TAX ON TRUST DISTRIBUTIONS TO NON-RESIDENTS: AN INTRODUCTION

BUSINESS AND FINANCIAL GROUP

January 13, 2014 | Andrea Tratnik

***All parts and sections referred to herein apply to the Income Tax Act, Canada (the "Act") unless otherwise specified.**

The tax treatment of trust distributions depends upon, amongst other factors, the residency of the trust and the residency of the beneficiaries. Several unique tax consequences may arise on distribution from a trust that is a resident of Canada to beneficiaries that are non-residents of Canada. This article will primarily discuss the application of Part XIII withholding tax. It will also briefly touch on the operation of section 107(2.1) deemed disposition rules, section 116 withholding tax and clearance certificate obligations, and Part XII.2 tax.

Part XIII advances a withholding tax payable on certain trust distributions to non-residents at the rate of twenty-five percent (25%), unless a treaty reduction is applicable. This withholding tax will, in accordance with sections 212(1)(c)(i) and (ii), be imposed on income of a trust to the extent that the amount:

(i) is included in computing the income of the non-resident beneficiary under section 104(13), except to the extent that the amount is deemed by section 104(21) to be a taxable capital gain of the non-resident beneficiary; or

(ii) can reasonably be considered to be a distribution of, or derived from, an amount received by the trust as a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend.

Generally, then, withholding tax applies on: (i) amounts that would be taxable under Part I if the beneficiary had been a person resident in Canada to whom Part I were applicable, less amounts captured under section 104(21) (an amount paid to a non-resident will generally fall within section 104(21) if it is a taxable capital gain of a mutual fund trust and the prescribed designation is made.); and (ii) capital dividends from a Canadian company.

The scope of the term "income" has been widened under section 212(1)(c) to include certain capital payments. Section 212(11) deems, for the purposes of section 212(1)(c), amounts paid by a trust to a non-resident beneficiary as income of the trust, regardless of the source from which the trust derived it. This does not mean that all capital distributions made by a trust to a non-resident beneficiary must be treated as income—capital distributions would only be subject to Part XIII tax to the extent that they were amounts described in sections 212(1)(c)(i) or (ii).

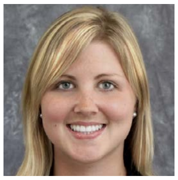
There are exemptions from Part XIII tax, including those found under section 212(9), being amounts classified as (i) a dividend or interest received by a trust from a non-resident-owned investment corporation (as defined in the Act); (ii) a royalty on a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work; (iii) interest received by a mutual fund trust maintained primarily for the benefit of non-resident persons; or (iv) a dividend or interest received by a trust that is created under certain compliant reinsurance trust agreements; so long as no tax would have been payable under Part XIII in respect of any such amounts if they had been paid directly to the non-resident beneficiary instead of the trust. The latter exemption was recently added to the Act pursuant to Bill C-48, which received Royal Assent on June 26, 2013 and is applicable to amounts paid or credited after 2000.

In addition to Part XIII tax, other tax consequences must be considered when making a trust distribution to a non-resident beneficiary. For example, section 107(2) provides for a tax-deferred rollover where property is distributed from a trust to a Canadian resident capital beneficiary. Where the beneficiary is non-resident, however, sections 107(5) and 107(2.1) generally dictate that such rollover is not available. In such a case, the trust is deemed to have disposed of the distributed property for proceeds equal to its fair market value, and the trust may consequently realize a capital gain or loss.

Additionally, on a trust's capital distribution to a non-resident beneficiary, the beneficiary is deemed to dispose of all or part of the capital interest in the trust. Pursuant to section 116, where the capital interest in a trust is "taxable Canadian property," a withholding tax of twenty-five percent (25%), or, in certain cases, fifty percent (50%), is applicable to account for any capital gains tax liability, unless the requisite clearance certificate is obtained. Taxable Canadian property is defined in section 248 to include, amongst other property, Canadian real property, Canadian resource property, timber resource properties, and certain company shares. There are no compliance obligations under section 116 for either the trust or the non-resident beneficiary if the capital interest in the trust is not taxable Canadian property or is otherwise excluded property, such as treaty exempt property.

A thirty-six percent (36%) tax may also be payable on certain non-resident distributions. Part XII.2 levies this special tax on designated income of certain Canadian resident inter vivos trusts with respect to distributions to non-resident beneficiaries. Generally speaking, designated income is defined in section 210.2 as income from Canadian real property, timber resource properties, Canadian resource property (other than properties acquired by the trust before 1972), and business carried on in Canada. Part XII.2 seeks to ensure that non-residents do not pay less tax on designated income through a trust than if such income were earned directly.

Part XIII withholding tax, section 107(2.1) deemed disposition rules, section 116 obligations, and/or Part XII.2 tax could be applicable to any given trust distribution to a non-resident beneficiary, depending generally on the source of distributed funds. This discussion only scratches the surface of tax considerations relating to trust distributions to non-residents. Further taxes and exceptions may apply in any given case. There are various factors to consider and it is always wise to engage a tax advisor when contemplating non-resident distributions.



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