S T E P

Society of Trust and Estate Practitioners

Federal Budget 2010: STEP Canada Summary

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Here are some of the highlights from the 2010 federal budget that could have an impact on members of STEP Canada and their clients.

Ottawa steps up its battle against alleged "aggressive tax-planning"

Ottawa is stepping up its fight against certain transactions that it considers to be aggressive tax planning. It is following in the footsteps of efforts recently launched by the Quebec government. It also cites regimes in the U.S. and U.K. as inspiration. This will no doubt spark some debate as the parameters of tax planning that would constitute tax avoidance are discussed.

The finance department plans to hold public consultations with stakeholders to develop proposals that will identify the plans that will be deemed "avoidance transactions." STEP Canada will consider making a submission.

In the budget, the federal government referred to existing rules in the federal *Income Tax Act* designed to "counter aggressive tax-planning" including the general anti-avoidance rule. However, the Canada Revenue Agency is conceding that it "must be able to identify aggressive tax planning in a timely manner."

It also concedes that there is no specific information reporting regime that identifies potentially abusive tax avoidance transactions other than tax shelters for the CRA, and since many "aggressive tax planning arrangements" do not meet the definition of a tax shelter, there is no specific information reporting regime that identifies other types of potentially abusive tax avoidance transactions. For this purpose, the Ottawa states in the budget that a reportable transaction would be an avoidance transaction, as currently defined in the *Income Tax Act*, which is entered into by or for the benefit of a taxpayer that bears at least two of the following three hallmarks:

A promoter or tax advisor in respect of the transaction is entitled to fees that are to any extent:

- attributable to the amount of the tax benefit from the transaction,
- contingent upon the obtaining of a tax benefit from the transaction, or
- attributable to the number of taxpayers who participate in the transaction or who have been provided access to advice given by the promoter or advisor regarding the tax consequences from the transaction.

A promoter or tax advisor in respect of the transaction requires "confidential protection" about the transaction.

The taxpayer or the person who entered into the transaction for the benefit of the taxpayer obtains "contractual protection" in respect of the transaction (otherwise than as a result of a fee described in the first hallmark).

When such a transaction has not been reported when required, Ottawa says that the CRA could deny the tax benefit resulting from the transaction. If the taxpayer still wanted to claim the tax benefit, it would be required to file with the CRA any required information and to pay a penalty.

However, mere disclosure of a reportable transaction would not necessarily result in a tax benefit. Instead, it “would simply assist the CRA in identifying the transaction.” However, Ottawa states in the budget, the disclosure of a reportable transaction would not be considered an admission that the general anti-avoidance rule applies to the transaction.

These proposals may be modified as a result of the public consultations. Nevertheless, they are intended to apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

Ottawa provides some relief from need to obtain s.116 clearance certificates

Canada taxes non-residents on their income and gains from the disposition of "taxable Canadian property." Generally a purchaser must withhold a portion of the amount paid when such property is disposed of by a non-resident, and remit it to the federal government on account of the non-resident vendor's potential Canadian tax liability.

However, the purchaser's obligation to withhold does not apply if the non-resident vendor obtains a "clearance certificate" from the Canada Revenue Agency. To obtain a clearance certificate, the non-resident vendor needs to remit an amount, post security, or satisfy the Canada Revenue Agency that no tax will be owed. These rules are contained in section 116 of the *Income Tax Act*.

Practitioners have raised a chorus of complaints over the process of obtaining clearance certificates – calling it onerous and lengthy.

In the 2010 federal budget, Ottawa proposes to amend the definition of taxable Canadian property in the *Income Tax Act* to exclude shares of corporations, and certain other interests, that do not derive their value principally from real or immovable property situated in Canada. “This measure will eliminate section 116 compliance obligations for these types of properties and will also bring Canada's domestic tax rules more in line with our tax treaties and the tax laws of our major trading partners,” Ottawa states in the budget.

It also says this amendment will “eliminate the need for tax reporting under section 116 of the *Income Tax Act* for many investments, enhancing the ability of Canadian businesses, including innovative high-growth companies that contribute to job creation and economic growth, to attract foreign venture capital.”

This measure will apply after March 4, 2010.

Many practitioners will be welcoming these developments. An alternative view raises the concern about whether these measures will adequately protect Canada’s tax base. The determination of taxable Canadian property or whether a taxpayer is truly non-resident is left in the hands of the non-resident. Is this a positive move? Is Ottawa estimating a generous inflow of foreign capital?

