Canadians with International Assets

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Topics to Discuss

1. Introduction: Know Your Client
2. Common law vs. Civil Law Jurisdictions
3. Recognition of Trusts
4. Multiple Taxation in Life or on Death
5. Canadian Outbound Taxation
6. Foreign Property Reporting
7. Offshore Investment Fund Property
8. Foreign Trusts

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Know Your Client

- Review comprehensive statement of net worth
- Identify location and ownership of all property
- Consider current estate plan, if any
- Review family tree, background, residence, domicile, citizenship for client and family members

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Common Law Versus Civil Law

- *Matrimonial Regimes*
  - Separation of property during marriage
  - On death or divorce: equitable division of property in common law jurisdictions
  - Community of property in civil law jurisdictions
- *Testamentary Freedom versus Forced Heirship*
  - General common law freedom limited by spousal and dependent claims
  - Civil law forced heirship provides for mandatory distribution of a portion of the estate to family members

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Recognition of Trusts

- Generally, civil law jurisdictions do not have the trust concept , i.e. the division of ownership between “legal” and “beneficial” is not recognized in law
- Hague Trust Convention provides for recognition in those jurisdictions it is in effect
  - The Hague Conference has currently 82 Members: 81 States and the European Union, including for example, France and Italy
- Income tax implications unclear in some civil law jurisdictions: separate entity/contract/agency ?

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Multiple Taxation in Life or on Death

- Tax can be levied on a living person, a deceased, an estate and/or a beneficiary
- Tax base can be: citizenship, residence, domicile, location of assets
- Some tax treaties provide relief from double taxation in life or on death
- Need for advance planning, including tax liability of intended beneficiaries

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Multiple Taxation in Life or on Death …cont'd

If Hold Interests in Certain U.S. Entities, There May Be Exposure to Double Taxation

- The CRA considers a Limited Liability Company ("LLC") to be a separate corporation for Canadian tax purposes, even though for U.S. tax purposes, these are treated as "pass-through" entities, like a partnership
- Recently, the CRA announced they would treat Limited Liability Partnerships ("LLPs") and Limited Liability Limited Partnerships ("LLLPs") created in Delaware and Florida also as separate corporations

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Multiple Taxation in Life or on Death ...cont'd

If Hold U.S. Real Estate, The Issues To Consider Include The Following:

- U.S. Estate tax at an escalating rate up to 40% of the gross value of U.S. *situs* property, such as a U.S. vacation home
- U.S. Gift tax on a similar scale
- U.S. income tax on sale of the property
- Canadian income tax on the capital gain either deemed to be realized on death or from actual sale of the property
- Avoiding double taxation

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Multiple Taxation in Life or on Death ...cont'd

Available Arrangements to Hold U.S. Vacation Property

- Individual ownership
- Holding company in Canada
- Holding company in U.S.
- Non-recourse mortgage
- Life Insurance
- Canadian family trust

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Multiple Taxation in Life or on Death ...cont'd

Use of Canadian Family Trust

- Structure
  - Spouse with resources contributes purchase price of property to trust as settlor
  - Other spouse is trustee
  - Beneficiaries include other spouse and issue (but not settlor spouse)

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Multiple Taxation in Life or on Death …cont'd

- Implications
  - Insulation from U.S. Estate tax and Gift tax
  - Avoidance of U.S. probate on death
  - Integration of trust with wills and estate planning
  - On sale, capital gain taxed in the U.S. to trust or individual beneficiaries at long-term capital gains rate, currently 20%
  - On sale, must recognize U.S. capital gain to trust or beneficiary in Canada , subject to maximum tax at 26.77%, with a foreign tax credit for the 20% tax paid to the U.S.

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Canadian Outbound Taxation

- Canada taxes Canadian residents earning income abroad
- “Residency-Based”
- A resident of Canada is subject to tax in Canada on his/her/its worldwide income under Part I of the Act
- 2 ways for a Canadian resident to earn income abroad:
  - Directly; or
  - Indirectly

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Canadian Outbound Taxation ...cont'd

Foreign Property Reporting

- A Canadian resident must report ownership of foreign income-producing property where the aggregate cost is more than $100,000
- Where a Canadian resident transfers or loans funds to a non-resident trust, or receives a distribution from such a trust, these transaction have to be reported
- A Canadian resident that has a foreign affiliate must report this as well

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Canadian Outbound Taxation ...cont'd

- The Income Tax Act was recently amended to require large multinational corporate groups to provide country-by-country reports that the CRA will share with other tax authorities: is this a sign of coming disclosure for individuals?

