TAX NOTES INTERNATIONAL

NON-RESIDENT TRUST UPDATE

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On October 11, 2002, the Department of Finance released the third iteration of the Non-Resident Trust Rules scheduled to take effect for the 2003 taxation years. The latest proposals which hopefully will represent the final or close to final version of the legislation, have not been substantially changed from the proposed legislation released in August of 2001. There are however some noteworthy and interesting differences which this article will review.

The overall scheme of the provisions continue to deem what would otherwise be a non-resident trust to be a resident of Canada where the trust has either a "resident contributor" or a "resident beneficiary. Exclusions continue to exist for exempt foreign trusts which set out specific categories of non-resident trusts exempt from the application of these rules including non-resident trusts used to administer benefit plans for non-Canadian residents, "true" charitable trusts and trusts established to assist non-Canadian resident children in marital breakdown situations.

Resident Contributor

The trust will have a resident contributor and therefore will be deemed to be a resident of Canada, where a Canadian resident makes a "contribution" to a non-resident trust. A settlor who was resident in Canada at the time of settlement and has since died would satisfy the definition of resident contributor. The contribution definition is essentially unchanged and includes any transfer or loan of property to a non-resident trust. Proposed subsection 94(2) contains a number of provisions which deem a transfer to be made to a trust or to an entity owned by a trust thereby substantially enlarging the term "transfer".

Excluded from the definition of resident contributor is any person who has not been a resident of Canada for 60 months from the end of the taxation year in which the transfer is made. This provision will continue to permit pre-immigration trusts. Consistent with previous drafts, the section clarifies that a "pre-immigration trust" may be created even after the person has become a Canadian resident.

In addition, the trust attribution provisions of subsection 75(2) will be modified consistent with previous drafts to permit pre-immigration trusts to be established without the need for the creation of a holding company.

Resident Beneficiary

If there is a "resident beneficiary", the non-resident trust will also be deemed to be a resident of Canada. A resident beneficiary is defined as any Canadian resident beneficiary of a trust with a connected contributor. Consistent with the August 2001 release, "beneficiary" continues to be defined by reference to the extensive "beneficially interested" definition contained in section 248(25).

A person that is a contributor to a trust will be a "connected contributor" unless, in the case of an entity, it made contributions to the trust only during a non-resident time or, in the case of an individual, the individual has not been resident of Canada for more than 60 months or the individual made contributions only at a non-resident time.

A contribution will be considered to have been made at a non-resident time if, in the case of an individual, the individual is not a resident of Canada at the time of contribution or within 60 months of the time of the contribution where the transfer is made after June 22, 2000 (within 18 months if the transfer is made before June 23, 2000 or the trust arises on the death of the individual). Consequently, individuals who cease to be resident in Canada after June 22, 2000 will have to wait 60 months before establishing a trust for the benefit of Canadian beneficiaries in order to avoid the application of these rules.

In the case of an entity, a contribution will be made at a non-resident time as long as the entity was not resident in Canada at any time in the preceding 60 months and does not become resident of Canada in the following 60 months.

A testamentary beneficiary is excluded from the definition of resident beneficiary and therefore from the application of these rules. This definition has not changed from previous versions. A testamentary beneficiary is an entity that is a beneficiary under the trust solely because the right of the beneficiary to enjoy or possess income or capital of the trust on or after the death of an individual who at that time is alive and is either a contributor to the trust, is related to a contributor to the trust or would have been related if the individual who was alive before that time were alive at that time.

A simple example will illustrate the application of this exception. Suppose a Canadian resident settled the trust to benefit his spouse and on the spouse's death, the settlor's children would participate as income and capital beneficiaries. Suppose the settlor's children are and continue to be Canadian residents and suppose further that the settlor and his spouse leave Canada. The non-resident trust will not be viewed at that time as having a resident beneficiary since the Canadian resident children will be viewed as "testamentary beneficiaries" for as long as the Canadian settlor or his spouse is alive and will not be deemed to be resident in Canada since the settlor will not be a "resident contributor". Upon the death of the survivor of the settlor and his spouse, the non-resident trust would have a resident beneficiary since, by definition, a testamentary beneficiary only includes a person who's right to receive income or capital from the trust is deferred <u>during the life of</u> the contributor or related person to the contributor. Once the settlor and his spouse die, the Canadian resident children will become resident beneficiaries.

