FIE-ASCO 2005!

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Two years ago, I wrote an article on the harsh FIE proposals. I complained that, even though the rules had not yet been passed into law, for most readers, they would be effective retroactive to January 1, 2003.

The purpose of this article is to update you on these proposals.

Since that article, there has been yet another round of draft legislation - in October, 2003. The rules are still in proposal form. But, believe it or not, once they have passed, they will still be effective for taxation years commencing after 2002 – i.e., for most readers, January 1st, 2003. Yes, that's two and one-half years ago. And with the government up in the air, there's no sign that they will be passed any time soon.

The FIE rules were originally designed to deal with investments in offshore investment funds resident in sunny Caribbean tax havens and the like. However, they are so broad that they can hit a very wide range of foreign investments of all kinds. Examples include a foreign mutual fund, even if not in a tax haven (including a U.S. fund); an interest in foreign real estate, e.g., vacant land or development co-ventures, if held through a foreign company – even a foreign insurance policy.

The FIE rules are designed to potentially apply to any foreign entity other than a controlled foreign affiliate (typically a non-resident corporation controlled by a small group of Canadians – see below), unless specific exemptions are met. Exemptions potentially apply to foreign active business co-ventures; however, even here, there are stringent requirements which, if not met, will trigger the FIE rules.

How they work. So what exactly happens if the FIE rules apply? The answer is this: there will be an amount added to your income for tax purposes, based on the cost ("designated cost") of your investment, multiplied by CanRev's prescribed interest rate for employee and income splitting loans, plus 2% (calculated on a monthly basis). Currently, the all-in rate is 5%, but this is adjusted quarterly. For investments held before the effective date of the rules - January 1, 2003 for most readers - the designated cost will be the value on that date. The 5% benefit applies irrespective of the income from the entity. You pay tax based on the 5%, for example, even if a fund or other entity loses money, or if it makes, say, 15%.

Example

> You have a minority interest in a U.S. corporation holding vacant land. The cost of your shares in the corporation is $Cdn. 100,000. Under the FIE rules, you would have to add $5,000 (i.e., 5% of $100,000) to your taxable income. Since, for most readers, the rules would be applicable retroactive to January 1st, 2003, you would now have to account for three years of these benefits if you held the investment at the beginning of 2003 (instead of the cost, you would use the value at this time as your cost).
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> Assuming that the rate remained at 5%, in the second year the benefit would be 5% of [100,000 + 5,000] = $5,250, in the third year it would be 5% of [100,000 + 5,000 + $5,250] = $5,513, and so on.

In limited circumstances, there may be options to pay tax based on increases/decreases in value of the FIE, or on the FIE's actual income; however, it is unlikely that many taxpayers would be in a position to take advantage of these alternatives, especially given the stringent requirements.

Now that you have the general idea, I would like to talk about some specific situations.

Foreign Funds

Provided that certain qualifications are met (I'll get to these in a moment), a foreign fund will *potentially* be exempt from the FIE rules if the fund either:

- **trades on a prescribed stock exchange** – the fund resides in a country where there is a prescribed stock exchange, provided that identical interests are widely held, and the fund is listed on a prescribed foreign exchange; or
- **is resident in a treaty country** – the fund is governed by the laws of a country in which Canada has a tax treaty, is resident in that country, and identical interests are widely held.

If these qualifications are met, you will be automatically exempt from the FIE rules if substantially all of the fund's income becomes payable within 120 days of its year end, or the fund is a "Regulated Investment Company" or "Real Estate Investment Trust" under the U.S. *Internal Revenue Code*. Under both exemptions, you must actually include the amounts payable in your income.

No tax avoidance motive. Otherwise, these types of funds are exempt if it is reasonable to conclude that you have no "tax avoidance motive." Actually, this could be the most ironic part of the legislation. The reason for the super complex proposals is that, under the pre-existing rules, a tax avoidance motive was, similarly, necessary. After many years, under the old regime, the CRA found that – guess what – very few, if any, taxpayers were fessing up to a tax-avoidance motive. Further, it is very difficult to enforce this sort of thing.