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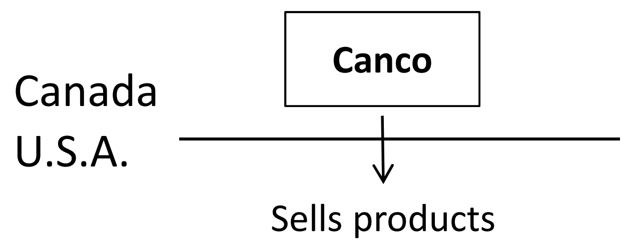
Canadian Outbound Taxation ...cont'd

Foreign income can be earned <u>directly</u> by a Canadian resident

- Example:



- Foreign income earned directly must be included in the resident's income and reported in the resident's Canadian tax return
- Such income may also be taxed in the country in which it was earned
- Foreign tax credits provide relief from double taxation

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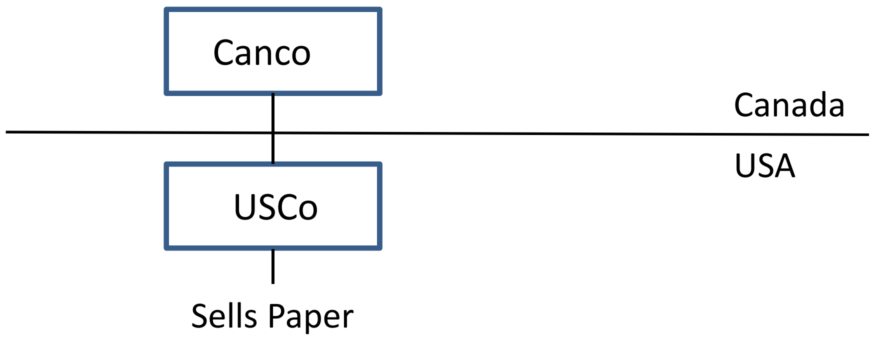
Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly

Example:



- Certain passive foreign income earned indirectly by a Canadian resident must be included in the resident's income on a current/accrual basis
- Active foreign income earned indirectly by a Canadian resident is only included in the resident's income when it is distributed to the resident

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly

- Foreign income can be earned indirectly by a Canadian resident through:
  - A foreign corporation:
    1. Foreign Affiliate
    2. Controlled Foreign Affiliate
    3. Holding "offshore investment fund property"
  - A Non-Resident Trust

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - Foreign Affiliate

- A foreign affiliate ("FA") is a foreign corporation that:
  - a Canadian resident alone, or together with other related persons (not necessarily Canadian residents), own 10% of the shares of a class or series of the foreign corporation; and
  - The Canadian resident itself owns at least 1% of those shares.

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- Canadian residents earning income abroad through FAs are required to track their earnings in surplus accounts
- <u>Exempt surplus account</u> - tracks active business income earned by an FA in a designated treaty country

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- Dividends paid out of an FA's *exempt surplus account* are included in the income of the Canadian corporate shareholder when received, but are fully deducted in computing taxable income of the Canadian corporate shareholder
- Therefore active business earnings earned in a designated treaty country are effectively not subject to Canadian tax
- A Canadian resident tracks passive income, non-active business income, and active business income earned in a country that is not a designated treaty country in a taxable surplus account

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- Dividends paid out of a FA's *taxable surplus* are included in the Canadian shareholder's income; however, a deduction in computing taxable income is allowed for the underlying foreign taxes paid by the foreign affiliate on its profits and for any foreign withholding taxes on the dividend
- Therefore passive, non-active and active business income earned in a country that is not a designated treaty country are subject to Canadian tax as *FAPI* ("foreign accrual property income")

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - FA Consequences

- If a FA holding company ("Barbco") were to dispose of the shares of another FA carrying on an active business for a capital gain, there would be no inclusion of the gain in *FAPI*. The capital gain would be included in the "hybrid surplus" of Barbco
- If a dividend from Barbco's hybrid surplus is received by a Canadian resident corporation, one-half would be tax-free and one-half would be included in its income, with a form of foreign tax credit being available for any Barbados taxes imposed on Barbco (which in this case would be nominal if any)

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - FA Consequences

- In summary, the regime for taxing income of foreign affiliates is based on characterizing the nature of the foreign income
  - *Exempt surplus* includes income earned from an active business carried on in a *designated treaty country* by a resident of that country
  - *Taxable surplus* consists of *FAPI*, *income from property*, active business income earned in countries that are not *designated treaty countries* and certain other amounts earned by foreign affiliates
  - *Hybrid surplus* arises from capital gains realized on the disposition of foreign affiliates.