Meanwhile, the budget also contains a proposal to amend section 164 of the *Income Tax Act* to permit the issuance of a refund if the overpayment is related to an assessment of the payor or

purchaser in respect of a required withholding under section 116, and the taxpayer files a return no more than two years after the date of that assessment.
This measure will be effective for applications for refunds claimed in returns filed after March 4, 2010.

Ottawa unveils yet another version of FIE/NRT taxation proposals

It has been 11 years since the proposed changes to overhaul the taxation of non-resident trusts (NRTs) and foreign investment entities (FIEs) were first introduced in the 1999 federal budget. Since the first draft of the legislation was released June 22, 2000, the implementation date of the legislation and its retroactive effective date have been delayed and amended numerous times. The last 11 years have seen new drafts of the proposals released, each time with substantial amendments, no less than six times. Most recently, proposals for amendments were tabled during the second session of the 39th Parliament, however these proposals were not enacted before Parliament was dissolved in September 2008.
The 2009 budget stated that the federal government would review the outstanding proposals before proceeding with measures in this area. In the 2010 budget, Ottawa reintroduces this controversial initiative, with some not so minor amendments designed to “simplify” these complex provisions.
Some of the more interesting revised proposals which will address certain concerns and challenges and also provide a degree of simplification are:

- Entities exempt from tax under section 149 of the *Income Tax Act* (for example, pension funds and registered charities) will be granted an exemption from resident-contributor and resident-beneficiary status.
- Investments in *bona fide* commercial trusts will not be caught by the new NRT rules.
- A commercial trust will not be caught by the deemed residence rules if it satisfies certain criteria, including that the trust not be a discretionary or personal trust and that each beneficiary be entitled to both the income and capital of the trust.
- Loans by a Canadian financial institution to a non-resident trust will not cause the financial institution to be a resident contributor to the trust provided the loan is made in the ordinary course of business.
- Resident Contributors to a trust that is deemed resident under these rules will no longer be jointly and severally liable for the trust’s income tax obligations, but would only be liable for their proportionate share of the trust’s income.

Unfortunately, the 2010 budget also proposes substantial modifications that effectively introduce a whole new level of complexity to the NRT legislation. It proposes to modify the taxation of a deemed Canadian resident trust by dividing the trust's property into “resident” and “non-resident” portions. The resident portion will consist of property acquired by the trust through contributions from residents and certain former residents (and property substituted for such property). The non-resident portion will consist of all other property contributed to the trust. It is proposed that the non-resident portion income will be excluded from Canadian taxation as long as it is not from sources in Canada on which non-residents would normally be required to pay tax.
New ordering rules would be introduced for distributions to trust beneficiaries. For example, distributions to Canadian resident beneficiaries will be deemed to be made first out of the

resident portion of the trust's income, while distributions to non-resident beneficiaries will be deemed made first out of the non-resident portion of the trust. Distributions to non-resident beneficiaries out of the non-resident portion of the trust will not be subject to Canadian withholding tax, whereas a distribution to a non-resident beneficiary out of the resident portion of the trust will be subject to withholding tax.

It is further proposed that, when income of the trust is not distributed to beneficiaries, the amount of the accumulated income will automatically be deemed to be a contribution by the trust's connected contributors and will form part of the resident portion for the next taxation year, unless the said accumulated income is kept separate and apart from all the property forming the resident portion.

Some other interesting proposals regarding NRTs:

- The reassessment period for income in respect of trusts subject to these rules will be extended by three years.
- The *Tax Conventions Interpretation Act* will be amended to clarify that a trust that is deemed to be resident in Canada under these rules is a resident of Canada and subject to Canadian tax for treaty purposes.
- The measures regarding non-resident trusts apply retroactively to the 2007 and later taxation years, except for the attribution of trust income to resident contributors, which applies only to taxation years ending after March 4, 2010.

With regard to FIEs, the 2010 budget announces that the federal government will not continue with the outstanding proposals on FIEs. The current rules, referred to as the "offshore investment fund property rules" (which were to be replaced by the FIE rules), will continue to apply with the following proposed modifications:

- The prescribed interest rate applicable in computing the income inclusion for an interest in an offshore investment fund property is increased to the three-month average Treasury Bill rate plus two percentage points.
- Broadening of the rules to require beneficiaries of certain non-resident trusts to report income on a modified foreign accrual property income basis so that these rules apply to any resident beneficiary who, together with non-arm's-length persons, holds 10 percent or more of the fair market value of any class of interests in a non-resident trust.
- Extending the reassessment period by three years for interests in offshore investment fund properties and require more detailed reporting in respect of "specified foreign property."

The measures regarding FIEs are to apply for taxation years that end after March 4, 2010.