While the original FIE proposals trashed the tax-avoidance motive test, in subsequent revisions, it was dropped back in. So, ironically, we have the same difficult-to-enforce test which will apply to what is probably the majority of foreign investments. In plain words, these rules do not substantially advance the government's cause – they just create complexities where none existed before. (Yes, they tinkered with the tax-avoidance motive test a bit, but it is hardly worth mentioning.) Generally, a tax avoidance motive will exist if the main reasons you acquired the fund included the deferral or reduction of tax.

> **Comment.** Provided that you do not have a tax avoidance motive, investments in funds in major countries such as the U.S. and U.K. generally should be exempt under these rules. Also, many U.S. funds either distribute their income, or specifically qualify as RICs or REITs, including SPDRs and other indexed funds traded or resident in the U.S.
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> For funds that are not automatically exempt, it may be a good idea to have something in your files showing that you had a non-tax motive for investing in the fund, e.g., a letter from your broker advising you that a similar investment isn't available in Canada, or that the foreign fund is, in one way or another, superior to an equivalent Canadian fund.

A list of prescribed stock exchanges is found in Regulation 3201 to the *Income Tax Act*. Besides major U.S. exchanges; investments traded on the Australian, Hong Kong, Tokyo, Mexico, Singapore, Zurich, Tel Aviv, or Johannesburg stock exchanges qualify, to name a few. The no-tax-avoidance-motive test also potentially applies to a Barbados or Irish fund, because Canada has a tax treaty with these countries. However, this is not the case for funds based in countries where a tax treaty with Canada does not exist. These include tax havens such as Cayman Islands, Bermuda, Bahamas, Turks & Caicos, and so on. In these cases, the FIE rules will probably apply.

It is even possible that the FIE rules could apply to an investment in a single corporation, as opposed to a fund, if it is essentially an investment holding company. As is generally the case, the rule here is that FIE rules potentially apply if more than 50% of a corporation's assets consist of so-called "investment property" such as portfolio share and debt investments, real estate, and so on.

Foreign Life Insurance Policies

If you have a foreign life insurance policy, the FIE rules may well apply to you, so that increases in the value of a policy's accumulating fund could be taxable. In this case, rather than a 5% taxable benefit, you must pay tax on the annual increase in value of the policy. There will be an exemption if you took out the policy more than five years before you came to Canada. However, the exemption will not apply if there has been an increase in premiums over the level originally contemplated under the policy, if this increase takes place within five years of becoming resident. (The October 2003 revisions tinkered with the foreign insurance rules a bit by exempting them from the FIE rules if the taxpayer can establish that the policy complies with Canadian rules for life insurance – a procedure that will apply to few, if any, foreign policies.)

Interest in Foreign Land Ventures

One of the biggest potential traps under the FIE rules will come into play if you have a minority interest in foreign land, held through a foreign holding company or other non-resident entity. Under the FIE rules, you must pay the 5% deemed interest, even if the investment is in vacant land or the venture is otherwise not generating a profit.

One example of this is if you are a shareholder in a U.S. company, with arm's length U.S. or other foreign shareholders holding at least 50% of the voting shares. The company could hold, say, some building lots in Colorado, or one or more condos in Hawaii or California. To make matters worse, if U.S. shareholders are involved, the company will typically be structured as an "LLC" (Limited Liability Company) because this will be advantageous for U.S. taxpayers. However, there will be Canadian tax traps to this type of structure which are beyond the scope of this article - professional advice should be sought.

In this and other cases, one antidote to the FIE rules could be a special election to treat the investment as a controlled foreign affiliate (to do this, you must have at least 10% of the shares of the company in terms of both votes and value). But for controlled foreign affiliates, the general rule is that you must then pay tax on your share of the company's rental or other passive income as well as capital gains.