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences: Summary

- Dividends received by a Canadian corporate shareholder are considered to be paid first out of the *exempt surplus* and then out of *taxable surplus* and *hybrid surplus*
- Once *exempt*, *taxable surplus* and *hybrid surplus* have been exhausted, further dividends are treated as a recovery of the shareholder's cost, and the adjusted cost base of the shares in the foreign affiliate is reduced accordingly

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - Controlled Foreign Affiliate ("CFA")

- Canadian corporate shareholders receiving *exempt surplus* through a CFA are subject to the same Canadian tax treatment thereof as an FA, i.e. no Canadian tax thereon
- CFAs are also subject to the same treatment of *taxable surplus* with one major exception – Canadian shareholders are taxable on an <u>accrual basis</u> on foreign accrual property income (*FAPI*) earned by CFAs, regardless of whether *FAPI* is actually distributed to the shareholder

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - Controlled Foreign Affiliate ("CFA")

- Moreover, an additional deduction is allowed in computing income of the Canadian shareholder in respect of dividends paid out of previously taxed *FAPI*, which was included in *taxable surplus*

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - FAPI

- *FAPI* very generally means passive income
- *FAPI* includes
  - "income from property",
  - income from a business, other than an active business, and
  - certain taxable capital gains.

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Directly - FAPI

- "Income from property" includes interest, rents, royalties, dividends and income from an "investment business"
- An "investment business" is a business (other than a business defined not to be active under the ITA) carried on principally to earn income from property, insuring or reinsuring risks, factoring trade accounts receivable, and profits from the disposition of investment property.

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The Offshore Investment Fund Property Rules

- The OIFP Rules are aimed at penalizing investments by Canadian residents in offshore entities that primarily earn investment or passive income.

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The Offshore Investment Fund Property Rules …cont'd

- In order for the OIFP rules to apply, the following conditions must be met at any time in a taxation year of the taxpayer:
  - The taxpayer must have an interest in an "offshore investment fund property"
  - It may reasonably be concluded that one of the main reasons for investing in the offshore investment fund property is to significantly reduce the income tax that would have been paid if the income had been earned directly by the taxpayer.

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The Offshore Investment Fund Property Rules ...cont'd

- An "offshore investment fund property" generally is a share of the capital stock of, an interest in, or a debt of, a non-resident entity (other than certain non-resident entities including *controlled foreign affiliates*) that may reasonably be considered to derive its value primarily from portfolio investments of that or any other non-resident entity in certain property.

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The Offshore Investment Fund Property Rules …cont'd

- If the OIFP Rules apply, an amount must be included in computing the taxpayer's income from the investment. This amount is determined generally by multiplying the "designated cost" of the taxpayer's investment by a factor based on the prescribed interest rate.

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The Non-Resident Trust Rules

- The Non-Resident Trust ("NRT") rules impose liability jointly on a Canadian contributor and the trust if there is either:
  - A connected contributor (i.e. having contributed at a time other than at a *non-resident time*), regardless of the beneficiaries' residency, or
  - A resident beneficiary (i.e. having a Canadian resident beneficiary <u>and</u> a connected contributor).

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The Non-Resident Trust Rules …cont'd

- The property of a NRT is divided into a "resident portion" and a "non-resident portion". The "resident portion" consists of property of the trust that has been contributed by residents and certain former residents of Canada (and any property substituted for such property).
- The "non-resident portion" consists of any property that is not part of the "resident portion" of the property of the trust.

