Stop Press - Canada to Tax Discretionary Interests in Foreign Discretionary Trusts

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CATEGORY: ARTICLE

Absent a late announcement by the Department of Finance, Canadian resident beneficiaries under foreign discretionary trusts may soon find themselves subject to immediate tax and reporting in Canada irrespective of whether or not they actually receive a distribution from the trust.

This significant change in tax policy is contained in new legislation relating to the taxation of foreign investment entities (FIEs) currently before the Canadian Senate (now Bill C-10). Contrary to previous drafts released over the last few years, this version of the FIE rules goes beyond the original objective to tax actual investments in foreign investment entities on an immediate basis and now targets “discretionary interests” in foreign trusts that are not purely discretionary. This would include, for example, trusts containing mandatory distribution language found in standard “termination clauses”. According to the Department of Finance, these clauses would be sufficient to result in a Canadian resident beneficiary having a fixed-interest in the trust and trigger the income inclusion treatment under the FIE rules.

This Stop Press will highlight the need for trustees to identify trust arrangements containing provisions that can potentially result in Canadian resident beneficiaries being subject to the FIE rules in Canada. Where possible, trustees will have until 31 December 2007 to amend their trust deeds to preclude any beneficiary who may be a Canadian resident from ever having the possibility of receiving income or capital otherwise than as a consequence of the future exercise of a discretionary power – subject to the terms and governing law of each particular trust. In the absence of such amendment, and unless this issue is clarified by the Department of Finance prior to 31 December 2007, harsh consequences will potentially affect a number of Canadian resident beneficiaries under the FIE rules – even if they previously assumed that the trusts were purely discretionary.

Background

In late October, the Canadian Minister of Finance reintroduced as Bill C-10 detailed legislation to prevent tax deferral and avoidance through the use of non-resident trusts (NRTs) and foreign investment entities (FIEs). This Bill is now before the Senate and is expected to be adopted shortly. The new rules are generally effective for taxation years beginning after 2006 (i.e., 1 January 2007).

Although the FIE rules were originally intended to tax actual investments of Canadian residents in FIEs, Bill C-10 now seeks to target interests in foreign trusts that are not purely discretionary. For example, Canadian resident beneficiaries may be subject to the new rules by reason only of standard “termination clauses” that provide for a mandatory distribution at the end of the trust period to the beneficiaries who are living at that time. Under Bill C-10, such clauses (in and of themselves) would result in a beneficiary effectively having a fixed-interest in the trust (for tax purposes) on the basis that he or she may receive income or capital otherwise than as a result of the exercise of discretion by the trustees.

By contrast, under the current rules, no immediate tax or reporting consequences arise in the hands of Canadian resident beneficiaries unless and until a distribution is received. It is even possible to avoid triggering Canadian tax by ensuring that distributions to them constitute distributions of capital (there are no accumulation rules as is the case in the US for example).

Income Inclusions under the New FIE Rules

The new FIE rules are aimed at taxing Canadian residents holding certain participations or interests in foreign entities (including trusts). Under these rules, Canadian residents are taxed currently, irrespective of whether a distribution is made. Three methods are provided for calculating the income inclusion: the default “imputed income” method and two elective methods: the “mark-to-market” and “accrual” methods. The mark-to-market and accrual methods are designed to alleviate the harshness and arbitrariness of the imputed income method, but may not be available in the case of discretionary trust interests.

Under the default “imputed income” method, the includable amount is determined, in general terms, by multiplying the “designated cost” of the taxpayer’s investment by an annual imputed interest (currently 7%). In the case of an interest in a foreign trust that is not purely discretionary, the “designated cost” of the interest (investment) is equal to the trust’s “cost amount” in its property. This amount is then prorated by the number of Canadian resident beneficiaries under the trust (irrespective of whether or not there are non-resident beneficiaries). It is unclear as to why this calculation only takes into account the number of Canadian resident beneficiaries, or why an income inclusion of this magnitude should arise even though the beneficiary may ultimately receive little or none of the income or capital.

