Offshore Tax Planning - There is Still a Lot Left!

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Presenter

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General Considerations

We need to first ask and answer the following question:

“What are the statutory barriers to using offshore planning to avoid, reduce or defer Canadian taxation?”
Subsection 2(1)

• Canadian residents taxable on *all* taxable income—not just Canadian source

• Remittance to Canada not a factor (limited relief in 161(6) re income in blocked currency).
Subsection 75(2)

- Basic point often overlooked!
- Can apply to any trust
- Will apply to allocate to settlor even without applying section 94/94.2
- Exemption for immigrant trusts
Section 94

• Has been undergoing revisions since 1999-still not settled!

• However, should assume that if a Canadian resident makes a “contribution” to a non-resident trust, the trust will be deemed Canadian resident and subject to Canadian tax, with joint liability for contributor
Section 94

- Latest version generally slated to apply after 2006
- Also, proposed new section 4.3 of *Income Tax Conventions Interpretation Act* will KO any hope for protection under “tie breaker” rule in tax treaty (e.g. as in *Garron*)
Subsection 91(1) “FAPI”

• “FAPI” generally investment income and capital gains; however, certain business income deemed FAPI.

• If a foreign corporation is a “controlled foreign affiliate” (“CFA”) of a Canadian resident, that Canadian resident taxable on share of undistributed FAPI
Subsection 91(1) “FAPI”

• CFA generally FA (10% or more of any class) where controlled by taxpayer and no more than 4 other Canadians, or taxpayer and related non-residents (other combinations with related persons can also make CFA).

• Must file T1134B if CFA
Section 94.1-OIFP

• “Offshore Investment Fund Property”
• Designed to catch certain offshore investments that 91(1)/94 does not catch
• Finance backed-off of most amendments (“FIE”) that were kicking-around for 10 years!
Section 94.1-OIFP (Cont’d)

• Where applicable, deemed income at CRA prescribed rate (currently 3%) applied to “designated cost”
• Because of “purpose test”, may have less application than Finance would want to admit.
Section 94.2

- Emanation from Finance backing off of “FIE” amendments
- Taxes share of income from commercial fixed interest trust where taxpayer and NAL hold 10% or more.
- Treats like CFA
Section 245

• “GAAR” can apply to abusive offshore transactions, including abuse of tax treaties

• Interestingly, in FCA decision in *Garron*, court did not believe that use of Barbados treaty to claim exemption was subject to GAAR-lost based on trust residency alone.
Section 247

- Transfer pricing
- Aimed at ensuring that income is not shifted to foreign entity as a result of improper charges for goods or services.
CRA Enforcement Tools

• T1135
• T1141
• T1142
• T1134A
• T1134B
• T106
Trust Structures

General observation:

• Can still use offshore trusts to legally avoid Canadian tax as long as the trust is not resident in Canada

• Canadian residency can result both from common law tests, as well as deemed residency under section 94
Trust Structures

• Also, because of recent *Antle* decision, additional care regarding the terms and operation of trust are required to ensure that it truly is respected as being a trust

• However, *Antle* an unusual situation because of *ephemeral* nature of trust
Trusts—Common Law Residency

- CRA views in IT-447
- Until recently, *Thibideau* only Canadian case-focus on residency of trustees
- Recent *Garron* decisions at both TCC and FCA adopts more of a “mind and management” approach—more care required
Potential Benefits of Offshore Trusts

- If not resident in Canada, trust not taxable on foreign-source income

- Distribution of capital to Canadian beneficiary not taxable—that can include capitalized income
Deemed Residency-Section 94

- Basic rule: “contribution” to trust by a Canadian resident leads to deemed Canadian residency for many purposes

- “Contribution” can result from various deeming rules (e.g. transfer to corporation owned by trust; directed payment; treasury shares from Canco)
Deemed Residency-Section 94

Various exemptions where “contribution” by Canadian resident does not create deemed residency, e.g.:

- Various pensions
- Charity
- Fixed interest; widely held
Using Trust Structures

Must avoid Canadian residency!

- Need offshore trustees, and they should not just be “puppets” for Canadians-view Garron as model of what not to do! (also care re role of any Canadian “protector”).

- Must avoid any “contribution” by Canadians
Using Trust Structures

Who can be a “contributor”?

