Tax Considerations for Investing in Foreign Entities

AGENDA

1. Overview of Investing in Foreign Entities
2. Investing in Foreign Partnerships
3. Investing in Foreign Corporations
4. Investing in Foreign Trusts
5. Offshore Investment Fund Property Rules
6. Other Tax Considerations

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OVERVIEW OF INVESTING IN FOREIGN ENTITIES

- Entity classification
- Character of returns
- Timing of income recognition and its computation
- Tax Treaty implications
- Withholding tax/foreign tax credit considerations
- Compliance requirements

ENTITY CLASSIFICATION

- Classification for Canadian tax purposes depends on how the entity would be viewed based on Canadian legal principles
- Two step approach applies

  1. What are the entity's (or arrangement's) features based on the foreign law under which it is governed?
  2. How do those features compare to the kinds of entities recognized under Canadian law

- Foreign tax law classification does not determine Canadian tax treatment

ENTITY CLASSIFICATION

- Watch for undivided co-ownership interests
  - Examples include Irish common contractual funds and UK authorised contractual schemes
- Watch for securitization vehicles that may be trusts rather than corporations
- Watch for partnerships that may be treated as corporate entities
- Watch for derivatives used to gain exposure to foreign entities
- Also important to confirm the legal nature and treatment of the security of the entity or arrangement held

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CHARACTER OF RETURNS

- Investments may be held on capital or income account depending on status of taxpayer, its intentions and other relevant facts related to investment
- Note that subsection 39(4) election only applies to “Canadian securities”
- The character of the entity as well as the particular security of the entity held will be relevant for determining the character of returns.
- Watch for difference between debt and equity investments of a particular entity

TIMING AND COMPUTATION OF RETURNS

- Very important to understand the legal means by which returns will be earned
- For example, tax treatment of a foreign dividend/distribution, a reduction of capital and redemption can be quite different
- Consider actual payments as well as potential accrual rules, including ITA 94.1, 94.2, FAPI, ITA 96 for partnerships and Reg. 7000 for debt investments
- Corporate actions involving foreign entities require special attention

INVESTING IN FOREIGN PARTNERSHIPS

- Canadian taxpayer must include in income its share of partnership income(loss) computed in accordance with the Income Tax Act
- Share determined based on partnership agreement
- Consider foreign exchange and FAPI issues, among others in computing income
- Often no requirement for the partnership to provide Canadian tax reporting
- Steps should be taken to gather the necessary information and report appropriate amounts
- Understanding nature of the partnership’s activity/investments is critical

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INVESTING IN FOREIGN PARTNERSHIPS

- Consistent with flow-through nature of partnerships, each partner is considered to have paid its share of foreign withholding tax
- If Canadian taxpayer invests in a partnership formed in foreign country A that invests in securities of foreign country B, confirm that country B treats the partnership as a flow-through and grants treaty benefits to taxpayer
- Ensure steps are taken to obtain treaty benefits including in particular the appropriate rate of withholding tax

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INVESTING IN FOREIGN PARTNERSHIPS

- A key issue is to confirm whether the foreign partnership carries on trade or business in US, or other jurisdictions
- Level of taxation and compliance requirements can change significantly if taxable on foreign business income
- Gain on disposition of an interest in a partnership that is taxable in the US on business income may also be taxable in the US as business income
- Very important to review impact of US tax reform on existing and future partnership investments

INVESTING IN NON-RESIDENT CORPORATIONS

- Determine whether the non-resident corporation is a foreign affiliate (FA) or a controlled foreign affiliate (CFA)
- Key concerns with investing in a non-resident corporation include:

1. trapping foreign withholding tax
2. not obtaining tax treaty benefits in respect of underlying income and gains
3. requirements to include in income imputed amounts that are different from actual receipts, and
4. proceeds treated as ordinary income rather than capital gains

INVESTING IN NON-RESIDENT CORPORATIONS

- Dividends included in income when received
- Dividend defined to exclude a stock dividend paid to a mutual fund trust by a non-resident corporation
- No amount received on a share of a FA will be treated as a dividend unless it is deemed by the ITA to be one
- An amount will be deemed to be a dividend from a FA if it is a pro rata distribution in respect of shares of the relevant class
- This excludes distributions made in the course of a liquidation, dissolution, redemption, cancellation of shares and qualifying return of capital

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INVESTING IN NON-RESIDENT CORPORATIONS

- If the non-resident corporation is a CFA, foreign accrual property income (FAPI) regime may apply to annually impute income in the taxpayer's income
- Assessing the potential for FAPI requires a good understanding of the nature of the corporation's activities and income
- Where the FAPI regime applies, income of the non-resident corporation must be computed in accordance with ITA
- Deductions available upon distribution of previously taxed FAPI

