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Trusts, Trustees, Trusteeships II

Foreign Trusts

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This paper covers a range of topics relating to foreign trusts, which for these purposes are trusts that are resident outside of Canada but that have Canadian beneficiaries. We first discuss how the residence of a trust is determined, at common law and for tax purposes, and how a change in residence may occur. This is followed by a brief discussion of the tax considerations relevant to foreign trusts, including the tax consequences to a Canadian beneficiary. Possible reasons for establishing a foreign trust are covered next, including a discussion of immigration trusts and asset protection trusts. A discussion of low-tax jurisdictions and developments in foreign jurisdictions follows. The paper concludes with an examination of the rights of Canadian beneficiaries as against the trustees of foreign trusts with a focus on the right of a beneficiary to information relating to the trust.

Determining the Residence of a Trust

The Common Law Management and Control Test

The law concerning residence of trusts is generally found in the common law, as the *Income Tax Act* (Canada) (the "Tax Act") does not provide guidance as to the factors to be considered in determining trust residence. In particular, the courts have stated that a trust is considered to be resident in the jurisdiction in which the majority of its trustees who exercise management and control reside.[1] This test is applicable to both the inter-provincial and international contexts.

The essential ingredient in the above-noted common law test is the jurisdiction in which the management and control of the trust assets are exercised. Thus, if a trust's non-resident trustees do not exercise actual control over the trust assets, instead acting as mere agents of some other party, then the residency of a trust may not be located in the jurisdiction where the nominal trustees reside but rather where the other party that actually manages or controls the property resides.[2] Beyond the issue of meeting the common law definition of a trust (as opposed engaging in a mere agency relationship), this test of actual control is relevant in the context of any foreign trusts where the foreign trustees exercise minimal decision-making power and it can be presumed that the settlor or one or more of the beneficiaries are providing directions regarding the administration of the trust property.

The International Context: Guidance from Tax Treaties?

While Canada's tax treaties generally define a "person" to include a trust, they rarely stipulate any determinative criteria for resolving the residence of a trust which is resident in both contracting states.[3] The vast majority of Canada's tax treaties provide that where by reason of the provisions of the treaty a person other than an individual is a resident of both contracting states, the competent authorities of the two countries shall endeavour to determine by mutual agreement its residence status.[4] Certain treaties identify certain indicia on the basis of which this mutual agreement shall be pursued, such as the place of the trust's effective management or the place

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[1] *Thibodeau Family Trust* v. *The Queen* [78 DTC 6376].

[2] David van Voorst, *Interprovincial Tax Planning-An Update*, 2006 Ontario Tax Conference, p.5:9.

[3] William Innes and Dessislav Dobrev, *Observations on Section 94*, 58th Tax Conference, Canadian Tax Foundation, 2006.

[4] See, for instance, paragraph 4 of Article IV of the Canada-US Tax Treaty.

where it is constituted.[5] Some also specify a fail-safe mechanism governing cases where the competent authorities cannot resolve the issue of residence.[6] According to this mechanism, in the absence of an agreement between the competent authorities the trust will not be entitled to the benefits under the treaty.

Changes in Residence

A change in residence may occur unintentionally, for example where a trustee involved in the management and control of the trust becomes a non-resident of Canada, such that the majority of trustees so involved are non-residents. Alternatively, the trustees may decide it is in the best interests of the beneficiaries to change the residence of the trust, for example if the laws governing the trust's current jurisdiction have changed to become less favourable. In this latter situation, the existing trustees will resign and trustees in the more favourable jurisdiction will be appointed.

