements do not violate the general principles of Canadian tax policy, since exemptions are provided under Canadian domestic law, the mind and management concept could nevertheless apply in these circumstances as well. Therefore all trusts which have a Canadian connection should be viewed as being potentially subject to the mind and management concept.

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Do

- act independently as a prudent and unfettered trustee
- refuse to follow guidance and suggestions unless fully justified by independent decision of trustee
- have custody of assets
- make all decisions
- document the decisions
- have key persons come to the jurisdiction for important events
- act like an owner (principal) would act

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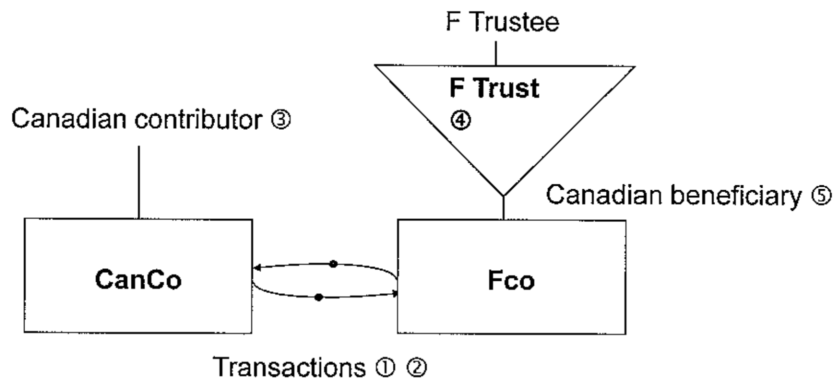
Foreign Reporting



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This slide shows the foreign reporting obligations of a hypothetical arrangement involving a foreign corporation, a foreign trust, and a Canadian corporation. The reporting obligations are shown on the chart and in the slide.

It is assumed that CanCo and FCo have transactions with one another, and that these corporations deal at non-arm's length.

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- ①Reporting of non-arm's length transactions if over $1 million total
  T-106
- ②Transfer pricing documentation rules
- ③Reporting of contributions annually
  T-1141

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1) Form T106 is required to be filed by CanCo reporting the non-arm's length transactions with FCo, if they are in total, over $1,000,000 in the particular year. Since these transactions include loans as well as transactions on income account, this is a reasonably low threshold. Failure to file form T106 can produce significant penalties. This form is used by CRA to identify transactions to which transfer pricing issues may arise.

2) The inter corporate transactions will be subject to Canada's transfer pricing regulation rules, which require extensive documentation of the transactions to justify that they are in accordance with an arm's-length standard. There is no particular form which is used for documentation of the transfer pricing, but it is expected that this documentation will be extensive and will be done in "real time" (i.e. as the transactions occur, rather than at the end of the year, or when CRA asks to see such documentation). A 10% penalty can arise in respect of the gross amount of the transactions which are subject to adjustment.

3) A Canadian resident person who has contributed property to the foreign trust (F Trust) is required to disclose these contributions on form T1141. This form is required each year even though the transactions may have occurred in previous years and being previously disclosed. This is filed by the Canadian resident contributor.

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- ④Reporting of ownership of foreign assets if trust is deemed resident and tax return
  - T-1135
  - T-1134A
  - T-1134B
  - T-3 and T-3 Supplementary
- ⑤Reporting of distributions
  - T-1142
- Severe penalties for non-reporting

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4) If the foreign trust (F Trust) is factually Canadian resident or deemed Canadian resident (which is more likely), then the trust has various filing obligations. These include form T1135 to disclose the holding of foreign assets with a cost of over $100,000. In addition, form T1134A or T1134B is required to disclose ownership of shares of FCo if FCo is a foreign affiliate (generally a 10% holding of any class shares). Lastly, the trust may be required to file a trust return (form T3).

5) A Canadian resident beneficiary who receives a distribution from a foreign trust is required to file form T1142 disclosing the receipt of the distribution, whether it is income or capital. If the distribution is income, then it is taxable to the Canadian resident beneficiary. However, if the distribution is a capital distribution, it is not taxable but must still be reported. The trustee should issue forms to Canadian resident beneficiaries showing the income (T3-Supp).