In this example, when the Canadian resident settlor leaves Canada, the trust would cease to be a resident of Canada under subsection 94(3) since there is neither a resident contributor nor a resident beneficiary. The trust would therefore be deemed to have disposed of all of its assets at fair market value and any gains would be recognized for Canadian tax purposes. When the settlor and his spouse die, it would appear that since the contribution was not made at a non-resident time of the settlor, the non-resident trust would again be deemed to be resident of Canada since the Canadian resident beneficiaries no longer qualify as testamentary beneficiaries. The trust would be deemed to have disposed of its assets immediately prior to this time and to have reacquired them at fair market value. The trust would then be subject to tax on future income earned subject to the distribution of such income to the beneficiaries.

This illustration demonstrates the complexity of the interaction of the provisions as well as the fact that a “testamentary beneficiary” can be a beneficiary of an inter-vivos as well as a testamentary trust.

In summary, a trust will be deemed to be resident in Canada under the proposed provisions of section 94 if (i) a resident of Canada has made a contribution to the trust or, (ii) there exists a person who was a resident of Canada either less than 60 months before, or who became a resident of Canada less than 60 months after, making a contribution to the trust and the trust has a “beneficiary” who is a resident of Canada.

This means that so called “Granny trusts” established for the benefit of Canadian residents by non-Canadian persons who have never been resident of Canada or at least have not been resident of Canada within 60 months preceding the establishment of the trust, will not be subject to the deeming rule contained in Section 94. Canadian residents having non-resident relatives may continue to benefit from the tax free accumulation in non-resident testamentary or inter-vivos trusts established by such relatives where such trusts only permit capital distributions to Canadian beneficiaries. Distributions or loans from inter vivos non-resident trusts must continue to be reported in accordance with section 233.6, while distributions from testamentary non-resident trusts are not subject to this reporting obligation.

As noted previously, 60 month pre-immigration trusts continue to be available and the structure can be simplified – there is no need for an intermediary corporation as previously was required to avoid the attribution rule in subsection 75(2).

Inbound trusts established by Canadian residents for the exclusive benefit of non-Canadian residents will however be deemed to be resident in Canada if a contribution is determined to have been made by a Canadian resident.

Arm's Length Transfer Exception

Excluded from the definition of contribution is a transfer or loan that is "an arm's length transfer". The definition of arms' length transfer has been modified in two ways. Firstly, an arm's length transfer will not include the transfer of "restricted property". Restricted property is defined as being a share or a right to acquire a share of a "closely-held corporation"[1] acquired as part of a series of transactions under which a share that is not prescribed under paragraph 110(1)(d) (essentially a preference share) was acquired or as being a debt owing by a closely-held corporation acquired as part of a series of transactions involving the acquisition of preference shares where the payment of interest on the debt is determined by reference to the productivity or income of the property of the issuing entity. Based on the series of transactions language, it appears that a

[1] Closely-held corporation is defined as any corporation other than a corporation the shares of a class of the capital stock of which are at that time widely held and actively traded as determined for purposes of the new proposed foreign investment entity rules.

common share will be a restricted property where it is issued as part of a series of transactions involving the acquisition of preferred shares.

The concern was that an estate freeze would be implemented with the owner manager receiving fixed value preference shares. New common shares could then be issued for nominal consideration to a non-resident who in turn could subsequently sell those shares to a non-resident trust having Canadian resident beneficiaries at their nominal fair market value.

Paragraph 94(2)(g) continues to apply to deem the issuance of any shares by a corporation to be a transfer of property by the corporation to the new shareholder. Accordingly, any issuance of preference shares and any accompanying issuance of common shares by a closely-held corporation to a trust in exchange for property of the trust will be a transfer of property that is restricted property, and therefore excluded from the definition arm's length transfer. This will have the important result of potentially affecting any non-resident trust no matter how remote its connection to Canada where preference shares (and common shares) of a closely-held Canadian corporation are issued or transferred to the non-resident trust in a series of transactions.

The definition of arm's length transfer has also been changed by requiring a two part test to be met. The first test is that a transfer may now be an arm's length transfer only if it is reasonable to conclude that none of the reasons (determined by reference to the terms of the trusts, letters of wishes etc.) for the transfer is the acquisition at *any* time by *any* entity of an interest as a beneficiary under a non-resident trust.