With respect to tax-motivated changes in residence (e.g. to low or no-tax jurisdictions), there has been some concern as to whether the general anti-avoidance rule in section 245 of the Tax Act could apply, based on the allegation of so-called "treaty-shopping." This concern has been diminished to some extent, at least in the corporate context, by the decision in *MIL Investments*, in which the Federal Court of Appeal upheld Bell J.'s decision at the Tax Court of Canada that a change in residence to a favourable tax jurisdiction (in that case, Luxembourg) prior to a sale did not result in an abuse or misuse of the Tax Act or the Canada-Luxembourg tax treaty.[7]

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[5] See, for instance, paragraph 3 of Article 4 of the Canada-Ireland Tax Convention.
[6] See, for instance, the Canada-Kazakhstan Tax Treaty.
[7] *R.* v. *MIL (Investments) S.A.*, 2007 FCA 236, upholding *MIL (Investments) S.A.* v. *R.*, 2006 TCC 460.

Tax Considerations

There are certain Canadian tax rules that apply to trusts generally, regardless of the residence of the trust. One such rule is that the transfer of property from a person resident in Canada to an *inter vivos* trust is generally a taxable disposition, as there are only limited provisions in the Tax Act that permit the transfer of property to an *inter vivos* trust on a tax deferred basis. A foreign trust could not meet the required terms for excluded trusts, such as spousal or alter-ego trusts residing in Canada. Another rule generally applicable to transfers of property to trusts is that, if the consideration received on the transfer has a value less than the fair market value of the property transferred, section 69 of the Tax Act will apply to deem the transfer to have occurred at fair market value.

The Canadian tax rules specific to Canadian residents who are beneficiaries of foreign trusts are spelled out in section 94 of the Tax Act. Significant amendments to section 94 have been proposed, thus the discussion of the regime under the current version of section 94 is followed by a brief overview of the proposed regime, which involves amendments originally set out in the 1999 federal budget. Generally speaking, section 94 of the Tax Act aims to ensure that there are no tax benefits to be gained in establishing a trust in an offshore jurisdiction as opposed to establishing the trust in Canada (with the exception of certain exempt trusts).

Current Rules

Section 94 of the Tax Act sets out how certain income earned by non-resident trusts which are not exempt trusts will be taxed. Section 94 generally applies if a person resident in Canada has transferred or loaned property to a non-resident trust that has one or more beneficiaries resident in Canada.

Pursuant to paragraph 94(1)(c) of the Tax Act, a trust not otherwise resident in Canada may be deemed to be a resident of Canada for the purposes of Part I of the Tax Act if distributions that may be made by the trust to its beneficiaries depend upon the exercise of discretionary powers. The provision deems a trust's taxable income for tax purposes to be the total of its Canadian source income and its foreign accrual property income ("FAPI"), if any. Each beneficiary is jointly and severally liable to pay the Canadian tax of the trust. However, the liability can be enforced against a particular beneficiary only to the extent that the beneficiary has received a distribution from the trust or proceeds from the sale of an interest in the trust.

Where paragraph 94(1)(c) does not apply (i.e. where distributions made by the trust are not discretionary), paragraph 94(1)(d) provides that the trust is to be treated in much the same manner as a non-resident corporation. Pursuant to paragraph 94(1)(d) then, if a Canadian resident beneficiary holds an interest in the trust with a fair market value equal to 10% or more of the total fair market value of all beneficial interests in the trust, the trust is deemed to be a controlled foreign affiliate of the beneficiary. This deeming rule results in the FAPI rules applying to the trust and to the beneficiary, requiring the beneficiary to include a portion of the FAPI of the trust in his or her income. On the other hand, beneficiaries whose beneficial interests are less than 10% of the total fair market value of all interests in the trust may be subject to tax under the offshore investment fund rules in section 94.1 of the Tax Act. If section 94.1 does not apply, such beneficiaries are taxed only if trust income becomes payable to them in the year in which it arises.

There are specific provisions stating that the deeming rules in section 94 do not apply to the following:

- immigration trusts;

- trusts settled prior to 1960 by a non-resident person to which no contribution has been made by the non-resident person since 1959;
- testamentary trusts that arose as a consequence of the death of an individual before 1976;
- "exempt foreign trusts" which include a variety of non-resident trusts; and
- registered charities.