Significant penalties apply for the failure to file foreign reporting forms, or for their late filing.

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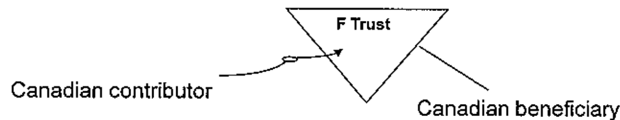
Foreign Trusts
Old Rules (still law)



3 conditions

1. Canadian resident contributor* (even nominal amount)
2. Canadian resident beneficiary (includes persons who may be added even if not added)
3. Contributor and beneficiary related (includes niece, nephew)

*unless not resident for 60 months lifetime or within 18 months if non-resident

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The rules concerning non-resident trusts have been in a state of change for thirteen years, and the proposed rules are still not law. Draft legislation has been issued on a number of occasions, most recently in 2010. This draft legislation is proposed to apply retroactive to 2007. However, there is some doubt as to whether the rules will in fact apply from 2007, or will be delayed. They have been delayed several times in the past.

The old rules, which are still law at this time, will deem a trust which is otherwise non-resident to be Canadian resident if three conditions are met. These conditions are that there has been a contribution by a Canadian resident contributor, a Canadian resident beneficiary (or the power to add persons who are related to a contributor to the trust and who are Canadian resident), and that the Canadian resident contributor and the beneficiary are related (which in this case includes nieces and nephews).

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- Allows: inbound (granny) trust
  60-month immigrant trust
  outbound trust where all beneficiaries non-resident
  trusts where beneficiary unrelated to contributor

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A Canadian resident contributor who has not been resident for 60 months in that persons lifetime is excluded from the rule. This allows for the 60-month exemption given to an immigrant trust. In addition, this allows inbound or granny trusts, since the contributor has never become Canadian resident. Also, a person who was previously a Canadian resident who contributes property to a non-resident trust but has not been resident in the past 18 months is also excluded. A trust which has only non-resident beneficiaries is excluded, because it will not meet the Canadian non-resident beneficiary test. Lastly, arrangements could be created where the beneficiaries are unrelated to the contributor although in practice, this might be called into question, particularly if reciprocal type arrangements are entered into.

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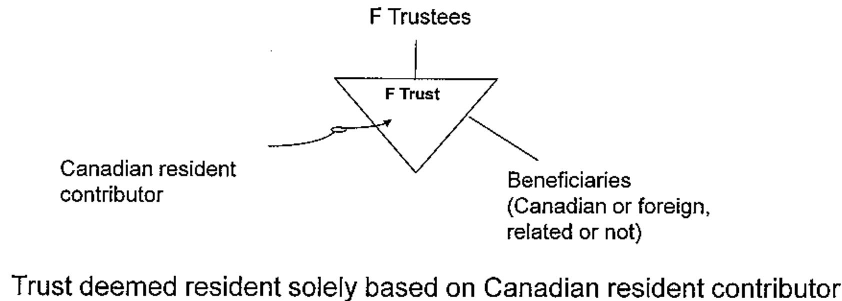
New Rules (Not yet law)



Trust deemed resident solely based on Canadian resident contributor

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The new rules, which are not yet law, are much more restrictive. They apply to any trust to which a Canadian resident contributor has made a contribution. Non-resident trusts with only non-resident beneficiaries, but a Canadian resident contributor will be taxable under the new rules, where it would not have been taxable under the old rules.

Canadian Tax Update

- Allows: inbound (granny) trust
  immigrant trust

Does not allow outbound trust or unrelated trust

Rules to apply from 2007 on

From 2010 on, contribution by Canadian resident to non-resident trust with contributions from non-resident does not make all income taxable. Instead pro-ration based on contributions.

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The new rules still allow for inbound or granny Trusts, and the 60-month immigrant trust. These rules are supposed to apply from 2007 onwards, but the delay in passing these rules called this into question. We will have to wait for the next round of draft legislation to see what the applicable date will actually be.