Charities benefit from further tax reform

Charities have been struggling with the "disbursement quota" that was introduced in 1976 to help control fundraising costs and limit charities' capital accumulation, thereby ensuring that a significant portion of a registered charity's resources are devoted to its charitable mandate. Charities have been asking Ottawa to eliminate the disbursement quota, stating that it imposes an onerous and costly administrative burden on them, especially small charities.

In light of recent federal changes to legislation and administrative policies used by the Canada Revenue Agency's to govern fundraising, including an ability impose sanctions or revoke the registration of a charity in situations where charities use their funds inappropriately, Ottawa is proposing to reform the disbursement quota for fiscal years that end on or after March 4, 2010. In particular, the 2010 budget contains proposals to: repeal the charitable expenditure rule; modify the capital accumulation rule; and strengthen related anti-avoidance rules for charities. Under the first proposal a number of concepts will no longer be required to be calculated under the disbursement quota:

- enduring property (gifts to a charity for endowments or multi-year charitable projects which are not subject to the charitable expenditure rule);
- the capital gains reduction and the capital gains pool (provisions that ensure that capital gains realized from the disposition of enduring property are not subject to the charitable expenditure rule and the capital accumulation rule);
- specified gifts (a provision that allows charities with disbursement excesses to help charities with disbursement shortfalls to meet their disbursement quota requirements); and
- exclusions from the calculation of the base to which the 3.5 percent disbursement rate is applied (provisions that ensure that funds subject to the charitable expenditure rule are not also subject to the capital accumulation rule).

The present rule providing the CRA with the discretion to allow charities to accumulate property for a particular purpose, such as a building project, will also be amended. The CRA will be given the discretion to exclude the accumulated property from the capital accumulation rule calculation.

There is currently an exemption from the capital accumulation rule for charities having $25,000 or less in assets not used in charitable programs or administration. The 2010 budget proposes to increase this threshold to $100,000 for charitable organizations. The threshold for charitable foundations will remain at $25,000.

Ottawa increases support for parents utilizing RDSPs

Ottawa is boosting it support for parents and others who are saving to ensure the long-term financial security of a child with a severe disability. In the 2010 budget, the federal government is proposing to extend the existing RRSP rollover rules to allow a rollover of a deceased individual's RRSP proceeds to the Registered Disability Savings Plans (RDSP) of a financially dependent infirm child or grandchild. RDSPs were introduced in the 2007 federal budget as savings vehicle in which investment income accumulates tax-free. These measures will be effective for deaths occurring on or after March 4, 2010.

Under the present roll-over rules, when an RRSP annuitant dies, the value of the RRSP is generally included in computing the deceased's income for the year of death. However, preferential tax treatment is provided on RRSP distributions made after death to the deceased's surviving spouse or common-law partner, or to children or grandchildren who were financially dependent on the deceased RRSP annuitant.

An individual who qualifies as an RDSP beneficiary will now be eligible to roll over RRSP proceeds received as a result of the death of their parent or grandparent to their RDSP if the requirements under the existing RRSP rollover rules are satisfied. An infirm child or grandchild is generally considered to be financially dependent if the child's income for the year preceding the year of death did not exceed a specified threshold ($17,621 for 2010). An infirm child with income above this amount may be considered financially dependent, but only if the dependency can be demonstrated based child’s particular fact situation.

The amount of RRSP proceeds rolled over into an RDSP will not be permitted to exceed the beneficiary's available RDSP contribution room. The lifetime contribution limit for RDSPs is $200,000.

The RDSP beneficiary or his or her legal representative will be required to make an election in prescribed form to transfer the RRSP proceeds to the RDSP on a rollover basis. The election would be made at the time of the RDSP contribution and filed with both the CRA and Human Resources and Skills Development Canada by the RDSP issuer.

Where the death of an RRSP annuitant occurs after 2007 and before 2011, special transitional rules will apply. The transitional rules will allow an eligible individual to make an election to contribute up to the amount of a deceased annuitant's RRSP proceeds to the RDSP of a child who is an infirm child or grandchild of the deceased annuitant and who was financially dependent on the deceased annuitant, subject to available RDSP contribution room.

In cases of deaths after March 3, 2010 and before 2011, taxpayers may use either the general measures or the transitional rules. This will accommodate situations where taxpayers may not have had an opportunity to adjust their estate planning to take advantage of the general measures.

To allow time for financial institutions and Human Resources and Skills Development Canada to adjust their RDSP systems, RDSP contributions benefiting from the proposed rollover measure cannot be made before July 2011.