• Person who never has been nor will be a Canadian resident

• Canadian expat if made >60 month after emigration, and do not return for 60 months after contribution

• If non-expat becomes Canadian resident, have 60 months before rules kick in (“immigrant trust”)
Using Trust Structures

• If trust not resident in Canada, no Canadian tax on income as long as does not become “payable” to any Canadian beneficiary in year earned (104(13)(a))

• If discretionary trust, income generally not “payable” in year

• Can distribute capitalized income tax-free
Inheritance Trust

• Powerful tool!
• Can allow Canadian tax to be avoided forever!
• Must be in will!
• T1142 for distributions
• No 94.1 issue per Finance
• Also 94.2 should be n/a even if non-discretionary
Rich Uncle Trust

- Powerful tool!
- Can allow Canadian tax to be avoided forever!
- Must be direct transfer-cannot pass through Canadian hands
- T1142 for distributions
- No 94.1 issue per Finance
- Also 94.2 should be n/a even if non-discretionary
Immigrant Trust

• Basically, a suspension of application of section 94 rules for first 60 months of residency.

• 75(2) n/a, so settlor can be beneficiary.
Immigrant Trust

• Allows foreign source income (and even certain Canadian source income) earned during first 60 months of residency to be sheltered from Canadian tax

• Also, appreciation tax-free, since “bump-up” on immigration-(see 128.1(1)(c) or 94(3)(c) if 94(4)(d) applies).
Immigrant Trust

• Unless actually immigrate the trust to Canada, may not get full 60 months-e.g. if individual becomes resident July 1, only 54 months.

• If immigrate (i.e. appoint Canadian trustees) just before the 60 months, 128.1(1)(a) should apply, and get 60 months
Immigrant Trust

Corporation below trust generally not needed anymore, because of 75(2) exemption.
Immigrant Trust

- Immigrant contributor needs to file T1141 after first year of residency

- Returning Canadian expats cannot use “immigrant trust”, but if marry while abroad, spouse can use if source of funds clear
Corporate Structures

The Four “Hurdles” To Overcome In Order To Avoid Canadian Taxation By Using Foreign Affiliate Corporation (“Forco”)

1. Corporate residency
2. Carrying On Business In Canada
3. FAPI
4. Transfer Pricing
Corporate Residency

• The fact that Forco formed outside of Canada does *not necessarily* mean not resident in Canada
• Instead, must look at “mind and management” - generally based on where Directors reside and meet
• Increased CRA focus
Carrying On Business In Canada

- Forco can be subject to Canadian tax on income from carrying on business in Canada
- Need to be careful that parent not viewed as agent for Forco, as well as 253(b)
- Note-Barbados IBC no treaty protection
FAPI

- Not just passive investment income
- Interest, royalties, rents, trading gains, FAPI unless >5 full-time employees or equivalent
- Even gains on real estate if not>5 full-time employees (e.g. building homes)
Business Income Treated as FAPI

- Charges to parent for “services”
- “Services” provides by certain Canadian residents
- Profits from goods sold to Canada (*Irving Oil* scenario)
Transfer Pricing-Section 247

- Must look at *value* of goods or services provided by parent or other Canadians to Forco
- If Forco does not pay enough, deemed income for shortfall
- Also, must consider whether parent disposed of part of business to Forco
Potential Benefits of Foreign Affiliates

- No Canadian taxation of foreign corporation on foreign source income

- As long as not FAPI, no taxation of income not distributed—even with FAPI can benefit—see below
Potential Benefits of Foreign Affiliates

• Dividends received by Canco from “foreign affiliates” (generally 10% or more) will be tax-free if paid out of “exempt surplus”

• “Exempt surplus” includes income from active business in treaty or TIEA country
Potential Benefits of Foreign Affiliates

• Exempt dividends into GRIP

• Income from ABI in other countries generally “taxable surplus”-only taxable when hits Canco-in addition, as long as underlying tax rate at least 28% (25% 2012), still no tax
Potential Benefits of Foreign Affiliates

Low tax jurisdictions:

Treaty: Barbados; UAE; Ireland

TIEA: 11 signed, although none yet in force, with generally zero tax jurisdictions!
Potential Benefits of Foreign Affiliates

Even with FAPI?