Immigration trusts, which are specifically exempt from both the current and proposed rules in section 94, are discussed below.

Proposed Rules

Proposed section 94 takes a different approach to the taxation of foreign trusts. In general, if a Canadian resident contributes property to a foreign trust, then the trust is deemed resident in Canada for a number of purposes, and the contributor, the foreign trust and certain Canadian resident beneficiaries of the trust may all become jointly and severally, or solidarily, liable to pay Canadian tax on the world-wide income of the trust.[8]

Except as indicated otherwise, if passed into legislation as currently drafted the amendments to section 94 will apply to trust taxation years that begin after 2006.[9]

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[8] The English-language expression "jointly and severally" no longer exists in the civil law of the province of Quebec and has been replaced in that civil law with the expression "solidarily". In the English-language version of section 94, the expression "solidarily" is added to the expression "jointly and severally", which latter expression is maintained for common-law purposes. The French-language version of new section 94 uses only the expression "solidaire" as this expression is appropriate for both the civil and common-law. These changes ensure that the Tax Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

[9] The proposed foreign trust rules were contained in Federal Bill C-33; First Senate Reading June 13, 2007; as amended by the Commons Finance Committee June 13, 2007. As the prorogation of Parliament occurred on September 14, 2007, Bill C-33 is technically no longer in existence. However, it is expected that the amendments to section 94 will be reintroduced in a new bill when Parliament reopens on October 16, 2007.

Specific-Use Foreign Trusts

As we have seen, a trust may become a foreign trust merely by virtue of a change in the residence of one or more of its trustees. In many cases, a change in the residence of a trust to become a foreign trust will not be useful or desirable, due to the deeming rules in section 94 of the Tax Act, as discussed above. In other circumstances, however, foreign trusts can prove very useful. Two examples are immigration trusts, which are exempt from the rules in subsection 94(1) of the Tax Act, and asset protection trusts, which, though not exempt from subsection 94(1), aim to achieve non-tax-driven results.

Immigration trusts

The "immigration trust" is a commonly-used structure that allows a prospective immigrant to Canada to avoid Canadian taxation on income and capital gains (other than capital gains on taxable Canadian property) in a non-resident trust for up to sixty months subsequent to their immigration. These trusts are typically established in tax haven jurisdictions (discussed below), and during the first sixty months after immigration, income is allowed to accumulate free of Canadian tax. This income is added to capital and may be distributed, together with the original capital, to Canadian beneficiaries without any incidence of Canadian tax. Care must be taken to ensure that the immigration trust is established and maintained in such a manner that Canadian attribution rules will not have their overriding application triggered.

The benefits of an immigration trust are only available to a trust which is not otherwise resident in Canada. If the trust is resident in Canada under the usual rules governing the residence of a trust, it is taxable in Canada like any other trust.

Some commentators have suggested that immigration trusts were designed specifically to permit non-Canadian executives of multinational companies to spend a few years in Canada working for Canadian subsidiaries of their foreign employers, while allowing the executive's investment income to accumulate offshore in tax havens.[10]

The essential characteristics of an immigration trust are as follows:

- There must be a trust settlement by the immigrating individual prior to the expiry of the first 60-months of residence in Canada;
- The trust must be a non-resident of Canada. This means, at a minimum, that the majority of trustees cannot be resident in Canada and that the trust cannot otherwise be controlled by residents of Canada;
- There are no limitations on where the trust can invest its property. However, if there are Canadian investments, the trust will be liable to pay Part XIII withholding tax if that tax otherwise applies. In that scenario, if at the end of the 60-month period the trust still holds Canadian investments, the trust might consider changing its residence to Canada, otherwise Canadians making payments to it will still be required to withhold tax;
- The trust will be excluded from the application of the section 94 trust rules until the year in which the 60-month period is reached. Hence, the greatest tax deferral will be achieved if the immigrating taxpayer immigrates at the beginning of the year; and

[10] William Innes and Dessislav Dobrev, *supra* note 3.