By the way, the 5% benefit generally applies to the cost of your shares in a corporation, but not to funds advanced in the form of loans to the company. In this case, if the loans are made by a Canadian corporation, other adverse rules may apply. In the case of an individual, though, it appears that one way to avoid the 5% benefit is to fund the foreign entity by loans rather than shares.

Business Ventures

As I stated, the FIE rules do not generally apply to *controlled foreign affiliates* (exceptions may apply if you have "tracking shares" or similar interests). These include non-resident corporations controlled by groups of five or less Canadian residents, or controlled by you and one or more non-Canadian residents with whom you do not deal at arm's length. A controlled foreign affiliate would include, for example, a U.S. corporation held 50/50 by yourself and, say, your brother from Los Angeles. However, if the foreigner is not related to you, the corporation will usually not be a controlled foreign affiliate so that the FIE rules potentially apply.

If the foreign company is not a controlled foreign affiliate, it will then be necessary to analyze whether the FIE rules apply. In this case, exemptions are available if not more than 50% of the company's assets are "investment properties" or if the principal business of the non-resident entity is an active business, other than an "investment business". (An "investment business" – which is a bad thing – includes a business the principal purpose of which is earning income from interest, dividends, rents, and so on.)

While this sounds promising, the rules are complex, and there are a number of tax traps, especially when foreign holding company structures are involved.

Rollovers Denied

The 2003 round of amendments added one more snafu to the FIE rules – and it's a nasty one. The proposals disallow certain rollovers involving corporations, including, most notably, when assets are transferred to a corporation, for most interests in FIEs. A "rollover" is a term used by tax drones to describe a tax-deferred transfer to another person/entity. Without a rollover, you are generally considered to have sold the asset at its market value. Generally, any interest in a FIE other than an "exempt interest" is no longer eligible for certain rollovers.

This means that if a foreign fund is transferred to a corporation, it may not be possible to do this on a tax-deferred basis. Fortunately, if a foreign fund is not taxable under the FIE rules because there is no tax avoidance motive (see above), it will be an "exempt interest" and therefore qualify for rollover status; however, if this is your filing position and the CRA successfully takes issue with it, e.g., because you have a tax avoidance motive, the rollover would be denied.

Note: The rollover between spouses/common law partners is not affected by these restrictions.

In summary . . .

The foregoing is about as simplistic a summary of the FIE rules as I can devise. While large public companies and the like may be able to cope with the rules, it is a different story for smaller scale investors. Needless to say, many will be tempted to simply ignore the rules. While ignorance can sometimes be bliss, you should be aware that the CCRA is rapidly amassing more and more information about foreign investments. Besides the tax on FIEs themselves, if a CRA auditor decrees that you are deliberately ignoring the foreign requirements, e.g., by not reporting foreign-source income, serious penalties could apply.

Chart 1

FIE Rules - Examples

Item	Old Rules	FIE Rules
Foreign Fund – traded on major stock exchange or resident in a treaty country	No tax unless tax avoidance motive is present	Tax unless tax avoidance motive is not present. Exempt if fund makes annual distributions or is a U.S. *RIC* or *REIT*
"Offshore Fund"	No tax unless tax avoidance motive is present	Apply – benefit based on 5% of cost
Real estate investment company – 50% or more of share held by non-Canadians**	No tax (if not a controlled foreign affiliate)	Potentially apply – benefit based on 5% of cost of shares*
Real estate investment company - controlled by five or fewer Canadians***	The FAPI rules apply – Canadian shareholders taxed on rent or other passive income	Same – FIE rules usually don't apply to controlled foreign affiliate
Foreign business company – 50% or more of shares held by non-Canadians**	No tax	May be exempt if tests are met – but watch out for holding company structures*
Foreign whole life insurance policy	Technically: subject to complex test for "exempt policies" under Canadian rules	Taxed on increase in policy value under FIE rules (unless policy complies with Canadian tax rules)

* Consider electing to be treated as a controlled foreign affiliate so as to be subject to FAPI rules, not FIE rules.

** Not a controlled foreign affiliate

*** A controlled foreign affiliate