

INTERNATIONAL TAXATION

November 26, 1999

The 1999 Federal Budget proposed a number of amendments to the Income Tax Act, which will dramatically affect the taxation of non-resident trusts, and foreign based investment funds. However, there still may be a way to escape the heat of Revenue Canada – and that shelter just may be found in Barbados.

GET OUT OF THE HEAT - COME TO BARBADOS

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On Tuesday, February 16, 1999, the Minister of Finance presented the 1999 Federal Budget. In an unexpected move, the Minister shocked international tax practitioners by proposing significant amendments to the *Income Tax Act (Canada)* (the "Act") to combat what the government has long perceived as an abuse of the Canadian tax system. Over the last couple of years the government has expressed concern with the inappropriate use of offshore trusts and their adverse impact on tax revenues in Canada. The new measures propose a fundamental change to the taxation of non-resident trusts. To ensure that tax practitioners took notice of the new proposals, the Budget further proposed a substantive change to the penalty provisions in the Act as a deterrent to third parties making statements or omissions, which support false tax claims.

These new measures clearly suggest that Revenue Canada will be turning up the heat on aggressive tax planning. However, there still exists legitimate international tax planning opportunities available to Canadian residents: especially for those considering the establishment of a new business. Barbados, despite its hot climate, may be the perfect jurisdiction to get out of the heat.

Before discussing the estate and tax planning advantages present in Barbados, it is important to understand not only the current methods by which Revenue Canada attempts to tax non-resident trusts and their holdings, but the new proposed measures as well.

TAXATION OF NON-RESIDENT TRUSTS

Current Rules

A trust is not a separate legal entity; it is a legal relationship. For tax purposes, however, a trust is deemed to be an individual and, therefore, taxed as a person separate and apart from its trustee. In determining the residence of a trust, the Common Law position is well established, in that a trust is deemed to be resident where the majority of its trustees are located (see *Thibodeau Family Trust v The Queen*, [1978] CTC 539; see also IT Bulletin 447 – “Residence of a Trust or Estate”). Irrespective of this Common Law test, a trust may be deemed resident in Canada for legislative purposes.

Assuming that the trust has been properly structured and, for Common Law purposes, is resident in a tax haven jurisdiction, it must now be determined when and if the Trust’s income will be subject to taxation in Canada. If a Canadian resident beneficiary does actually receive income from a non-resident trust, the income will be included as taxable income during the year in which the income was received. If the income of the trust is not distributed to the Canadian resident beneficiary, such income will only be taxable in Canada if the non-resident trust is deemed to otherwise be resident in Canada. A discretionary trust that would otherwise be non-resident will be deemed to be resident in Canada for tax purposes pursuant to subsection 94(1) of the Act if two distinct tests are met:

(i) *Resident Beneficiary Test*

This first test looks to the residence of any beneficiary of the trust. The test is satisfied if any beneficiary of the non-resident trust is a person resident in Canada. For the purposes of the Act, a person is beneficially interested in a trust, if that person has a right to receive any of the income or capital of the trust, either directly from the trust or indirectly through multiple trusts. This right may be either an immediate or future right and may be absolute, contingent or conditional on or subject to the exercise of a discretionary power. For the "resident beneficiary test" to be satisfied, it is sufficient if the beneficiary is a resident of Canada for tax purposes at any time during the taxation year in question. Furthermore, the size of the Canadian beneficiary's interest in the trust is not relevant.

(ii) *Source of Property Test*

This second test relates to the source from which the property of the trust is acquired. To satisfy the "source of property test" the non-resident trust must have acquired (whether by

gift, purchase or any other manner) the property from a person meeting each of the following three tests:

1. The person was a resident beneficiary (as provided under the "resident beneficiary test") or the person was related to a resident beneficiary, or the uncle, aunt, nephew or niece of the resident beneficiary. The Act provides that individuals are deemed to be related if they are connected by blood relationship, marriage or adoption;
2. The person was resident in Canada at some point during the 18 months immediately preceding the end of the taxation year of the non-resident trust; and
3. The person had been resident in Canada for a period or periods totaling, in the aggregate, at least 60 months.

For the purposes of clarification, it should be noted that the tests set out in enumerated paragraphs (2) and (3) above are to be applied with respect to each taxation year of the trust and not restricted to the initial tax year in which the trust property was acquired.

Proposed Rules

The 1999 Federal Budget proposed substantial amendments to the Act in relation to the taxation of non-resident trusts that have acquired property from residents of Canada. Under the proposed rules, a non-resident trust that acquires property or receives loans from a Canadian resident would be deemed to be resident in Canada and would be taxed on all of its undistributed income. This new rule would apply regardless of whether there is a Canadian resident "beneficially interested" in the trust. Furthermore, the transferor and the trust would be jointly liable for any unpaid tax.