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INVESTING IN NON-RESIDENT CORPORATIONS

- Where the corporation is not a CFA, consider the offshore investment fund property rules in ITA 94.1

INVESTING IN FOREIGN TRUSTS

Meaning of "Trust"

- "Trust" referred to in ITA, not specifically defined except to exclude arrangements where trust is an agent for beneficiaries – "bare trust"

INVESTING IN FOREIGN TRUSTS

Must have three certainties based on jurisprudence:

1. Intention to create a trust (by settlor);
2. Subject matter (property) of the trust; and
3. Object of the trust (beneficiaries)

Examples CRA views to be trusts:

– German investment fund
– Austrian foundation

INVESTING IN FOREIGN TRUSTS

Implications of Investing in a Trust

- Canadian investor includes share of income paid or payable
- All trust income is from property unless designation allowed
- Taxable portion of distributions computed in accordance with Canadian tax rules
- Allows 50% of capital gains to be included
  - Non-taxable portion of capital gains reduces ACB

Non-Resident Trust (NRT) Rules – Section 94

- Intended to capture offshore trusts used by taxpayers to earn income in low or no-tax jurisdictions
- Deemed Canadian resident for certain purposes – liable to tax in Canada on trust's income if at the end of the year:
  - "resident contributor" or "resident beneficiary"
- General exemption for most mutual funds, other funds may be exempted if "exempt foreign trust"

Non-Resident Commercial Trusts – ITA 94.2

Three conditions for rules to apply:

1. NRT is an "***exempt foreign trust***"
2. ***Not less than 10%*** of total FMV of all fixed interest of a particular class held by beneficiary and any persons not dealing at arm's length, and
3. Beneficiary is a resident beneficiary, a ***mutual fund*** (most MFT or MFC), a controlled foreign affiliate (CFA), or partnership of which person described is a member

INVESTING IN FOREIGN TRUSTS

Non-Resident Commercial Trusts – ITA 94.2

Implications:

- NRT deemed to be CFA of beneficiary for purposes of ITA 95, FAPI rules and ITA 94.1
- FAPI must be computed in accordance with Canadian tax rules
- FAPI reduced by income from the trust already included in beneficiary's income

INVESTING IN FOREIGN TRUSTS

Non-Resident Commercial Trusts – ITA 94.2

Observations:

- Rules not properly aligned with CFA rules
- Different investment threshold – 10% of a class vs. control
- Difficult to practically apply with multi-classed NRT structures
- Challenge in acquiring information from NRTs to compute FAPI

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OFFSHORE INVESTMENT FUND PROPERTY

ITA 94.1 – Offshore investment fund property (OIFP)

Conditions:

1. Share of capital stock of, an interest in, or debt of a non-resident entity;
2. Derives its value primarily from portfolio investment; and
3. One of the main reasons is to reduce or defer taxes

OFFSHORE INVESTMENT FUND PROPERTY

Implications of OIFP Rules

Income inclusion equal to:

- “designated cost” at the end of the month, multiplied by
- 1/12 of prescribed interest rate for month + 2%, less
- Income otherwise included in income (other than capital gains)

OFFSHORE INVESTMENT FUND PROPERTY

What is meant by "one of the main reasons"?

CRA views 2013-0485311C6

- "… tax reduction or deferral does not have to be the only reason, or even the main reason for the investment; it merely has to be one of the main reasons."
- Obtain foreign fund manager's expertise may be another main reason for investment – CRA expects investing in fund resident in tax haven country subject to OIFP rules

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OFFSHORE INVESTMENT FUND PROPERTY

What is meant by "one of the main reasons"?

Gerbro Holdings Company v. The Queen 2016 TCC 173

- Distinction between main and ancillary purposes
- Importance of tax motivation for a court to consider it to be a "main purpose" under ITA 94.1
- Importance of maintaining documentation
- Case has been appealed

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OTHER TAX CONSIDERATIONS

Additional Canadian Tax Information Return Filings

- Form T106 – Information Return of Non-Arm's Length Transactions with Non-Residents
- Form T1134 – Information Return Relating to Controlled and Not-Controlled Foreign Affiliates
- Form T1135 – Foreign Income Verification Statement
- Form T1142 – Information Return in Respect of Distributions from and Indebtedness to a Non-Resident Trust

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OTHER TAX CONSIDERATIONS

Foreign Tax Filings?

- Depends on foreign entity structure and laws of foreign country

QUESTIONS?