From 2010 onwards, a new rule has been introduced where contributions are made by a Canadian resident person and also by a non-resident person to a non-resident trust. Under the old rules, any contribution by a Canadian resident person, however nominal, would result in the trust being deemed Canadian resident. However, under the new rules, a proration is to be applied, based on the relative contributions. Under this proration, only income applicable to the Canadian resident contribution will be subject to tax. Detailed rules provide for a tracing or ordering of the contributions, in order to determine the resident portion and the non-resident portion of the trust's income. This is welcome because in the past, even a nominal contribution by a Canadian resident could taint the non-resident status of the trust.

For trusts created by non-residents previously Canadian resident, the 18-month rule is extended to 60 months. But if the trust has no Canadian beneficiaries, it can be set up immediately. Some further special rules apply.

The new rules have extensive deeming provisions for indirect ways of funding a non-resident trust (for example, through an estate freeze). These deeming rules are very difficult (theoretically impossible) to work around so as to create or a purely non-resident trust (i.e. a trust which is not deemed resident) where in substance through some means Canadian resident persons have funded the trust.

Where a trust would not be resident under the old rules, but is deemed resident under the new rules, a step up is given in the tax cost of assets of the trust to fair market value at the time of transition. There is also some limited grandfathering of certain for trusts created before certain dates (created before October 2003 and have not received a contribution from a Canadian resident after July 18, 2005).

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International Structures – Canadian Rules

- Active income vs. passive (FAPI)
- Active income of foreign corporation not taxed until paid out by dividend
- Dividend exempt to Canadian corporation
- But passive income taxed to Canadian shareholder as earned
- What is active vs. passive?
- Basic rule – active unless passive
- Investment income (interest, dividends, rents, royalties, capital gains) normally passive

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Foreign corporations owned by Canadian persons (through Canadian corporate groups or personally by individuals or trusts) which carry on an active business outside of Canada, are not taxed. Instead, taxes applied on repatriation of funds, subject to certain complicated rules for corporate groups (the exempt surplus/taxable surplus rules). However, this favorable treatment does not apply to passive income. Instead, passive income may be imputed to the Canadian shareholder as it is earned, and taxed accordingly. It is important, therefore, to distinguish between active and passive income.

The basic rule is that income will be active unless it is considered passive. Passive income includes, in its simplest form, interest, dividends, rents, royalties, and capital gains. However, there are complicated rules which can deem active income to be passive and passive income to be active.

Canadian Tax Update

Exceptions:

- 6 full-time employees
- deducted by another foreign affiliate in a group from an active business
- inter-group dividends
- sale of subsidiary active business

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Certain types of investment income may be considered active if the foreign corporation employs throughout the year more than five full time employees. Also, if the income has resulted in a deduction by another foreign affiliate from its active income, then the income may be deemed to be active. This could apply, for example, to interest paid within a corporate group, or to rents and royalties. Also, inter group dividends are not deemed to be passive, and an exemption is provided on the sale of shares of a foreign affiliate within a corporate group, where the foreign affiliate carries on an active business and uses at least 90% of its assets in that active business.

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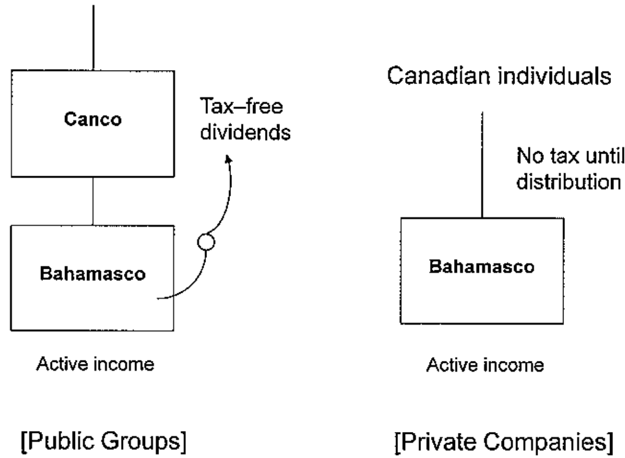
Types of Corporate Structures