The Budget also proposes to tax distributions by a non-resident trust of any previously untaxed accumulated income. Presently once trust income, including taxable capital gains, has been accumulated and capitalized, any subsequent distribution to a Canadian resident beneficiary is received on a tax-free basis pursuant to paragraph 104(13)(c) of the Act. Since many of these non-resident trusts were established in tax haven jurisdictions, the gains could theoretically be passed on to a Canadian resident free of tax. This new measure may not only affect non-resident trusts settled by a Canadian, but any non-resident trust with Canadian resident beneficiaries.

Provided these proposals become law, the new rules would apply to a non-resident trust for taxation years beginning after 1999 if a Canadian resident transferred or loaned property to the trust on or after February 16, 1999.

ORGANIZING THE PROPER SHARE STRUCTURE

In certain circumstances, it may be appropriate when organizing the ownership of a newly incorporated Canadian company to introduce an international shareholder into the planning process. Establishing a discretionary trust (the "Trust") in Barbados to acquire all or a portion of the growth shares (the "Equity Shares") in a newly incorporated operating company ("Opco") offers many potential advantages. Although it may be tax effective to establish the Trust in a tax-free jurisdiction that does not have a tax treaty with Canada (i.e. Cayman Islands, Bahamas, Turks & Caicos Islands), the future disposition of the Equity Shares may be taxable in Canada if the Equity Shares are at the time of the disposition classified as "taxable Canadian property" ("TCP") (as defined in the Act). Non-TCP that is received as a result of an exchange involving TCP, remains TCP for the purposes of the Act. Therefore, unless the Equity Shares were non-TCP at the time they were acquired by the Trust (which is rarely the case with shares of a start-up company) the benefits of a tax treaty will be required.

SALE OF SHARES (CANADA-BARBADOS TAX TREATY)

By ensuring that the Trust is resident in a treaty jurisdiction (for the purposes of this newsletter we are assuming that the Trust will be resident in Barbados) the disposition of the Equity Shares (even if classified as TCP) can potentially be completed on a tax-free basis. The disposition of the Equity Shares will be exempt from capital gains tax in Canada pursuant to the provisions of Article XIV of the Canada-Barbados Tax Treaty (the "Treaty"). Article XIV of the Treaty provides:

Article XIV

1. Gains from the alienation of immovable property may be taxed in the Contracting State in which such property is situated.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) may be taxed in the other State. However, gains from the alienation of ships and aircraft operate in international traffic and movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the Contracting State in which such property is taxable according to paragraph of Article XXIV.
3. (a) Gains from the alienation of shares of a company, the property of which consists principally of immovable property situated in a Contracting State, may be taxed in that State.

(b) Gains from the alienation of an interest in a partnership or a trust, the property of which consists principally of immovable property situated in a Contracting State, may be taxed in that State.

4. Gains from the alienation of any property, other than those mentioned in paragraphs 1, 2 and 3 may be taxed only in the Contracting State of which the alienator is a resident.

5. The provisions of paragraph 4 shall not affect the right of a Contracting State to levy, according to its domestic law, a tax on gains from the alienation of any property derived by an individual who is a resident of other Contracting State and who

(a) possesses the nationality of the first-mentioned State or was resident therein for ten years or more prior to the alienation of the property and

(b) was resident in the first-mentioned State of anytime during the five years immediately preceding the alienation of the property.

Provided the Equity Shares will not be property within the meanings set out in sections 1, 2 or 3 above, any gain will be taxable in accordance with the domestic tax law in Barbados. Barbados does not currently tax capital gains and therefore, the disposition of the shares would not incur any taxation in Barbados.

Distribution to Beneficiaries

As a result of the above, any sale of the Equity Shares by the Trust will be completed on a tax-free basis. As discussed, currently a distribution of capital to a Canadian resident beneficiary would not be taxable in Canada. However, the proposed rules for the taxation of non-resident trusts would seem to suggest that such a distribution might now be taxable. Irrespective of this, such tax planning will create the opportunity to defer Canadian taxes.

