

INCOME FUNDS AND ROYALTY TRUSTS

CANADIAN INCOME TAX ISSUES FOR THE TRUST WITH NON-RESIDENT INVESTORS

MAY 20, 2004

Presented by Ron Mar

**BLAKE,
CASSELS &
GRAYDON
LLP**

INTRODUCTION/PROGRAM

- BRIEF OVERVIEW
- PREVIOUS TAX TREATMENT AND ISSUES SPECIFIC TO NON-RESIDENTS
- PROPOSED CHANGES RELEASED MARCH 23, 2004
- WHAT THE PROPOSED CHANGES MEAN

OVERVIEW

Qualifying As A Mutual Fund Trust

"Mutual Fund Trust"

To qualify as a mutual fund trust under the *Income Tax Act* (Canada) certain conditions must be met:

- The trusts only undertaking must be the investing of funds in property (other than real property that is not capital property);
- The trust must be a unit trust resident in Canada; and
- The trust must meet prescribed conditions with respect to the dispersal of units and public trading.

PREVIOUS TAX TREATMENT AND ISSUES SPECIFIC TO NON-RESIDENTS

Non-resident Ownership Restriction Unitholders

- A mutual fund trust must not be "established or maintained primarily for the benefit of non-residents" of Canada

"established or maintained primarily for the benefit of non-residents"

- Lack of Clarity on meaning of this phrase
- generally interpreted to mean that no more than 49% of the units of a trust may be held by non-residents of Canada.

PREVIOUS TAX TREATMENT AND ISSUES SPECIFIC TO NON-RESIDENTS

Non-resident Ownership Restriction

- a mutual fund trust that has never held more than 10% of their assets in "taxable Canadian property" ("TCP") is not subject to the foreign ownership restrictions - s. 132(7)(a)

PREVIOUS TAX TREATMENT AND ISSUES SPECIFIC TO NON-RESIDENTS

Non-resident Ownership Restriction

"TCP" includes, in particular:

- shares of Canadian corporations;
- units of certain Canadian trusts;
- partnership interests;
- Canadian real property;
- certain Canadian resource properties.

CANADIAN TAX REASONS FOR THE NON-RESIDENT OWNERSHIP RESTRICTION:

- non-residents are not subject to income tax on capital gains, unless the gains are considered to arise in Canada (i.e. realized on the disposition of TCP);
- in most circumstances, units of a mutual fund trust are expressly excluded from the definition of taxable Canadian property; and
- non-residents that invest in Canada through mutual funds are not generally taxed in Canada on these gains.

IMPACT ON REVENUE OF THE PREVIOUS REGIME

- shifts the taxation of income from the corporate level to unitholders;
- accelerates the incidence of taxation at the unitholder level;
- defers the incidence of taxation in circumstances where income trust units are held by deferred income plans (i.e. RRSP's and RPP's); and
- may result in some revenue loss to the extent that income trust units are held by non-residents and used to flow “business” income out of Canada.

BUDGET PLAN 2004

Non-residents' Investment Through Mutual Funds

Purpose Of The Proposed Changes

"To reduce the disparity between the tax treatment of those non-residents who invest in TCP through a Canadian mutual fund and the treatment of those who invest directly"

BUDGET PLAN 2004

PROPOSALS

- Taxation of TCP gain distributions;
- Withholding on otherwise non-taxable distributions;
- Losses on disposition; and
- Clarification on definition of TCP.

BUDGET PLAN 2004

Taxation Of TCP Gain Distributions

- Distributions paid out of gains on TCP by a mutual fund trust will be treated as "ordinary" distributions of Canadian source trust income;
- Such distributions will be subject to withholding tax when paid to a non-resident;
- Applies to distributions made after March 22, 2004; and
- All mutual fund trusts must create a new notional account to track capital gains in respect of TCP.

BUDGET PLAN 2004

Withholding On Non-taxable Distributions

- Applies to mutual fund trusts and mutual fund corporations that are listed on a prescribed Canadian or foreign stock exchange, and the value of which is primarily attributable to Canadian real estate, Canadian resource property or timber resource property (i.e. resource royalty trusts and real estate investment trusts);
- Such distributions will be subject to tax as a tax on capital gains (unless already taxable in the hands of the investor as income);

BUDGET PLAN 2004

Withholding On Non-taxable Distributions

- Tax withheld from distributions at source at the rate of 15%;
- Tax withheld will be a final tax-no reporting or adjustment to the cost base of the share or unit; and
- Applies to distributions made after 2004.

BUDGET PLAN 2004

Losses On Disposition

- A non-resident investor that realizes a loss on the disposition of a unit or share (to which the investor has paid the new tax on the distribution) can apply a portion of that capital loss to offset the tax;
- The loss cannot exceed the amount of distributions subject to tax;
- The non-resident investor must file a special Canadian income tax return for the year the unit or share was disposed of; and
- This special form of capital loss may be carried back three taxation years or carried forward indefinitely.

BUDGET PLAN 2004

10% Threshold

- Clarifies that Canadian resource properties and timber resource properties must be included in computing a mutual funds 10% threshold.
- A mutual fund trust or mutual fund corporation that is affected by this change will have until January 1, 2007 to comply.

IMPACT OF CHANGES

- Increased levels of withholding on REITS and resource trusts may affect non-resident interest levels particularly since rules do not apply to other types of trusts
- Increased compliance costs may deter some investors
- Lack of clarity of certain definitional concepts may cause uncertainty on application of new withholding tax measures
- Largest impact will likely be TCP changes and resulting effects

IMPACT OF TCP CHANGES

- Will force the issue of what is meant by “maintained primarily for the benefit of non-residents”
- Existing trusts being pushed to comply with a provision which currently lacks clarity
- Increased emphasis on monitoring and enforcing non-resident ownership restrictions
- May not be possible to effectively control non-resident ownership levels with existing trust indenture provisions

IMPACT OF TCP CHANGES

- Probably not an issue restricted to interlisted trusts
- Other types of restrictions or structural changes will evolve
 - Pengrowth A/B structure
 - variations on stapled unit or IDS type structures
 - parallel foreign entities
- May be additional planning available around the TCP exemption although may be aggressive

IMPACT OF TCP CHANGES

- Still possible to create “business” income trusts which could take advantage of TCP exemption through use of leveraged commercial trusts and partnerships

GOING FORWARD

"The Department of Finance will continue to evaluate the development of the income trust market as part of its ongoing monitoring and assessment of Canadian financial markets and the Canadian tax system"

- Further changes in this area are possible

INCOME FUNDS AND ROYALTY TRUSTS

CANADIAN INCOME TAX ISSUES FOR THE TRUST WITH NON-RESIDENT INVESTORS

MAY 20, 2004

Presented by Ron Mar

**BLAKE,
CASSELS &
GRAYDON
LLP**