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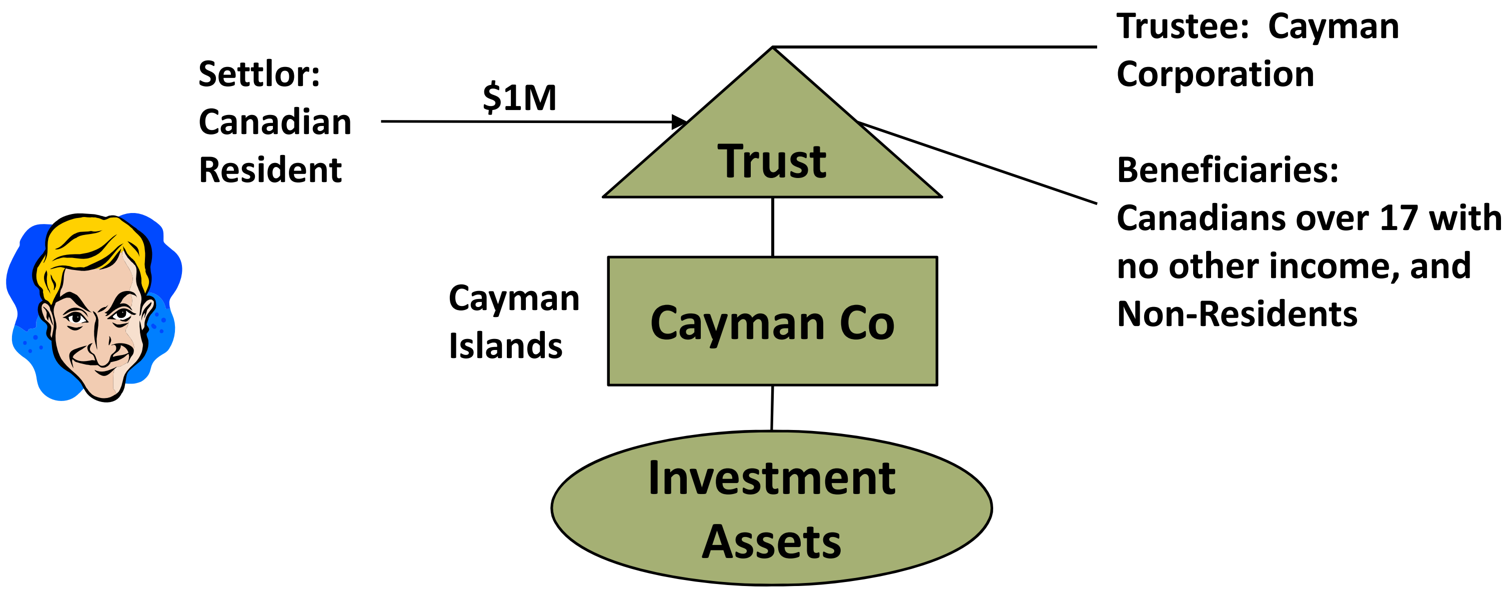
Outbound Offshore Trust



- Deemed to be Canadian Trust (NRT)
- Trust may allocate income every year to Non-Resident Beneficiaries, if such Beneficiary can take advantage of remittance-based taxation
- Withholding tax applies on distributions to Non-Resident Beneficiaries out of the “resident portion”
- 25% tax rate compared to 53%