OFFSHORE STRUCTURE

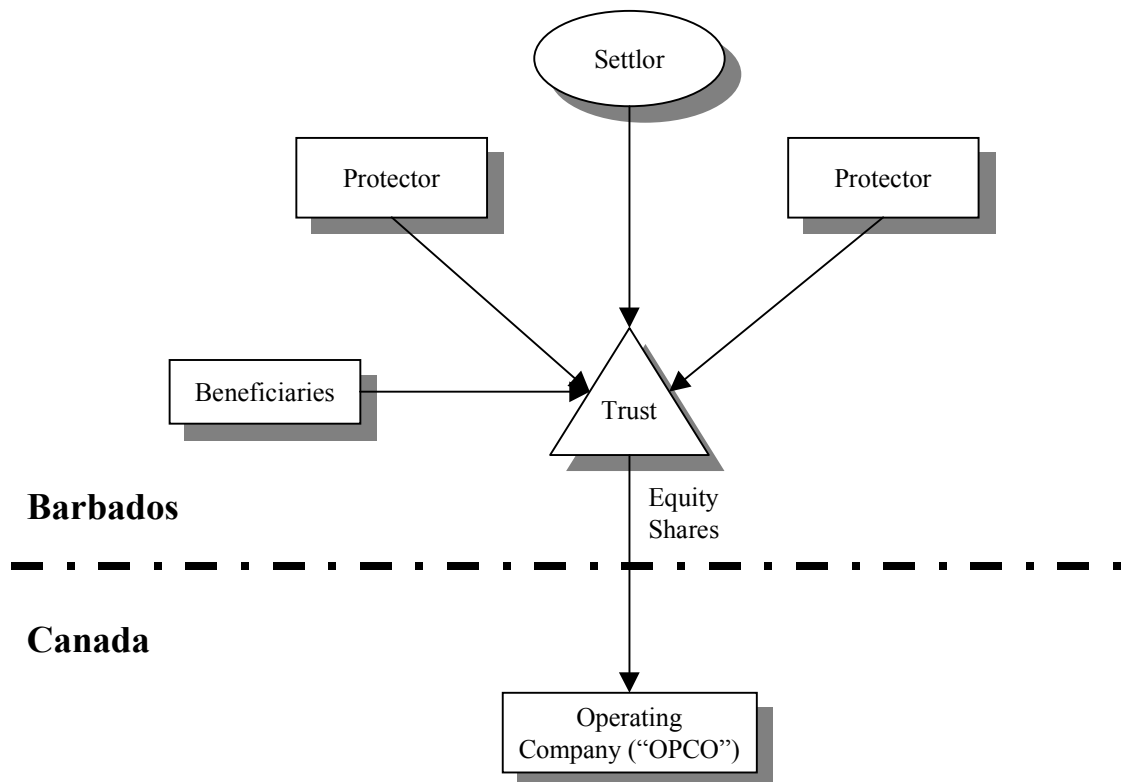
To ensure that the trust is resident in Barbados and not deemed to be a resident of Canada pursuant to subsection 94(1) of the Act (or the new rules), the Trust must be settled by a non-resident of Canada. A non-resident Settlor (preferably a family friend or relative) would settle a discretionary Barbados International Trust for the benefit of a Canadian resident, spouse and/or issue.

The Settlor would transfer a nominal sum of money (i.e. \$1,000) by way of an irrevocable settlement to an arm's length trustee carrying on business in Barbados. Upon receipt of the settlement funds, the Trustee would utilize a portion of these funds (i.e. \$100) to purchase the

Equity Shares in the capital of Opco. With its shareholding in Opco, the Trust would be able to participate in dividends and the future growth in the value of Opco.

The Trustee in Barbados would invest the remaining balance of the funds. Investing a portion of the settled funds in Barbados is recommended to ensure that the Trust will be deemed to be resident in Barbados pursuant to the provisions of the Treaty. (see *The Queen v. Crown Forest Industries Limited et al.*, 95 DTC 5389 (SCC)). Revenue Canada has previously expressed that a person (which would include a trust) can only obtain the benefit of a tax treaty if that person is subject to the most comprehensive basis of taxation that the foreign country (i.e. Barbados) applies (see Revenue Canada views doc. No. 9524971). Given the fact that a Barbados International Trust is only taxed on income sourced within Barbados, by ensuring that the Trust earns interest income within Barbados, it can be argued that the Trust is subject to the most comprehensive basis of taxation that Barbados applies. Barbados currently imposes a marginal tax rate of 40% on the investment income.

Essentially, the corporate structure would look like this:



Trustee

- A professional trustee resident in Barbados.

- Operating Company (“Opco”)** - New company to be incorporated (resident in Canada for taxation purposes) in which the Trust will own all or a portion of the Equity Shares.
- Settlor** - Individual, corporation or other legal entity that will transfer assets to the Trustee, in accordance with the terms of the Declaration of Trust.
- Protector** - An individual, corporation or other legal entity that will act as the Protector of the Trust. The appointment of a Protector is not a legal requirement, but may offer a degree of comfort to the ultimate beneficiaries.
- Trust** - An irrevocable trust, resident in Barbados and established in accordance with the terms of the Declaration of Trust.
- Beneficiaries** - Any person or class of persons that the Settlor wants to bestow a benefit upon. The Beneficiaries may be residents of Canada.

If structured as provided above, any future gain on the disposition of the Equity Shares will not be taxable in either Canada or Barbados.

CONCLUSION

The above structure to be effective, unlike many schemes, does not require the business of Opco to be conducted offshore. The goal of such planning is not to reduce or defer the taxation in Canada of business income, but rather to defer or possibly eliminate the Canadian taxation on the actual or deemed disposition of the Equity Shares. If planned properly the tax savings can be quite dramatic. Remember, Canada has a \$500,000 lifetime capital gains exemption: whereas the Barbados exemption is unlimited.

The foregoing information is provided for general informational purposes only and readers are encouraged to consult with their professional advisors as to their specific circumstances.