- The trust will be treated as a non-resident trust under the Tax Act, such that Canadian resident contributors and beneficiaries will be subject to the foreign property reporting rules.

At the end of the 60 month period, the residence of an immigration trust should be changed in order to cause a step-up in the basis of its assets. This should be done prior to the expiry of the 60 month period. Where the country of origin does not have a departure tax, the gain on the trust assets may be exempt in that country by virtue of its treaty with Canada.[11]

Asset protection trusts

The legal structure of a trust lends itself well to planning for creditor proofing. A trust, generally, is established by the settlor transferring property to a third party (the trustee) with the instruction that the property is to be held for the benefit of the beneficiaries. This separation of the legal ownership from the beneficial use of the property can provide significant protection from creditors without significantly altering the settlor's ability to use the property. It should be noted that it is generally the case that to be an effective asset protection tool, a trust must be irrevocable.

A trust which is established to provide protection against claims of future creditors in the context of a planning arrangement is commonly referred to by practitioners as an "asset protection trust." An asset protection trust can be established in Canada or in other common law jurisdictions.

The successful asset protection trust will require that the settlor not have a definite interest in the trust property. Whether the settlor can be a discretionary beneficiary will be dependent on the

[11] For further discussion see David P. Stevens, *Update on Trusts and Tax Planning: Technical and Topical Points of Interest*, 2004 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2004), 12B:1-63.

circumstances. As well, the settlor cannot be a controlling trustee. Further, the settlor must be prepared to relinquish ownership of the property: the settlor should never own the assets again. Finally, a settlor should not hold a determinative life interest in the trust.

Asset protection trusts often have a "protector" who is also a third party who is available to provide input to the trustees and to watch over the trust. Often such a person is connected (but not related) to the original settlor. Again, the settlor rarely has authority to force the protector to act and should not have such authority if the broadest possible asset protection is to be achieved.

In considering where the trust should be established, the secrecy and asset protection laws of foreign jurisdictions should be considered and compared against the analogous laws in Canada. Generally, if the trust is established in Canada and the trust property is located here, upon opposition by a creditor there will be a greater risk that a Canadian court will review the structure and, where it is deemed appropriate, will apply one of the many statutory remedies available at Canadian law to set aside the trust and deliver the assets to the creditors. For this reason, many taxpayers in need of asset protection will opt for establishing the asset protection trust in an offshore jurisdiction.[12]

Numerous foreign jurisdictions have enacted legislation that restricts the rights of a creditor or trustee in bankruptcy to impeach a conveyance of property to a trust governed by that legislation. These jurisdictions are, generally speaking, tax haven jurisdictions with sophisticated legal systems. Thus, they offer the advantages of well developed trust law, security of assets, and confidential banking arrangements.

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[12] Susan M. Manwaring, *Recent Developments in the Taxation of Shareholders and Their Businesses: Asset Protection and Tax Planning*, 2003 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2003), 15:1-15.

Asset protection legislation is designed to force a creditor or trustee in bankruptcy who wishes to set aside a conveyance to an asset protection trust to sue in the asset protection jurisdiction and have the courts of that jurisdiction adjudicate the issue on the basis of their domestic law. The requirement to bring an action in a foreign jurisdiction is often, in itself, sufficient to deter creditors from attempting to attack a foreign trust.[13]

Generally, trust companies or third parties in these jurisdictions assume the decision making role although they often remain in contact with the original transferor of the property. The notion is that they will closely consider the settlor's wishes notwithstanding that the settlor has no legal recourse to require the trustees to act in a certain manner.

