Heartbreak Hotel – Foreign Estates and the FIE Rules

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Some fine print in the revised draft foreign investment entity legislation released in July clarifies the circumstances in which Canadian-resident beneficiaries of foreign estates may have to pay Canadian tax by virtue of their interests. And it looks to me like, not only will this typically be the case, but worse still, it will become advisable for tax/estate professionals to review a beneficiary's interest in a foreign estate to see if the dreaded FIE rules apply.

Caught in a Trap

The proposals stipulate that a "participating interest"[1] in a non-resident entity includes a "specified interest" in a trust – which presumably includes an estate.[2] The good news – a "specified interest" does not arise where the sole right to receive income or capital from the trust arises only on the death of a person - alive at the particular time - who is a contributor to the trust or a related person.[3] However, once that person passes away, the beneficiary will be considered to have a specified interest in the trust, and thus subject to the FIE rules.[4]

So here's a simple example: Uncle Elvis, who is 70 and lives in Memphis, names you as a beneficiary, perhaps under his will or an *inter vivos* trust, often used for U.S. estate planning. While Uncle Elvis is still alive, there is no problem.[5] But once he passes away, you likely have a participating interest in a FIE. There may be an exception to specified interest status if your interest in the trust/estate is discretionary;[6] however, the rules say that *every* amount of income or capital you stand to receive must be completely discretionary[7]. If, for example, Uncle Elvis gives you a thousand dollars and leaves the rest at the discretion of his executors, you have a specified interest - and are caught in the rules.[8]

If so, you must then determine your income inclusion. The primary method of determining the taxable amount as a result of holding a FIE is the "imputed income" method. Under this regime, an interest factor (currently 5%) is applied monthly to the "designated cost" of the interest in the FIE.[9] So if the FIE rules apply, and the designated cost of your interest in the Elvis estate is $1,000,000, you must include $50,000 in income the first year they apply, $52,500 the next year, and so on.

Perhaps your initial reaction is that, since most beneficiaries do not pay anything for their interest in the estate, the designated cost will be nil. However, a good read of the "designated cost" definition[10] leads to a different result. To begin with, if the individual was a beneficiary prior to the beginning of 2003, when the rules came into effect, "designated cost" will be based on the fair market value of the beneficiary's interest in the estate at that time.[11] Therefore those who are beneficiaries before the new rules came into effect may now be facing a sizable liability under the imputed income regime.

But it may well be the case that newer beneficiaries could also be caught. Buried in the definition of designated cost is a provision that indicates that, where the interest in the FIE is acquired after 2002, the designated cost will be the amount by which the fair market value of the interest exceeds the cost amount to the taxpayer,[12] which will normally be nil[13].

Theoretically at least, the other possibility available in these circumstances is to pay tax based on the accrual method. Essentially, this requires a calculation of your share of income of the trust under Canadian tax rules. You must pro-rate the trust's income based on the fair market value of your interest in the trust relative to the total.[14] Whether or not this will give rise to a better result than the imputed income regime is a difficult question that, of course, is largely fact based. In addition, it is necessary to go into the intricacies of the comparative calculations, which can be quite complex.[15] Of course, all of this presupposes that the information is available to comply with the accrual calculations to begin with. And if everything else looks promising, the killer could be subparagraph 94.3(2)(b)(ix) which provides that, if the non-resident entity is a trust, the accrual method will not be available if any amount of income or capital that *any* entity or individual may receive depends on the exercise of a discretionary power.

Don’t be Cruel

As I said at the beginning of the article, the rules can have widespread application to beneficiaries of foreign estates. Professionals who purposely ignore the rules may do so at their peril, as the so-called "civil penalties" for advisors may apply.

Obviously, this considerably broadens ambit of the non-resident trust and FIE proposals. In previous articles, I have warned that dealing with a structure involving a non-resident trust may put a Canadian-resident taxpayer in serious jeopardy.[16] Now, the "FIE warning" extends to those who are beneficiaries of foreign estates.

Thus, these proposals are not some fine print relegated to a few specialists in offshore funds. They can apply to day-to-day client situations involving multinational business structures, not to mention personal tax and estate planning. It seems like every time I take a good look at the non-resident trust and FIE proposals, some anomaly or other becomes apparent. But this is not some esoteric trap: the proposals do nothing less than impose an annual tax on foreign estates.