Interests in Discretionary trusts

As mentioned, a Canadian resident beneficiary will be subject to the new FIE rules if, at the end of the taxation year of the non-resident trust, he or she has a “specified interest” in a foreign trust. Although the FIE rules were not originally designed to apply to discretionary trusts, the
definition of “specified interest” for this purpose is extremely broad, and includes any interest as a beneficiary under a foreign trust unless “every amount of income and capital of the trust that the entity or individual may receive at or after that time depends at and after that time on the exercise – after that time, in favour of the entity or individual, and by any other entity or individual – of a discretionary power”. In other words, the exception from the application of the FIE rules is very limited and requires that the trust be purely discretionary. [7] Otherwise, beneficiaries will be treated as having a “specified interest” in the trust. We also note that the definition of “beneficiary” is very broad and may include certain persons who are not currently named as beneficiaries under the trust deed.

In practice, a number of situations could potentially result in beneficiaries receiving income or capital under a trust otherwise than as a result of the exercise of discretion by the trustees. For example, it is common to find existing trust deeds containing a standard “termination clause” providing for the mandatory distribution (whether “in equal shares” or otherwise) by the trustees at the end of the trust period. Though not affecting the discretionary nature of the trust per se, there is a real concern that the mere presence of a standard “termination clause” could suffice to bring the Canadian resident discretionary beneficiary within the ambit of the FIE rules as it would result in the discretionary beneficiary receiving income or capital under the terms of a trust deed otherwise than as a result of the exercise of discretion by the trustees (or other person holding a power of appointment). According to Bill C-10, this would result in Canadian beneficiaries having a fixed-interest in the trust for tax purposes.

Impact of the New Rules

As discussed above, Canadian resident beneficiaries may be required to include in their income for the year an amount calculated under the “imputed income” method with respect to their “discretionary interest” in foreign trusts that are not purely discretionary. In order to do so, at a minimum, beneficiaries will be required to obtain relevant information from the foreign trustees, including, for example, the tax attributes of the trust property.

The arbitrary nature of these new rules as a basis for taxation is astonishing and it is hoped that the Department of Finance will address the problem before the end of the year.

Since the new legislation will be effective for taxation years beginning after 2006 (i.e., 1 January 2007) and since the FIE rules will apply to taxpayers only if they have a “specified interest” at the end of the trust’s taxation year, trustees should review their existing trust arrangements with a view to determining whether it is appropriate (or possible) to amend the “termination clause” (or any other clause giving rise to mandatory vesting in favour of one or more Canadian resident beneficiaries) and prevent the application of the FIE rules as of 31 December 2007 (subject to the terms and governing law of each particular trust). Other exceptions may also be available (for example, by using successor beneficiary language in the deed).

Although it is expected that the Department of Finance will correct or clarify the tax treatment of interests in foreign discretionary trusts, the lack of clear guidance from the Department at this late stage combined with the approaching deadline of 31 December 2007 leave trustees with a very small window of opportunity if they want to avoid the harsh (and unintended) results of the FIE rules.

[1] On 29 October 2007, Bill C-33 (which died on the Order Paper when Parliament was prorogued in September) was reintroduced as Bill C-10 and was adopted by the House of Commons. Previous draft versions were released June 2000, August 2001, October 2002, October 2003, July 2005 and November 2006 (Bill C-33).

[2] Importantly, all trust distributions, whether from the income or capital of the trust, must be reported by the recipient.

[3] Complicated rules are applicable where the trust holds preferred shares and other property that may have received in connection with an estate freeze.

[4] For example, if on 31 December 2007 a Canadian resident beneficiary has a “specified interest” in an offshore trust having a cost amount in the trust property of say $100 million, he or she would face a $7 million income inclusion for 2007 irrespective of whether or not he or she actually receives anything from the trust – for example, if there are other beneficiaries under the trust etc.

[5] Once included, it is unclear as to how a taxpayer (or his estate) will be able to claim a deduction in the event where he in fact receives nothing at all.

[6] As mentioned, the original objective was to target actual investments including, for example, fixed-interests in foreign trusts.

[7] Oddly, the exception from the application of the FIE rules no longer refers to interests that have not ‘indefeasibly vested’.