As discussed in "Tax Considerations," above, it is only in the more unusual factual circumstances that a foreign asset protection trust would not be required to file as a Canadian taxpayer and report its annual income and pay tax on it. The Tax Act has been amended significantly to ensure that such offshore arrangements are not effective vehicles to shelter income offshore. However, if the goal of the plan is to protect assets from potential creditors, presumably the fact that the trust may be caught by the Canadian tax rules will not be a disincentive to the structure.[14]

Tax Havens

Jurisdictions that provide generous income tax exemptions are often referred to as "tax havens." The Organization for Economic Cooperation and Development (the "OECD") keeps a close watch on tax haven jurisdictions and maintains a list of countries which, in the view of the

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[13] See Norman C. Tobias, *The Uses and Abuses of Foreign Asset Protection Trusts*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 14:1-42.

[14] Susan M. Manwaring, *supra* note 12.

OECD, have not yet taken necessary steps towards reducing what it considers to be harmful tax practices. In reviewing these jurisdictions, the OECD is particularly concerned with transparency in tax regimes and effective exchange of information programs. As of the date of this paper, only three countries remain on the OECD's list of "Uncooperative Tax Havens": Andorra, Liechtenstein and Monaco.

The OECD also has a list of "Jurisdictions Committed to Improving Transparency and Establishing Effective Exchange of Information in Tax Matters," which includes 35 countries, many of which are also considered tax haven jurisdicitons: Anguilla, Cook Islands, Malta, San Marino, Antigua and Barbuda, Cyprus, Marshall Islands, Seychelles, Aruba, Dominica, Mauritius, St. Lucia, Bahamas, Gibraltar, Montserrat, St. Kitts & Nevis, Bahrain, Grenada, Nauru, St. Vincent and the Grenadines, Bermuda, Guernsey, Netherlands Antilles, Turks & Caicos Islands, Belize, Isle of Man, Niue, US Virgin Islands, British Virgin Islands, Jersey, Panama, Vanuatu, Cayman Islands, Liberia and Samoa. These jurisdictions have been deemed no longer uncooperative by the OECD, but still in need of progress.

While such classifications by the OECD have no official or legal consequences, OECD views of a particular jurisdiction should not be ignored when establishing a foreign trust, as the Canada Revenue Agency will generally look more closely at a foreign trust which has been established in a jurisdiction which has received negative attention from the OECD.

International Developments

A sampling of trust law developments in various foreign jurisdictions are discussed below.

Developments in the UK - Changes to the Tax Residence of Trusts

UK Legislation introduced with effect from April 6, 2006 presented a new definition of trust residence in that country for both income tax and capital gains tax purposes. In summary, the UK test of trust residence will now be based initially on the residence status of the trustees and will use the residence/domicile status of the settlor as a tie breaker where the trustees represent a mixture of UK residents and non-UK residents. Previously there was a let-out provision for UK professional trustees where the settlor was non-UK domiciled but this exception has been withdrawn because it was understood to breach European Union restrictions. Accordingly, in effect now, if a UK resident wishes to set up a non-UK resident trust for capital gains tax purposes, all of the trustees must be non-UK resident. Notably, if a settlor with no connection with the UK (e.g. a resident of Canada) wishes to set up an offshore trust which is not UK resident for inheritance tax and capital gains tax purposes, the trust can have any number of UK resident trustees provided that there is at least one non-UK trustee. However, if the settlor becomes a resident of the UK or becomes domiciled in the UK and wishes to add to the trust property, any UK resident trustee should consider retiring in the tax year before the settlor becomes UK resident.

Developments in Jersey, Guernsey and the Bahamas – Foundations

The Bahamas, Jersey and Guernsey are all actively taking steps to implement proposals to incorporate foundations (along the lines of Liechtenstein Foundations) with a view to providing an alternative to trusts for clients who desire more control over the assets they settle than can be provided by trusts. In terms of entity characterization, foundations may be thought of as hybrids between trusts and corporations, as foundations have characteristics in common with both of those legal structures. However it should be noted that it is not clear how the Canada Revenue Agency would characterize foundations for Canadian tax purposes.