All Shook Up

Ask any tax practitioner – even by *Income Tax Act* standards, the non-resident trust and FIE proposals are some of the most complex and obtuse rules imaginable. But unless the current proposals are changed, it will now be necessary for advisors to beneficiaries of non-resident trusts and estates to become intimately familiar with the rules.

Consider, for example, what happens when Elvis leaves the building. Under the imputed income option, if the Elvis estate pays out a partial bequest, there does not appear to be an offset to "designated cost" as a result of the bequest; so you still include the amounts I mentioned earlier. Happily, income from the estate which is payable/taxable to you would appear to give you relief from double-taxation under subsection 94.4(1); by comparison, if the income is taxed to the estate, you would continue to be subject to the 5% imputed income without relief for underlying foreign tax. Distribution of the capital to you would have the effect previously mentioned; as well, you would, of course, pay tax on the whatever actual income is earned from the bequest.[17]

Suspicious Minds

To be fair, the Department of Finance is trying to cope with what it no doubt perceives to be nefarious offshore structures. But at its most basic, perhaps the real message behind the NRT/FIE proposals is that it is dangerous to deal with foreign trusts and investments – so stay away.

Personally, I believe that there is a lot more tax revenue to be gained by taking a closer look at those who may not be complying with the system, than by imposing such complex rules. Worse still, making the rules so tough will simply discourage compliance by the vast majority of Canadians who will find the FIE and NRT rules to be yet another black hole of incomprehension. I guess that’s what disturbs me most from a tax-policy standpoint. I keep getting the feeling that the farther I get from King and Bay, the more people are out there with offshore bank accounts and the like - who think that those who play by the system are a bunch of chumps.

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[1] Per proposed subsection 94.1(1)

[2] Through a rather tortured interpretation of "specified interest" and "beneficiary", it is possible to assert that the definition of "trust" in subsection 94(1) which specifically includes an estate, is applicable. Obviously, however, a normal 104(1) definition would presumably give rise to the same result. See, for example, *Taxation and Estate Planning,* Third Edition (Cullity & Brown)*,* p.275.

[3] See "specified interest", per proposed subsection 94.1(1) and "successor beneficiary", per proposed subsection 94(1).

[4] Of course, the trust must be a foreign investment entity to begin with. Notably, this would not be the case if, at the end of a particular taxation year, the carrying value of the entity's "investment properties" is not greater than one-half of the carrying value of all of its property, or throughout a particular taxation year, the principal undertaking of the entity was carrying on business that was not an investment business. However, most trusts will not be subject to these exemptions.

[5] If Uncle Elvis has done a will, presumably no trust arises until he passes away.

[6] See paragraph (b)(ii) of the definition of "specified interest", in proposed subsection 94.1(1). There is also an exception in respect of "successor beneficiary" status which ignores contributors of less than 10% of total contributions.

[7] At the STEP conference on non-resident trusts and FIEs presented on September 12, my colleague, Michael Atlas, suggested that if the executors/trustees were given the discretion to distribute income and capital either to the individual or to a wholly-owned corporation, this could make the trust completely discretionary. This, of course, presumes that the drafting is done with the FIE rules in mind; it is, of course, quite possible that the drafter would not even turn his or her mind to Canadian tax issues.

[8] It appears that this problem can be remedied by distributing these funds.

[9] Per proposed subsection 94.1(4).

[10] Per proposed subsection 94.1(1).

[11] I.e., the end of the last taxation year commencing before 2003. See clause D of the "designated cost" definition in proposed subsection 94.1(1).

[12] See clause F of the definition of "designated cost", per proposed subsection 94.1(1). I am grateful to Peter Wong who recently pointed this out. Based on previous casual discussions with practitioners, there seemed to be a common belief that, for a "new system" estate or trust interest, there would probably not be a designated cost.

[13] The definition of "cost amount" in subsection 108(1) applies only to subdivision k.

[14] See proposed subsection 94.3(1).

[15] One advantage of the accrual method is that there is relief for foreign taxes, where applicable.

[16] See "NRT Rules: Harsher Than You Think", *Tax Topics*, report #1705, November 11, 2004.

[17] More generally, it is becoming increasingly dangerous to be involved as an advisor in the estates and trusts area without a detailed knowledge of the *Income Tax Act.* For example, a simple change of trustees can result in the "change-of-control" rules applying for any corporation that is controlled by the estate or trust. See "Change of Trustees = Tax Disaster?", *Tax Topics*, report #1736, June 16, 2005.