If the first test is met, the transfer must still be one of several possible types of transfers which include a transfer that is an arm's length return on an investment, a reduction of paid-up capital, and a transfer to satisfy an obligation which arose on a transfer or loan made on arm's length terms other than a transfer referred to in paragraph 94(2)(g). The

94(2)(g) restriction in the third case does not however appear to apply where common shares are issued directly by a corporation to a trust for property of the trust. Accordingly, it appears that the issuance of common shares may be capable of being an arm's length transfer where the shares are issued in exchange for property of the trust, but may not be an arm's length transfer where the shares are issued to satisfy an obligation involving a previous transfer of property.

Deemed Canadian Residence

If the trust is deemed to be resident of Canada, proposed subsection 94(3) will apply to deem the trust to be resident of Canada for the following purposes:

- The trust will be taxable in Canada on its worldwide income with a corresponding filing obligation.

- The trust will be required to report foreign property held and interests in foreign affiliates.

- If an election is filed, the income of the trust will be deemed to be from sources in the country in which the trust is resident at common law for purposes of foreign tax credit rules.

- The trust will be subject to the deemed disposition rules on ceasing to be or becoming a resident of Canada.

- The trust will not be liable to pay Part XIII withholding tax (Canada's 25% withholding tax on payments of passive income) in respect of payments made to it by Canadian residents. According to the Department of Finance explanatory notes accompanying the draft legislation, Canadian taxpayers must still withhold

25% in respect of any income paid to such a trust. The trust would apply for a refund net of any Part I tax owing.

Subject to certain restrictions, a contributor and the beneficiaries will have a joint and several liability for the trust's Canadian income tax.

Where a trust is deemed to be resident of Canada, there will be little Canadian tax cost where the deemed Canadian resident trust has non-Canadian resident beneficiaries provided that: (i) the trust income is paid or made payable on an annual basis and (ii) the trust income is not from a Canadian source. The trust will however still have to go to the trouble of filing a Canadian income tax return as well as a separate disclosure of ownership in foreign affiliates (greater than 10% ownership interest in non-Canadian corporations) and other foreign property. In addition, the fact that the trust income must be paid or made payable to the beneficiaries to avoid Canadian tax may frustrate the very purpose for which the trust was originally created. The requirement to make such a distribution in order to avoid the extra-territorial reach created by the proposed changes to Section 94 seems an unwarranted intrusion on non-resident's ability to plan their private affairs.

Limitations on the Deductions a Deemed Canadian Resident Trust Can Claim

Where section 94 applies to deem a trust to be resident of Canada and the trust has certain types of Canadian source income, proposed subsection 104(7.01) will deny the deduction the trust would otherwise be able to claim in respect of its income that becomes payable to its beneficiaries to the extent the Canadian source income is paid or becomes payable by the trust to non-resident beneficiaries. Income remaining in a non-resident trust deemed to be resident in Canada should not be subject to provincial income tax but will be subject to a 48% federal surtax resulting in an effective tax rate of just less than 43% (a rate that is lower than many provinces such as Ontario which has a top rate of 46.4%).

The type of Canadian source income subject to the denied deduction is "designated income", which is essentially comprised of taxable capital gains from dispositions of taxable Canadian property (eg. Canadian real estate and shares of Canadian private companies) and income from realty or a Canadian resource property situated in Canada, and income which would otherwise be subject to Part XIII withholding tax such as dividend or royalty income received from Canadian payers.

The purpose of subsection 104(7.01) is to act as a proxy for the withholding tax that would otherwise have applied if the Canadian source income had been received directly by the beneficiary from the Canadian payer. Subsection 104(7.01) will deny the deduction from the income of the trust to ensure sufficient income remains in the trust, taxable at the top marginal rate for an individual resident in Canada, so that the trust pays an amount of Canadian tax roughly equal to the withholding tax not paid.

The formula contained in Subsection 104(7.01) has been revised again to address a problem with respect to the prior draft which appeared to penalize the distributions made from a deemed Canadian resident trust to non-Canadian beneficiaries resident in treaty jurisdictions.

The denied deduction is now equal to the aggregate of the trust's "designated income" and all amounts determined by the formula A x B.

A is an amount of income paid to the trust that would otherwise be subject to Part XIII withholding tax that is payable in the year by the trust to a non-resident beneficiary.

B represents 35% of this amount if the trust can establish to the satisfaction of CCRA that the beneficiary to whom the amount is payable is resident in a country with which Canada has a tax treaty which would have reduced the withholding tax payable if the amount had been paid directly to the beneficiary and 60% of the amount in any other case.