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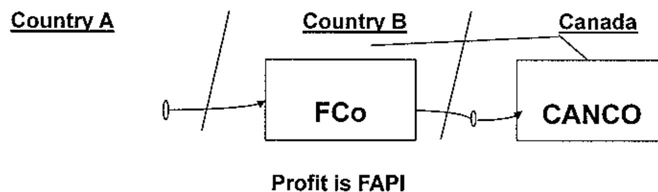
Active income deemed passive
- adventure in nature of trade
- services performed by Canadian resident (except in sale of goods)
- trading company buying goods to import into Canada to related company unless made or processed in country where trading company established



Profit is FAPI

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There are a number of rules which deem active income to be passive. These include income from an adventure in the nature of trade (an isolated transaction giving rise to gains, an example might be real estate speculation). Services revenue earned by a foreign corporation may be deemed passive where the services are performed by a Canadian resident person (there is an exception where the services are in connection with the sale of goods). A trading company may be deemed to have passive income in respect of its trading activities, where goods are imported into Canada through a related Canadian corporation, and the goods are not manufactured or processed in the country where the trading company is established.

Many of these rules are not well known, and may have widespread and surprisingly harsh results. The rules are being continually broadened and expanded in scope. Other rules may apply to captive insurance companies, financial transactions, and various other circumstances, to deem income passive.

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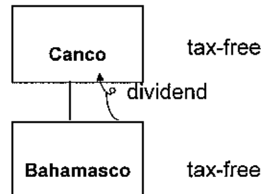
TIEA Advantage
TIEA offers opportunity for tax-free repatriation



What structures work?
Bona fide active business (Bahamas based)
Software licensing*
Royalties business*
Hotels, tourism, real estate development
Financial services*
Inter-group interest charge
Holding company for subsidiary
Captive insurance*
Trading company (sales to other than Canada)
6 full-time employees

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Having a tax information exchange agreement in place allows tax-free repatriation of active business income from a foreign corporation to a Canadian parent company. This is particularly advantageous for Canadian public groups. Now that the Bahamas has this status, it should be in a position to attract Canadian businesses to set up active business structures.

Structures that work

A number of different types of active business could be considered by Canadians looking to establish activities in the Bahamas where a nil rate of tax can be enjoyed.

Any active business carried on in the Bahamas and outside of Canada should qualify, unless the activities are deemed passive. Other types of businesses could include software development and licensing (but there may be a requirement for 6 full-time employees), a royalties business (again possibly a 6 full time employee requirement), activities related to hotels, tourism, and real estate development (possibly a 6 full-time employee requirement). In addition, financial services which are licensed in the Bahamas and have 6 full-time employees in the business should be considered to earn active income. Within inter-corporate groups, consideration could be given to using a Bahamas company for inter-corporate financing, the earning of royalty income, commissions, management fees, etc. A Bahamas corporation could be used as a holding company.

Subject to licensing requirements and certain other rules, captive insurance companies should be able to get active business treatment and tax-free repatriation back to Canada. Also, a trading company established in the Bahamas should be able to earn active business income, on goods purchased internationally, as long as they are not sold to a related Canadian company.

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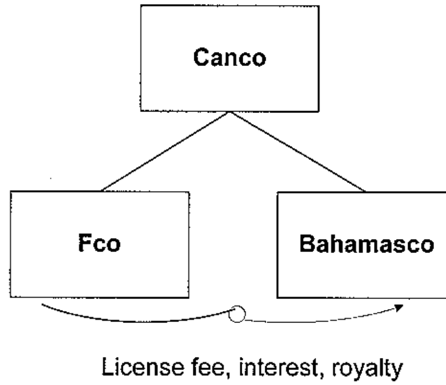

License fee, interest, royalty

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Declining Corporate Rates

- Completion of corporate rate reductions
- Canadian small business, first $500,000
  - annually 15.5%
- General rate 25% - 27%
  - (varies by province)
- Substantially lower than U.S. rate of 35% plus state tax

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The corporate rate reductions were announced almost ten years ago, and have proceeded roughly as planned, to result in a general corporate tax rate of 25% - 27%; among the lowest in the G7 countries. Canadian small business now enjoys a tax rate of approximately 15.5% (federal and provincial combined) on the first $500,000 of Canada active business income annually.

