On 9 November 2006, the Canadian Minister of Finance tabled a lengthy Notice of Ways and Means Motion in the House of Commons to prevent tax deferral and avoidance through the use of non-resident trusts and foreign investment entities. This replaces (with some changes) the draft legislation that was previously released on July 18, 2005 [1].

The new rules are generally effective for taxation years beginning after 2006 (i.e., 1 January 2007) – by contrast, previous releases were to take effect retroactively to 1 January 2003. Trusts created in 2001, 2002, 2003, 2004, 2005 or 2006 may elect in writing to have the new rules apply.

Shortly after introducing the Notice of Ways and Means Motion in Parliament, the Minister of Finance also indicated that Ottawa was currently scrutinizing offshore tax havens and the "significant tax avoidance" by some Canadians, stating that the Motion was not part of his review of tax havens. It is expected that the Minister of Finance will announce further steps aimed at abusive offshore structures benefiting Canadian residents.

This note provides an overview of the more significant changes in the Notice of Ways and Means Motion of 9 November 2006.

**Important Changes to the Taxation of Non-resident Trusts (and Foundations)***

In general, a non-resident trust (or foundation) that is subject to the new rules will be subject to tax and reporting in Canada as a tax resident and the foreign trustees will be liable to pay tax jointly and severally with the settlor (contributor) or Canadian resident beneficiaries (as the case may be). The joint liability extends both to tax liability and penalties for failure to meet certain reporting and other compliance requirements. The new rules also target foreign entities and arrangements that are considered to be "trusts" for Canadian income tax purposes (e.g., foundations, etc).

**Planning Opportunities (still available under the new rules)***

- The new rules do not affect settlements by non-residents for Canadian resident beneficiaries. These trusts, if appropriately structured, continue to have the possibility to make tax-free distributions of capital to Canadian resident beneficiaries (subject to a number of conditions).

- The new rules do not affect settlements made with Canadian transnational trust companies (established in New Brunswick or Prince Edward Island). The trusts, if appropriately structured, will continue to be available (subject to a number of conditions).

- Lastly, the new rules do not affect the availability of immigration trusts for new immigrants and foreign executives (or employees) establishing tax residency in Canada. As detailed further below, these trusts can avoid Canadian tax on non-Canadian source income for up to 5-years. In fact, the new rules further facilitate the use of trust structures.

**The New Rules**
Under the new rules, a non-resident trust is deemed to reside in Canada for tax purposes if:

- there is a “resident contributor” to the trust: namely, there is a person who has made a “contribution” to the trust (i.e., irrespective of the time when the contribution was made) and who is now a resident in Canada; or

- there is a “resident beneficiary” under the trust: namely, there is a Canadian resident beneficiary under the trust and the trust has acquired property from a person (even if such person has since died) who was a resident of Canada at the time of the contribution or who was a resident of Canada within five (5) years prior to making the contribution to the trust (or who resumed Canadian residency within a five (5) year period after making the contribution).

In general, a non-resident trust (or foundation) that is subject to the new rules will be subject to tax and reporting in Canada as a deemed tax resident and the foreign trustees will be liable to report and pay tax jointly and severally with the settlor (contributor) or Canadian resident beneficiaries (as the case may be). Where the status of a non-resident trust changes pursuant to these rules, a number of transitional effects will occur, including a step-up in cost base for Canadian tax purposes upon commencing Canadian residency or liability for tax on unrealized appreciation in assets upon terminating Canadian residency.

The new legislation contains convoluted definitions, deeming rules and exceptions that significantly expand the ordinary meaning of the words used in the legislation. For example, the definition of what constitutes a “contribution” by a Canadian resident person is significantly expanded to include direct or indirect transfers or loans of property as well as services. Similarly, the meaning of “beneficiary” is very broad and includes a person who has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any person) as a beneficiary under the trust to receive any of the income or capital of the trust.

Limited exceptions remain for “exempt foreign trusts” such as non-resident trusts established to provide for the maintenance of children (education, mental or physical infirmity, etc), for certain specific (though limited) “arm’s length” transfers (e.g., cash dividends from a Canadian private company), as well as exceptions for new immigrants (or foreign executives) to Canada (until such time as they have reached sixty (60) months of residency in Canada). Importantly, according to the Department of Finance, a trust that is deemed resident in Canada under the new rules will be treated as a resident for treaty purposes.