The Department of Finance in its explanatory notes provides the following fact situation involving a trust with the following beneficiaries:

Linda	Canadian resident
Barton	US resident
Tim	non-treaty land resident

In 2003, the trust earned $1600 of which $400 was a taxable dividend to which Part XIII withholding would otherwise apply. The trust allocated the income as follows:

	Taxable Dividend	**Other Income**
Linda	100	350
Barton	100	950
Tim	200	0

In this example, the trust would normally obtain a $1600 deduction from income thereby resulting in nil income for Canadian tax purposes. However, because $100 is allocated to a non-Canadian resident beneficiary, 35% of this amount will be denied the deduction or $35. In addition, because $200 is allocated to a beneficiary resident in a non-tax treaty country, 60% of this amount or $120 would be denied as a deduction. The total denied deduction therefore is $155 resulting in an actual deduction of $1445. For some reason the explanatory notes use a tax rate of 48% rate on $155 resulting in $74 of taxes payable. Finance suggests this is a good proxy of the withholding tax that would have applied to direct payments made to Tim and to Barton. For example, if a $200 taxable dividend was paid directly to Tim, assuming withholding tax at a 25% rate applied, $50 of tax would be payable. Similarly, Barton would be required to pay $15 of withholding tax for a total of $65. Based on these rates, there is still a penalty associated with the formula. However, if the actual non-resident rate of about 43% is used, the effective rate of tax on distributions made to treaty residents will be very close to 15% (43% x 35%) and the rate on distributions made to non-treaty residents will be only slightly higher than 25% (60% x 43%).

Deemed Transfer Rules

As previously noted, the provisions of subsection 94(2) deem various transactions to be a transfer for purposes of determining whether a potentially tainting contribution has been made to a non-resident trust. Interestingly, the new proposals contain some additional paragraphs which deem a transfer *not* to have been made.

Paragraph 94(2)(s) in general terms provides that a transfer or loan of property to a trust by a particular entity that is a manager or sponsor of the trust in exchange for an interest as a beneficiary under the trust will not be considered a contribution of the particular entity to the trust while the beneficial interest is acquired and held by the particular entity because of a requirement imposed under the governing securities laws. As noted in the explanatory notes, this paragraph will be relevant in the relatively rare circumstance in which a commercial investment trust cannot rely on the exemptions for exempt foreign trust in order to avoid the application of subsection 94(3).

Of greater interest is proposed paragraph 94(2)(t) which in the words of the explanatory notes "generally expunges a contribution of shares of a Canadian corporation from the corporation to a trust if the trust acquired the shares in circumstances described in subparagraph 94(2)(g)(i) and the trust later sells the shares in circumstances in which the parties to the sale deal with each other on an arm's length basis."

For example, the provision would appear to apply where an otherwise non-resident trust acquired treasury shares from a Canadian corporation and the issuance of the shares was deemed to be a transfer under proposed paragraph 94(2)(g). This would have the effect of deeming the non-resident trust to be a resident of Canada by virtue of it having a Canadian resident contributor. The corporation issuing the shares would be a Canadian resident contributor and would accordingly become jointly and severally liable for any Canadian income tax payable on the world-wide income of the trust and liable as well for any penalties in respect of failing to report any transfers or loans made to the trust in accordance with Section 233.2. This paragraph is intended to ensure that if the trust sells the shares of the Canadian corporation to an arm's length third party, any liability of the Canadian corporation for tax payable by the trust will end as that proposed paragraph 94(2)(4) will deem a transfer not to have been made by the corporation to the trust. It is not clear to us however that the language used in this proposed paragraph accomplishes the stated intention.

The explanatory notes do however make it clear that the intention is *not* to untaint the non-Canadian resident trust from the application of section 94 that is, the original issuance of shares will continue to be treated as a transfer of property to the trust made by a Canadian resident and the trust will continue to be deemed to be resident in Canada.

New proposed paragraph 94(2)(u) applies to a transfer before October 11, 2003 to a personal trust by an individual. Where the conditions of those paragraphs are met, the transfer of the property is deemed not to be a contribution of the particular property by the individual to the trust. As stated in the explanatory notes, this provision is "intended to provide relief to individuals that have transferred a relatively small amount of property to a trust, for example, the initial settlement of a coin on the trust, where the individual can reasonably be considered not to have been involved with the use of the trust as part of what is commonly referred to as an estate freeze".