Particularly significant is the differential between the Canadian corporate tax rate and the U.S. corporate tax rate the later being 35% plus state tax as applicable. As originally contemplated, this has now created an incentive for multi-national companies to operate in Canada rater than in the U.S., to enjoy the lower corporate tax rates.

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Rising Personal Rates

- Tax rate on Canadian dividends
  - Increased (Ontario was 22% on "eligible" dividends, gradual increase now 31%)
- 3% rate increase in Ontario over $500,000 of taxable income (top rate now almost 50% by 2013)

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Canadian personal tax rates have been increasing partly to offset the corporate rate reductions. Dividends are divided into three types for personal income tax purposes, being foreign, Canadian eligible dividends, Canadian ineligible dividends. Foreign dividends are taxed as regular income. Canadian eligible dividends are taxed at a lower rate than ineligible dividends, and vary considerably by province. In Ontario, the top personal tax rate on eligible dividends is now approximately 31% and on ineligible dividends approximately 35%.

As a result of provincial politics, the top Ontario personal tax rate will be approximately 48% in 2012, rising to almost 50% by 2013, on taxable income over $500,000. Because the personal rates are so significantly higher than the corporate tax rates, this is creating an incentive to earn income in a corporation and retain it there. These considerations are relevant to both Canadian and international tax planning for corporations and their shareholders.

Canadian Tax Update

Backlog of Draft Legislation

- Several packages of draft legislation pending
- Includes changes to non-resident trusts
  - and foreign affiliates
- Foreign investment entity rules
  - (like U.S. PFIC rules) abandoned
- Important changes applies from taxation of non-resident
  - trusts (2007?)
- Expect 1,000 pages of legislation some day
  - (could be soon)

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There is a large backlog draft legislation which is pending. Most significantly, these include the changes to non-resident trusts, which were originally announced in 1999. These rules have been pending for thirteen years, and it is not clear when they will be effective, or the final form that they will take. Other legislation has been abandoned, such as the foreign investment entity rules (similar to the U.S. PFIC rules).

The shear volume of draft legislation which is outstanding is daunting and worrisome. Some of the amendments go back as far as 1995. Other amendments which are still in draft have changed several times, such that different rules apply during different periods. It is generally expected that this draft legislation will be consolidated into a bill containing all of it, rumored to be a thousand pages or so in length.

Canadian Tax Update

Increased Focus on Tax Avoidance

- Income splitting with children under 18
  - on capital gains prevented on non-arm's length transactions of private company shares
- Reportable transactions rules
- Prevention of stripping profits and
  - IP tax-free from Canadian groups
- Loans from foreign corporation to
  - Canadian corporation, income unless repaid in 2 years
- Limitations on tax-free dividends to
  - Canadian parent from capital gains sale of shares of foreign company (hybrid surplus rules)

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A large number of rules have been introduced to prevent tax avoidance. Tax planning arrangements which would have worked successfully in the past (even one year ago) are now being curtailed through anti-avoidance legislation.

Rules now prevent income splitting on capital gains with children under 18 on non-arm's length sales of private company shares. Such capital gains will now be taxed at the top tax rate, even if the child has no income.

The system of reportable transactions has been introduced, similar to the system in the U.K. and the U.S. If the transaction meets the criteria for this reporting and is not reported, then it is never statute barred and can be attacked under the general anti-avoidance rule.

A set of rules was introduced in the March 2012 federal budget to prevent the stripping of profits and the removal of intellectual property from Canadian corporate groups on a tax-free basis. In addition, loans between a foreign corporation and a Canadian corporation may now be assessed as income if not repaid within two years, preventing what was essentially a strategy to repatriate income tax-free through loans.

Lastly, rules are to be introduced to prevent the tax-free repatriation of dividends resulting from capital gains from the sale of shares of a foreign company within a Canadian corporate group.

All of these anti-avoidance rules make tax planning more difficult, and require that transactions be analyzed carefully against these new rules.

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Summary

- International tax planning alive and well but becoming harder
- Treaty advantage for trusts far less important
- Mind and management key emerging issue
- TIEA advantage important
- Tax avoidance rules expanding
- Aggressive approach by CRA
- But OFC's still have important role in tax planning

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