The new rules are generally effective for taxation years beginning after 2006 (by contrast, previous releases were to take effect retroactively to 1 January 2003). Trusts created in 2001, 2002, 2003, 2004, 2005 or 2006 may elect in writing to have the new rules apply. As a result, there may be an opportunity for trustees (or foundation boards) to consider reorganizing their structures prior to 1 January 2007.

- **Noteworthy Changes**

For the most part, the new legislation reintroduces or revises amendments previously released. Noteworthy changes include:

- streamlining of rules pertaining to so-called tax-exempt immigration trusts (or “5-year” trusts) for new immigrants or temporary residents (foreign executives, etc);

- new reporting rules to target arrangements or entities governed by foreign law;

- new deeming rules to treat “services” performed by Canadian residents as “contributions” (subject to limited exceptions);

- trusts by departing residents;

- use of offshore insurance policies;

- immediate income imputation for interests in foreign investment entities

These changes are discussed below.

**Streamlined rules for immigration trust planning**

The use of so-called immigration trusts for new Canadian immigrants or temporary residents remains available to avoid Canadian tax on non-Canadian source income for a period of up to 5 years. The Department of Finance recognized that this planning tool was an important part of the Canadian government’s incentive package intended to attract immigrants and foreign executives (or employees) to Canada. Combined with the
interest in foreign investment entities (FIE)

Services rendered by Canadian residents constituting "contributions" to a foreign trust

Offshore insurance policies for Canadian resident (or new residents)

Trusts by departing residents

Interest in foreign investment entities (FIE)
These rules remain exceedingly complex and extend far beyond the originally announced purpose of ensuring that Canadians cannot avoid income tax by transferring funds to offshore entities.

**Impact for Foreign Trustees, Board Members and Service Providers**

Where the new rules apply to deem an otherwise non-resident trust (or foundation) as a resident of Canada, the trustees (or board members etc) will be directly liable for tax and reporting in Canada and each resident contributor and resident beneficiary will be jointly and severally liable with the trustees (board members) with respect to the obligations of the trust.

Although a trust is generally allowed a deduction for annual income paid or payable to beneficiaries in the year (thereby reducing its taxable income for Canadian tax purposes), a withholding tax may now apply on distributions to non-resident beneficiaries, even if the trust income is not from Canadian sources. Failure to withhold such amounts carry significant penalties.

Canadian tax law provides clear rules for assessing civil penalties for making or counselling false statements in respect of another person’s tax liability. Under these “third party penalty” rules, significant penalties can extend to every person who participates in the making of or causes another person to make or furnish a statement to the tax authorities that the person knows or would reasonably be expected to know is a false statement.

In summary, where the new rules apply:

- an otherwise non-resident trust (or foundations etc) is deemed resident of Canada for tax purposes, throughout the taxation year;

- the trustees (or board members) are subject to Canadian tax and reporting on the trust’s worldwide income;

- the trustees (or board members) are liable for Canadian tax and reporting;

- there is no justification available to the trustees where the trust documentation does not allow the trustees (or board members) to comply with such laws (to be balanced against any risk of legal action on the part of affected beneficiaries);

- the trustees (or board members) may be exposed to legal action where they comply with a perceived “unenforceable” tax obligation/claim, or where they fail to comply with such tax obligation/claim.

It is expected that this Notice of Ways and Means Motion will move very quickly through Parliament (without much scrutiny given its complexity). Because the new rules are generally effective for taxation years beginning after 2006, there may be an opportunity for trustees (or foundation boards) to consider reorganizing their structures prior to 1 January 2007.

1. It is the sixth time the package, now comprising more than 500 pages of convoluted rules and more than 300 pages of explanatory notes), has been released (previous releases were made in June 2000, August 2001, October 2002, October 2003 and July 2005).

2. For example, a contribution made in 1986 by a non-resident who has since then immigrated to Canada would be caught under this test. As a result, the trust will be a resident of Canada, irrespective of whether or not there is a Canadian resident beneficiary under the trust.