In order to obtain the benefit of this provision, the individual must identify the trust in prescribed form filed with the Minister and satisfy the Minister that the trust never acquired restricted property from the individual or a person not dealing at arms' length with the individual as part of an estate freeze associated with the individual and that the amount contributed by the individual before October 11, 2002 does not exceed the greater of 1% of the total of all amounts contributed to the trust before October 11 ,2002 and $500.

Natural Persons

Another interesting but subtle change to the non-resident trust rules is the definition of "entity" which includes an association, a corporation, fund or joint venture, organization, partnership, syndicate and trust. Added to this definition under the October release is "a natural person". Normally, references in the Income Tax Act are made to an individual, which includes both natural persons and trusts by virtue of subsection 104(1), or an individual other than a trust, which means a natural person. For example, the proposed definition of resident contributor contains a reference to an "individual (other than a trust)".

The specific reference to a natural person will be the only such reference in the Act.

It appears that Finance wishes to make a distinction between a natural person and a trust for the purposes of the application of Canada's Tax Treaties. The following excerpt from the explanatory notes highlights this point:

> "Under paragraph 1 of the resident article in Canada's income tax treaties, a reference in such a treaty to a "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation in that State by reason of the person's domicile, residence, place of management or any other criterion of a similar nature. A person, in this context, would generally include a trust because of the definition "person" in Canada's income tax treaties. Because a trust to which subsection 94(3) applies is deemed to be resident of Canada and is liable to tax in Canada on its worldwide income, it will be considered a resident of Canada under paragraph 1 of the resident article in Canada's income tax

> treaties, whether it is also considered to be resident, under the applicable treaty, in another country or not.
>
> A trust that is also resident of the other contracting state under a particular treaty would be a dual resident under the treaty. In the event of dual residency under an income tax treaty, the tie-breaker rules in the resident article applicable to individuals would not apply. The Canada Customs and Revenue Agency has expressed the view that in this context, the term "individual" is to be interpreted to mean natural person and not a trust. The Agency has indicated that this interpretation would generally prevail across most if not all of Canada's income tax treaties if the definition "person" in the particular treaty under consideration makes reference to both an "individual" and a "trust". Even if a trust were considered an individual for the purpose of an income tax treaty, it is clear from the context of the tie-breaker rule applicable to individuals that it is intended to apply only to natural persons. This is because expressions such as "personal home", "center of vital interest" and "habitual abode" used in the tie-breaker rules have meaning only in reference to natural persons and would not be of use in clarifying the residence of a trust for the purpose of a treaty.
>
> In general, therefore, under the income tax treaty the competent authorities of each contracting state would have to enter into an agreement to determine in which state the trust would be resident for the purpose of the particular treaty. In the absence of such an agreement Canada would exercise its first right to tax. Canada would grant foreign tax credits for the other State's income taxes paid by the trust and thus any double tax would be expected to be minimized if not altogether eliminated."

It is interesting to speculate about the real purpose of this dissertation. A possible target may be a plan involving a transfer of common shares to a spousal trust situate in Barbados but deemed resident in Canada by subsection 94(3). The trust claimed to be a resident of Barbados for purposes of the tax treaty with Canada thereby claiming an exemption from capital gains arising on the sale of taxable Canadian property. The explanatory notes clearly indicate that CCRA and Finance do not hold this view.

Another possibility may be an attempt to bolster an argument in favour of the application of the general anti-avoidance rule ("GAAR") as it relates to treaty shopping involving trusts.

Various judicial decisions have indicated that extrinsic aides including explanatory notes released by Finance may be of assistance in permitting courts to determine the underlying policy or scheme of the Act which is a step in determining whether a transaction is abusive and therefore subject to GAAR. The extensive discussion set out in the explanatory notes may be the beginning of a new approach by Finance intended to assist the CCRA in making such arguments. It is interesting to contrast this thought with the caveat found on the page following the preface of the explanatory notes. The caveat reads:

> "These explanatory notes are provided to assist in an understanding of proposed amendments to the *Income Tax Act* and a related Act. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe."

