CANADIAN IMMIGRATION TRUST EXEMPTION WITHDRAWN

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INTRODUCTION

For over 40 years, Canada offered a unique tax benefit to individuals not previously Canadian resident or who had been resident in Canada for less than 60 months. Such persons were allowed to establish a nonresident trust, which would not be taxable by Canada and from which a Canadian resident beneficiary could receive tax-free capital distributions. In addition, and in comparison to U.S. tax rules, income accumulated in the trust at the end of the calendar year automatically became capital, following typical provisions in discretionary trusts. Once converted into capital, the rules for tax-free distributions of capital became applicable.

This made Canada an attractive jurisdiction for global elite. Wealthy immigrants to Canada could shelter foreign investment income and capital gains from Canadian tax for a period of up to 60 months after becoming resident. Needless to say, these structures became quite popular.

In a surprise move announced in February 2014, the tax benefit was withdrawn from 2015 onwards. However, if the trust received a contribution after February 22, 2014, it would become taxable from 2014 onwards. Importantly, no grandfathering was provided for existing trust arrangements, which is both unfortunate and unfair. The change impacts a large number of individuals, as many people have structured their tax planning on the basis of having this exemption for 60 months.

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CANADIAN TAX SYSTEM

Canada has a common law definition of residence, which is basically a facts and circumstances test. When an individual establishes sufficient ties to Canada, that person will become resident. While Canada also has a substantial presence rule (183 days in the calendar year), this rule is only applicable to persons who spend time in Canada without becoming resident under common law principles. Citizenship and immigration status are not a basis for levying tax.

Canada has relatively high personal income tax rates, which vary by province and are progressive based on income. The top tax rate is reached at income of about C$150,000 and varies from 39% to 50% depending on the province.

Given these high personal tax rates, clearly there was a large incentive for high net worth individuals to structure tax planning arrangements wherever possible. The

so-called “immigrant trust” offered an excellent opportunity for tax reduction, at least for the first five years of Canadian residence.

CANADIAN CITIZENSHIP

Many immigrants to Canada do not actually intend to live in Canada permanently but are interested in obtaining a Canadian passport. This requires physical presence in Canada for three years over a four-year period. Allowing for some delays and the possibility of additional time spent outside of Canada, five years (or 60 months) was a very convenient and appropriate timeframe within which to apply for and obtain Canadian citizenship. Combined with the immigrant trust, a high net worth person coming from a country such as Russia or China or a geographical area such as the Middle East could obtain a Canadian passport within the five-year period and then leave Canada and pay virtually no Canadian tax.

"In a surprise move, the immigration trust exemption was completely withdrawn.”

This type of plan became very popular with immigration consultants who would often sell a Canadian investment fund (which allowed a fast track to permanent residency status, the Canadian equivalent of a green card) and earn a sizeable commission.

The physical presence requirement to obtain Canadian citizenship gave rise to many cases of abuse, where people lied about their physical presence in Canada and used false addresses. These issues, combined with a general lack of compliance on the part of many newcomers (not wanting to pay tax on foreign income after the 60-month exemption), together with political pressures (resulting from newcomers buying up old quaint properties, typically in Vancouver, then tearing them down and building “monster homes”) brought the topic to the forefront.

The first change was to tighten up the citizenship process and to change the rules to require four years of presence within six years rather than three years within four. More extensive and detailed reporting of foreign assets created additional scrutiny from the Canada Revenue Agency. Then, in a surprise move, the immigration trust exemption was completely withdrawn.

IMMIGRANT TAX PLANNING – WHAT IS LEFT?

Unfortunately, there is no equivalent to replace the immigrant trust exemption and the tax planning that remains is now quite limited.

If a Canadian resident has contributed to a nonresident trust, that trust will be deemed Canadian-resident, and therefore taxable on its world income, from January 1 of the year in which the person becomes Canadian resident. Accordingly, starting from 2015 (or 2014 if a contribution is made after February 22, 2014) the nonresident trust will be deemed resident from January 1 of that year. Someone who moves to Canada and has previously funded a nonresident trust (including a U.S. trust) will find that the trust is deemed resident from January 1 onwards (*viz.*, it covers the period prior to the date when the person became Canadian resident).