With falling corporate tax rates, FA may provide tax deferral benefits even if FAPI!

How?

“relevant tax factor” currently down to 28%, and 25% in 2012. Say, have US income taxed at 30%, no top-up in Canada
Corporate Structures

- Operating corporations
- Financing corporations
- IP corporations
- Holding corporations
Operating Corporations

- Offshore sales affiliates
- Manufacturing subsidiaries
Operating Corporations

- Charges to parent for services re sale of goods generally not FAPI under 95(2)(b), because of “services” definition (95(3)(b)).
- Note that profits from goods manufactured abroad and sold to parent may be excluded from FAPI (95(2)(a.1)(ii)(A))
Financing Corporations

• Object is to reduce global tax liability by interest charges to other foreign subs
• Interest is not FAPI because of 95(2)(a)(ii)
• Challenge is interest deductibility and reducing withholding in payor country
Financing Corporations

- Often, includes “double dip” structure involving deduction in Canada as well as in foreign jurisdiction.

- Flaherty tried to KO “double dip” (see section 18.2), but this was ultimately repealed when he saw the light.
IP Corporations

Ways in which IP can generate non-FAPI income:

• >5 employees
• Royalties charged against ABI of other FA
• Earn non-royalty income
IP Corporations

• With the first two ways, where royalties are charged, challenge is usually foreign withholding tax
• Answer is generally imaginative use of treaties, and low tax jurisdictions (and EU)
• Google example with Ireland
IP Corporations

How to get IP in FA?

- No tax-free rollover of IP into FA
- Ideal: put in at early stage when FMV insignificant
- If significant value: either “bite the bullet” and pay tax on gain, or license to FA at reasonable rate
Holding Corporations

Potential benefits:

• Deferring tax on dividends from FAs
• Reducing personal tax on dividends from FAs
• Creating “pipeline”
• Deferring tax on gains from sale of FA shares
Holding Corporations

In certain cases Canadian Holdco may be better than foreign one
Holding Corporations

Deferring tax on dividends

- Dividends between foreign affiliates always tax-deferred (i.e. not in FAPI)
- Canco receipt of dividends from taxable surplus may be taxable
Holding Corporations

• Canadian Holdco can allow the benefit of “gross-up and credit” in connection with dividends paid to resident individuals, even if source is FA

• Often added to GRIP
Holding Corporations

- Tax-free “pipeline”-generally note payable to shareholder that allows shareholder to withdraw funds tax-free

- Can be created on transfer of high-cost base FA shares
Holding Corporations

• Note that both Canadian and foreign Holdco can be used for “pipeline”

• Canada: as part of 85(1)

• Foreign: as part of 85.1(3)
Deferring Tax on Gains

• If shares are “excluded property”, taxable capital gain not FAPI
• 85.1(4) problematic if rollover with sale in mind
• Best to set-up at early stage
• Dividends can be problematic—“treaty shopping”
Immigrant Holdco

- Works best as a supplement, not a substitute, for immigrant trust
- Strategy: move FA shares into Holdco after expiry of 60 months period
- Cost base “bumped” to FMV at that time- allows “pipeline” for that amount.
Immigrant Holdco

- Canco Holdco-dividends out of exempt surplus tax-free; taxable surplus, taxable, but grossed-up deduction for underlying tax; pre-acquisition surplus, reduces ACB
- Deduction under section 113, means GRIP addition
- Reduced taxation on pay-out
Immigrant Holdco

Forco Holdco-Dividends not FAPI
Inheritance Holdco

Ideally, should not exist—should use trust

However, if trust not used, can give benefits similar to immigrant Holdco
Offshore Mutual Funds

Potential Advantages

• No T5/T3 allocating income
• Assuming no actual income distributions, no taxation until dispositions (or negative ACB)
• Can convert income (interest; dividends) to capital gains
Offshore Mutual Funds

Does Section 94.1 apply?

• Proposed changes ("FIE") rules would have definitely applied and "leveled playing field"

• However, "old" 94.1 has purpose test—may not apply

• Strong argument that, at least equity based funds, are not OIFP because of purpose test
Offshore Planning For Shares of Cancos

• Prior to March 4, 2010 changes, shares of private corporations resident in Canada (“Cancos”) were generally TCP (see M.A. article in CCH Tax Topics #1986, April 1, 2010).