Other Changes

New paragraph 104(4)(a.5) will provide for a deemed disposition day for a trust that is deemed by subsection 94(3) to be resident in Canada. The deemed disposition day is the day that is immediately before the particular day on which, because a contributor to the trust either ceases to be resident in Canada or ceases to be a contributor to the trust because of the application of paragraph 94(2)(t), there is no resident contributor to the trust. However, no deemed disposition will occur under this paragraph if subsection 94(5) applies in respect of the contributor ceasing to be a resident contributor of the trust. If new 104(5)(a.5) applies, there will not be a second disposition 21 years later by virtue of an amendment to paragraph 104(4)(c). The 21 year deemed disposition rule is generally applicable to trusts resident in Canada and is designed to ensure that Canada's deemed disposition on death rules are not avoided by perpetual trusts.

A settlor will generally be jointly, severally and solidarily liable for the taxes arising under these new rules while Canadian resident beneficiaries will generally only be liable to the extent of any distributions or benefits received.

A new subsection to the joint liability rules under section 160 is being proposed which will allow CCRA to assess a taxpayer at any time in respect of any amount payable because of the application of subsection 94(3).

Finally, section 216, (which provides for an election by a non-resident to pay Part I tax on net rental income instead of being subject to a 25% Canadian withholding tax on gross rental income) is being amended to correct a deficiency which would otherwise exist in relation to the application of this provision to a trust deemed to be a resident of Canada under subsection 94(3). Without the change, a non-resident trust deemed to be resident in Canada would not be able to rely on existing subsection 216(4) because the provisions of paragraph 94(3)(a) would apply to deem the trust to be resident in Canada for purposes of Part XIII withholding.

Proposed subsection 216(4.1) is intended to provide some relief in these circumstances. Under this subsection, if a trust is deemed to be resident in Canada, a person who is otherwise required to withhold an amount from a payment of rent on real property or a timber royalty may elect in a prescribed form not to remit under Part XIII in respect of any amounts received after the election is made. Instead, under the proposed subsection, the elector shall:

- when any amount is available out of the rent or royalty (that is, determined net of applicable expenses) received for remittance to the trust, deduct 25% of the amount available and remit the amount deducted to the Receiver General on behalf of the trust on account of the trust's tax under Part I; and

- if the trust does not file a return for the year as required by section 150, or does not pay the tax that the trust is liable to pay under Part I, pay to the Receiver General, on account of the trust's tax under Part I, the amount by which the full amount that the elector would otherwise have been required to remit in the year in respect of the rent or royalty exceeds the amount that the elector has remitted in the year out of amounts available.

Foreign reporting requirements in respect of non-resident trusts

Existing section 233.2 of the Act requires certain persons who have made transfers or loans to a "specified foreign trust" or to a non-resident corporation that is a controlled foreign affiliate of such a trust to file annual information returns with respect to the trust. A "specified foreign trust" (as defined) includes a trust with a "specified beneficiary" resident in Canada. A "specified beneficiary" is generally any beneficiary under the trust with the exception of certain persons who are listed (including mutual fund corporations, non-resident-owned investment corporations, mutual fund trusts, registered investments and trusts all of the taxable income of which is exempt from tax). Before section 233.2 will require a return to be filed as a consequence of a transfer or loan, it is necessary that a "non-arm's length indicator", as defined in subsection 233.2(2), apply to the transfer or loan.

The new rules extensively amend section 233.2. In particular, the definitions of "specified beneficiary", "specified foreign trust" and "non-arm's length indicator" are all repealed as they are no longer required. In general, amended subsection 233.2(4) requires a person to file an information return in respect of a taxation year of a non-resident trust if the person made a "contribution" to the trust on or before the end of the trust's taxation year and the person is resident in Canada at the end of the trust's taxation year.

The definitions and extended meanings set out in subsections 94(1) and (2) apply for purposes of the section, including the determination of whether a person has made a contribution to a non-resident trust. Accordingly, where a transfer is an "arm's length transfer", it will not be viewed as a contribution and the transfer need not be reported. It should be noted, however, that one of the tests that a transfer must meet to be an arm's length transfer is that there must be no intention that it will lend to a person acquiring an interest as a beneficiary in a non-resident trust.

Certain entities are expressly exempted from any requirement to report under section 233.2. The entities exempted are generally the same as the entities who cannot be “specified beneficiaries” under the existing definition including mutual fund corporations, mutual fund trusts and non-resident owned investment corporations.

A person resident in Canada who makes a contribution to an exempt foreign trust (other than a trust set up for physically or mentally infirm dependant individuals or a trust set up for children after the breakdown of a marriage) is not required to file any information returns with respect to the trust.