To prevent Canadian tax on the pre-arrival income of the trust, that income should be paid out of the trust as an income distribution prior to the person becoming

resident. Even then, a nonresident withholding tax might apply. Unfortunately, winding up the trust during the portion of the year before the person becomes Canadian resident will not prevent the trust from being deemed resident for that entire calendar year. This is a major trap for persons who are not properly advised, and the failure to obtain this advice before moving to Canada may results in a very unpleasant surprise. Therefore, pre-arrival planning is now vital and, as the rules have become complicated, requires specialized advice.

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Two remaining plans for arriving persons involve accessing the bump-up in cost basis that occurs at the time of immigration and planning for distributions from inbound trusts funded by nonresident family members. Where the immigrant has a foreign business which is considered an active business, certain tax planning options are still available, as described below.

Canada allows a step-up for tax purposes in the cost of property owned at the time an individual becomes Canadian resident. The step-up can be combined with a distribution pattern incident to a series of redemptions to monetize that value for the benefit of the Canadian shareholder.

Suppose that the immigrant has a foreign active business operated in corporate form. Suppose further that the shares of the corporation have a nominal cost base (say $100 of share capital). However, the fair market value is, say, $6 million at the time Canadian residence is established. The shares will take on a cost base for Canadian tax purposes equal to $6 million. This $6 million cost base can be “extracted” free of Canadian tax in a number of ways (*e.g.*, a transfer of the shares to a holding company for a note, a redemption of the shares possibly combined with a corporate reorganization to segregate the share class into preferred shares, and so forth). This can allow tax-free repatriation of an amount up to the value of those shares, which may prove very useful. This tax planning will only work if the income of the foreign corporation is active business income and not passive income. Otherwise, the Canadian “Controlled Foreign Corporation (‘C.F.C.’) rules” will apply to impute the income directly to the Canadian resident shareholder as the income arises.

A second opportunity that remains for newly arrived Canadian residents is the inbound trust. This is a trust to which no Canadian resident has contributed property. Such a trust is not deemed Canadian resident, and a Canadian resident may receive capital distributions from that trust free of tax. A Canadian resident who has, for example, wealthy parents living abroad can benefit from a nonresident trust structure set up by the parents. The trust would earn income, retain the income such that it becomes capital, and distribute the capital to Canadian resident beneficiaries without tax. However, if the newcomer to Canada gives the assets to a nonresident individual – typically a family member – before arrival, who then puts these assets into a nonresident trust, this will be viewed as an indirect contribution, and the trust will be deemed Canadian resident.

L.L.C.’S – TRAPS FOR THE UNWARY

American citizens moving to Canada have a particularly complex task of tax planning because of the ongoing requirement to pay U.S. tax on worldwide income, subject to foreign tax credit relief.

Added to this is the unfortunate mismatch between how Canada and the U.S. regard limited liability companies ("L.L.C.'s"). For U.S. tax purposes, the L.L.C. will typically be a flow-through entity so that the owner will report the income. However, for Canadian tax purposes, the L.L.C. is regarded as a foreign corporation, and the income is not taxed until withdrawn (unless the income is passive income, in which case it will be taxed as it arises). Accordingly, the income can be taxed for U.S. purposes on an annual basis and taxed by Canada at a later date when funds are withdrawn from the L.L.C.

The failure to take this into account can lead to double taxation, particularly because Canada's foreign tax credit in this circumstance does not allow for a carryforward or a carryback. Careful attention must therefore be paid to analyzing the corporate structures of newcomers to Canada to make sure the structures are appropriate and will not lead to adverse Canadian tax consequences. A key problem is that the implementation of a restructuring plan prior to arrival in Canada may lead to unnecessary tax in the U.S., whether implemented during or after the period of U.S. residence.

CONCLUSION

Tax planning opportunities for newcomers to Canada are now much more limited and far less lucrative than was the case with the immigrant trust. Tax planning opportunities still exist, particularly for foreign active businesses, because of the step-up in cost base which is granted. But a large part of the tax planning will now be devoted to preventing problems, including double taxation, and making sure that any corporate structures are suitable within the Canadian context. For this reason, it is now even more important to obtain Canadian tax advice at an early stage and certainly well before the intended arrival date of the new Canadian resident.