To use the example of the Bahamian structure, Bahamian foundations have the following characteristics:

- a foundation is intended to be a legal entity and may be established by a charter or by a will;
- assets transferred to a foundation are the legal and beneficial property of the foundation and cease to be the property of the transferor;
- the property of the foundation does not become the property of a beneficiary unless and until properly distributed to the beneficiary by the foundation council;
- the foundation council owes fiduciary duties to beneficiaries of the foundation (who need not be named in the charter);
- the officers, protector and members of the foundation council may not disclose information relating to foundation beneficiaries or assets unless pursuant to Bahamian law or a Bahamian court order; and
- a foundation may be established for private, commercial or charitable purposes.

The Bahamas passed legislation in 2004 which opened the door to the use of foundations in that country, while Jersey and Guernsey have proposed similar legislation.

Developments in Israel - Taxation of Trusts

New legislation relating to the taxation of trusts, introduced on January 1, 2006, defines three types of trusts: (i) trusts established by Israeli residents, which are taxable on worldwide income; (ii) foreign settlor trusts, which carry certain advantages due to the trust being considered a foreign resident (whereby if trust income or profits are not derived from sources in Israel, they are not taxable in Israel and there are no reporting obligations in Israel); and (iii) foreign resident beneficiary trusts (trusts established by an Israeli resident for a foreign resident beneficiary), in which the assets and income earned by the trust are removed from the Israeli tax net.

The Rights of Beneficiaries

A justifiable concern for individuals interested in setting up foreign trusts is how the trust assets will be managed and what recourse, if any, may be had against a foreign trustee who, in the opinion of the settlor or the beneficiaries, is not acting in the best interests of the beneficiaries of the trust.

A precursor to holding a foreign trustee accountable for his or her activities is to request information pertaining to the trust. Thus, a beneficiary's right to information concerning the trust assets is often a pressing issue for the individuals involved. Disclosure of information is not always a straightforward matter where foreign trusts are concerned, however, as disclosure requirements in foreign jurisdictions will vary widely depending upon the particular jurisdiction and the type of trust in play.

As a preliminary matter, a beneficiary's right to information and the duty of the foreign trustee to provide that information are to be distinguished from the rights and duties that arise in legal proceedings. Discovery is a process enabling a party to litigation to gain access to the documents of other parties that are relevant to the issues in the litigation. The entitlement arising under litigation proceedings therefore does not depend upon the relationship between the parties.

On the other hand, a beneficiary's right to information and the duty of the trustee to disclose arises because of the relationship between them. As a fiduciary, a trustee owes duties to the beneficiaries, and it is because of these duties that rights and obligations arise with respect to information pertaining to the trust.[15]

The law dealing with a beneficiary's right to information has changed over the years. Whereas previously there was a general rule of disclosure in favour of the beneficiaries of a trust, which rule was subject to certain exceptions (notably, with respect to documents concerning the reasons for the exercise of discretion by the trustees as well as documents in respect of which a third party had a right of confidentiality as against the trustees), now it appears that it is a matter for the court to exercise its discretion by balancing competing interests.[16]

Therefore, in a situation where a foreign trustee is not complying with requests for information disclosure, a beneficiary may have to bring an action in the jurisdiction of the trust in order to force the trustee to disclose information.

Conclusion

Foreign trusts have great utility in tax and asset protection planning in particular circumstances. However, the potential complexities with respect to Canadian tax laws and interactions with foreign trustees serve as a reminder that establishing a foreign trust has an element of risk and may have significant consequences for both the settlor and the beneficiaries of the foreign trust.

[15] Ian V. Gzell, *Trust Law: Right to Information and Duties of Disclosure and Confidentiality*, The International Academy of Estate and Trust Law, 2005 Meeting in Santa Fe, New Mexico.

[16] *Ibid* citing *Schmidt* v *Rosewood Trust Ltd* [2003] 2 AC 709.