Note that section 233.5 continues to provide some relief from the reporting requirement under section 233.2. Section 233.5 provides that information is not required in a report required to be filed under 233.2 in respect of a trust where the information is unavailable to the person required to file the report and

(i) there is reasonable disclosure in the return filed of the unavailability of the information;

(ii) the person exercised due diligence in attempting to attain the information; and

(iii) generally speaking, at the time of each contribution made to the trust that gives rise to the requirement to file the return or that affects the information required to be reported in the return, it was reasonable to expect that sufficient information would be available to the person to complete the return required under section 233.2.

Foreign reporting requirements in respect of transfers or loans to a foreign arrangement or nonresident entity

It is not always clear whether a particular foreign arrangement is a trust for Canadian tax purposes. Finance was concerned that persons resident in Canada might take the position that certain foreign arrangements are not trusts and, on that basis, not report contributions to the arrangement under section 233.2. New subsection 233.2(4.1) expands the foreign reporting rules to impose reporting requirements in certain circumstances on a person resident in Canada who has transferred or loaned property to a foreign arrangement or entity in respect of which reporting would not otherwise be required. The reporting requirement will ensure that the CCRA is alerted to the existence of any such foreign arrangement so that it can at least form its own opinion as to whether the particular foreign arrangement should be considered to be a trust for Canadian tax purposes.

More specifically, subsection 233.2(4.1) applies where a person has, directly or indirectly, transferred or loaned property to be held

- (i) under an arrangement governed by laws that are not the laws of Canada or a province, or
- (ii) by a non-resident entity (as defined in subsection 94.1(1)).

In general, except where the Minister of National Revenue otherwise permits in writing, the person who transferred or loaned property must file an information return under subsection 233.2(4), as if the arrangement or entity were a trust not resident in Canada and the transfer or loan of property to the arrangement or entity were a "contribution" to a non-resident trust, if all of the following conditions are satisfied:

- (a) the transfer or loan is not an "arm's length transfer";
- (b) the transfer or loan is not solely in exchange for property that would be described as "specified foreign property" in subsection 233.3(1) if certain changes were made to that definition;
- (c) the arrangement or entity is not a trust in respect of which the person would otherwise be required to file an information return for a taxation year that includes that time; and
- (d) the arrangement or entity is not
  - (i) an exempt foreign trust (as defined in subsection 94(1)).

(ii) a foreign affiliate in respect of which the person is a reporting entity (as defined in subsection 233.4(1)), or

(iii) an exempt trust (as defined in subsection 233.2(1)).

Where these conditions are satisfied, the person's reporting obligations under subsection 233.2(4) are determined as if the transfer were a contribution, the entity or arrangement were a non-resident trust throughout the calendar year that includes the time of the transfer or loan and the taxation year of the entity or arrangement were that calendar year.

Amended subsection 233.2(4.1) applies to returns in respect of taxation years that begin after 2002.

Penalties for falling to meet foreign reporting requirements

Subsection 163(2.4) imposes a penalty on a person who knowingly or in circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in, the making of a false statement or omission in a return required to be filed under any of the foreign property reporting rules. The penalty imposed in respect of a return required to be filed under amended section 233.2 is equal to the greater of $24,000 and 5% of a specified amount in respect of the return. The specified amount for a person is essentially equally to 5% of the fair market value of the "contributions" made by the person that gave rise to the obligation to file the return.

Foreign reporting requirements in respect of an interest in a non-resident trust

Section 233.3 of the Act provides that certain persons resident Canada and certain taxpayers must file an information return in respect of the "specified foreign properties" they hold if the total cost amount of such properties to the person or partnership exceeds $100,000. A "specified foreign property", as defined in subsection 233.3(1) of the Act, includes an interest in a non-resident trust or a trust that would be non-resident were it not for section 94. It does not include an interest in a trust that was not acquired for consideration by the person or partnership holding it.

In certain circumstances, where a person resident in Canada or a partnership receives a distribution of property or a loan from a non-resident trust (other than an excluded trust) in a taxation year or fiscal period and the person or partnership is beneficially interested in the trust at any time in the year or period, section 233.6 provides that the person or partnership shall file an information return in respect of the year or period.

There are no amendments to section 233.6 under the new rules. However, a person or partnership does not have a reporting requirement under section 233.6 where the person or partnership already has a reporting requirement in respect of the trust under section 233.2. To the extent that the new rules broaden the reporting requirements under section 233.2, they will reduce the reporting requirements under section 233.6.