• Meant gain taxable unless treaty protected
Offshore Planning For Shares of Cancos

- After March 4, 2010, generally TCP only if >50% of value attributable to Canadian real estate (or resource/timber properties)

- So, shares of normal “Opco” Cancos generally *not* TCP any longer
Offshore Planning For Shares of Cancos

- Prior to changes, Canco shares generally not focus of offshore planning by Canadians, except for aggressive tax planning, such as “Barbados freeze” and “bump-up” strategies.
- Changes may facilitate different types of offshore planning for shares of Cancos
Offshore Planning For Shares of Cancos

• Object of planning: to avoid or defer Canadian taxation of gains from the disposition of Canco shares

• In smaller situations, where $750K exemption covers all or most of gain, likely n/a-applicable to larger scale situations
Offshore Planning For Shares of Cancos

Traditional 50/50 structure with non-resident:

Canadian  Non-Resident

Canco
Offshore Planning For Shares of Cancos

Structure aimed at deferring tax on gains

Canadian Non-Resident

Forco

Canco
Offshore Planning For Shares of Cancos

• Theoretically, could have done even before March 4 changes, if Forco is treaty jurisdiction which did not tax gain (e.g. Barbados, Luxembourg)

• However, would have had section 116 issues

• Also, use of trust was more appealing!
Offshore Planning For Shares of Cancos

Notes re structure:

• Assuming unrelated non-resident, Forco not CFA, so gains on sale of Canco shares not taxable until distributed

• 94.1 applicable? Purpose test likely met, but what is a “portfolio investment”-per CICA not this?
Offshore Planning For Shares of Cancos

Notes re structure (cont.)

• Even if 94.1 applies, taxable amount may be small since can keep “designated cost” low by direct investment in Canco

• Can maintain Canco as CCPC by issuing “just votes” shares to Canadians
Offshore Planning For Shares of Cancos

Notes re structure (cont.)
Should be able to have tax-free dividends from Canco to Canadian Holdco shareholder by various structures aimed at direct dividends on special class of shares.
Offshore Planning For Shares of Cancos

Notes re structure (cont.)

Canadian shareholder interpose wholly-owned foreign Holdco so that share proceeds may be distributed tax-free.
Offshore Planning For Shares of Cancos

• Prior to March 2010 changes, generally no benefit to hold Canco shares in immigrant trust, since no cost base increase on immigration

• Now, if not TCP, can make sense so that appreciation during first 60 months sheltered from Canadian tax
Offshore Planning For Shares of Cancos

• The same might be said for “inheritance” and “Rich Uncle” trusts
• However, risk that this could accidentally taint trust for purposes of section 94
• *But*, direct ownership by non-resident family should be considered—many adopt an “all in the family” approach
Offshore Planning For Shares of Cancos

- Can be Canadian owned Forco if not CFA of any shareholder
- >9 unrelated Canadians avoids CFA and FAPI issues
- 94.1? What is “portfolio investment”? Also, can avoid any significant designated cost
- Exit strategy to spit-up funds? Separate classes of shares=FA
Foundations

A feature of civil law jurisdictions, such as Panama, Liechtenstein—even Quebec!
Foundations

What are they?

Strong legal arguments that they are corporations because of separate legal personality-hence not trusts for tax purposes.
Foundations

If they are corporations:

• Assuming not resident in Canada, not subject to Canadian tax on foreign source income

• Since assumed no share capital, cannot be CFA-hence no taxation of FAPI

• Section 94.1? May apply because can include “interest” in a corporation
Foundations

If they are corporations:

What is treatment of any distributions? Not clear!
Foundations

• CRA seems to be leaning in direction of treating them as *trusts* (see 2008-026625117; 2008-0278801C6)
• This reverses in part IT-343R position re Liechtenstein Anstalt being a corporation.
• CRA places less emphasis on “separate personality” factor
Foundations

If CRA is right, section 94 rules would apply.
Foundations

Information reporting:

• If trust-T1141

• If corporation?-none?
Foundations

• Issue may be particularly relevant in connection with demands by CRA for information from Credit Suisse re Canadians
• Apparently used Liechtenstein Foundations
• Are they really guilty of anything?
Questions?

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