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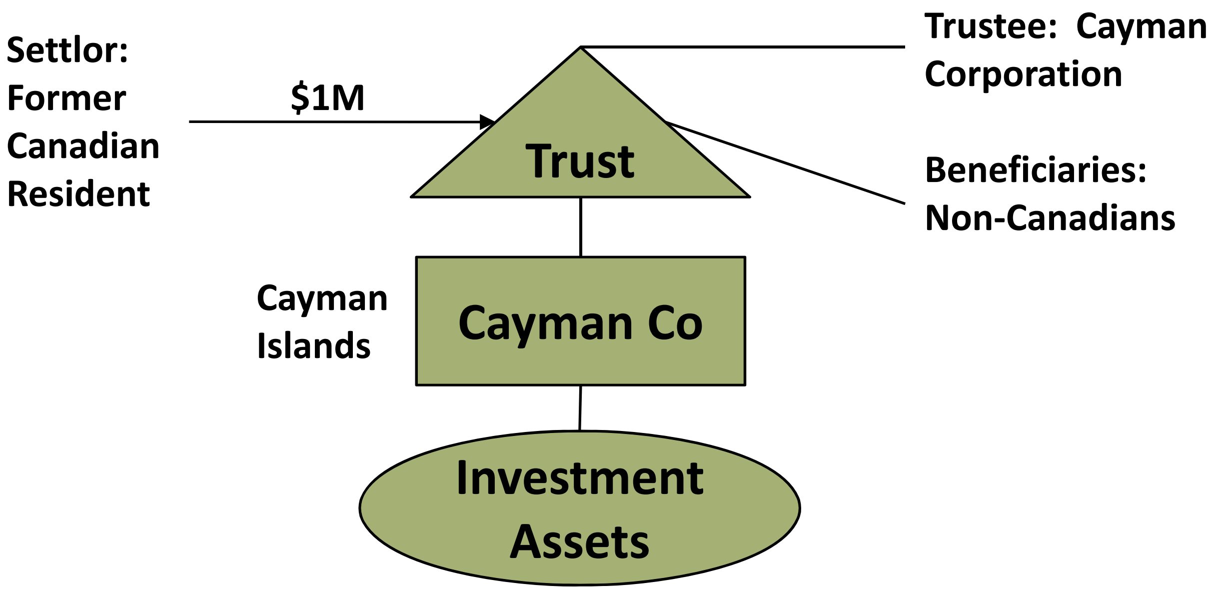
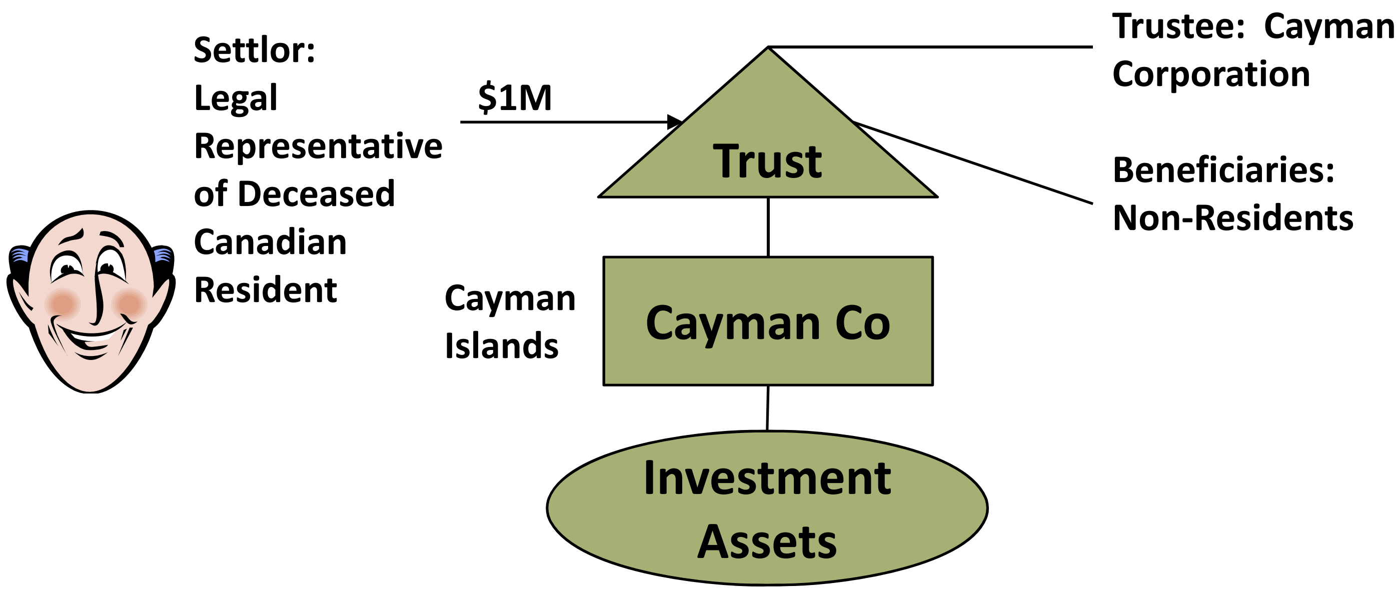
Offshore Trust Subsequent to Leaving Canada



- Trust not subject to Canadian tax as no Canadian contributor
- May eliminate tax in new country
- Trust cannot have Canadian Beneficiaries

Offshore Trust in Will



- May be able to minimize tax in the country of residence of the Beneficiaries

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Questions?

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