Tax Insights
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Canada's new non-resident trust rules: What they mean for global equity plans

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In brief

Newly enacted non-resident trust (NRT) rules will likely create tax liabilities and filing requirements for global equity plans that use foreign trusts and have Canadian-resident participant employees.

Now is the time to consider whether the new NRT rules apply to your global equity plan and, if they do:

- what the implications are
- what filing requirements and deadlines apply
- whether any elections should be filed to mitigate their tax bite

In detail

The new rules

Canada's approach to taxing NRTs was transformed when Bill C-48 received royal assent on June 26, 2013. The legislation is complex and meant to combat offshore tax evasion.

Global equity plans

The new rules will affect the Canadian tax liability and administration of global equity plans with participants in Canada.

Their impact means that foreign trusts used to hold shares for Canadian employees are now subject to treatment similar to that of equity plans funded through Canadian-resident trusts or custodial arrangements.

In a nutshell

An NRT will be deemed to be resident, and taxable, in Canada:

- on its worldwide income, or
- if an election is made, only on income on contributions made (or deemed to be made) by Canadian residents

Instead of paying tax at the NRT level, Canadian employers can be subject to corporate tax rates (which are lower than trust tax rates) by filing an election that deems the NRT's income to be the employer's income.

Joint, several and solidary liability is imposed on contributors (Canadian employers) and resident beneficiaries (employee participants) for Canadian taxes not paid by the NRT, but recovery limits can apply.

The rules are retroactive to taxation years ending after 2006. Transitional measures allow until June 26, 2014, to file most of the elections and tax returns required to comply for taxation years ending before 2013.

The general rule

An NRT generally is deemed to be resident in Canada for a taxation year, if at the end of that taxation year, there is either:

- a 'resident contributor' to the trust
- a 'resident beneficiary' under the trust

Exempt foreign trust

Under an important exception, an NRT that is an 'exempt foreign trust' is exempt from the NRT rules.

An exempt foreign trust includes certain types of trusts that provide employee benefits. However, for an incentive plan under which securities are held in trust to qualify as an exempt foreign trust any benefits the trust provides must be in respect of 'qualifying services.'

Qualifying services

Qualifying services mean, among other things, services provided primarily by non-resident or temporarily resident employees – a definition that would exclude a trust providing benefits to employees ordinarily resident in Canada.

PwC's comments

Given possible variations on share-based arrangements, each circumstance should be reviewed to determine if the trust could be an exempt foreign trust in which case the application of the NRT rules would be avoided.

In a typical global equity plan or arrangement, shares of the global parent are purchased with contributions from the global parent or from participating employers for later distribution to employees who have been awarded Restricted Share Units, Performance Share Units or some other equity-based award.

The employees of Canadian-resident subsidiaries participate in the global equity plan and receive shares from the NRT when their awards vest. If a trust is used in connection with the distribution of shares or other benefits to Canadian employees, the arrangement should be reviewed to determine whether the new NRT rules apply.

Resident contributor

Most NRTs used to fund global equity plans likely will have a resident contributor. A resident contributor is a person who:

- has made a contribution to the NRT at any time
- is a resident of Canada at the end of the NRT's taxation year (excluding an individual who has been resident in Canada for less than 60 months (a 'new Canadian')), and
- at the time of applying the test is in existence and a resident of Canada

Residency at the time of the contribution is not relevant.

PwC's comments

For many global equity plans, having Canadian participants will mean that the Canadian employer will be obliged either to:

- repay, under a recharge agreement, to its foreign parent the costs associated with the plan, with the charge reflecting the compensation cost expensed under the relevant generally-accepted accounting principles
- make direct contributions to the trust

In either case, the Canadian-resident employer will be considered to have made a contribution to the NRT and will therefore be treated as a resident contributor.

Contribution

Generally, a 'contribution' to an NRT means a transfer or loan of property to the NRT. Therefore, a direct contribution would clearly qualify.

A contribution also includes transfers or loans to other entities when there is a series of transactions that includes that transfer or loan and a separate transfer or loan to the NRT.

Exceptions

An exception is made for transfers or loans, and deemed transfers or loans, that generally are on arm's length terms.

However, this exception does not apply to a transfer if it is reasonable to conclude that one of the reasons for the transfer is the acquisition of a beneficial interest in the NRT.

PwC's comments

When there is a recharge to a Canadian entity, it is arguable that one of the reasons for the recharge is the acquisition of a beneficial interest in the NRT by an employee participant. This is because the recharge is for the cost of providing benefits under the global equity plan to a Canadian entity's employees.

It is also likely that the recharge is contemplated at the time of the transfer and can be considered part of a series of transactions that would result in a contribution.

In addition, there are several deeming provisions that will deem transfers to have been made.

For example, a transfer of property is deemed to be made jointly by a person and a second person if:

- that person transfers property to another person or partnership, and
- a purpose or effect of the transfer may reasonably be considered to provide benefits in respect of the services of an employee of the second person (the Canadian employer).

Consequently, all transfers by a foreign parent (or any person or partnership) to an NRT or to someone who, in turn, contributes to an NRT are deemed to be jointly made by the person or partnership and the Canadian employer if they are made to provide benefits to the employees of the Canadian employer.

Taxation of worldwide income

When a Canadian-resident employer has made a direct, indirect or deemed contribution to an NRT, it will be a resident contributor, and the NRT will be liable for tax in Canada on its worldwide income.

Electing trusts

Relief from worldwide taxation is available to an 'electing trust.'

The relief results in no Canadian tax on income and capital gains from the properties contributed (or deemed to be contributed) by non-residents (other than Canadian tax that otherwise applies to non-residents of Canada, e.g. Canadian withholding tax on certain Canadian-sourced income).

If the NRT received contributions – perhaps even the bulk of its contributions – from non-residents, it will likely want to elect to be an electing trust.

Filing deadline

The election must be made for the first taxation year in which:

- the NRT had property contributed by non-residents, and
- throughout which it is deemed resident in Canada

However, under a transitional rule that applies to NRTs in existence on June 26, 2014, the election must be filed on or before June 26, 2014 (i.e. 365 days after Bill C-48 received royal assent).

Late filed elections will not be accepted.

What electing trusts must do

An electing trust must track the properties that were contributed by Canadian residents (referred to as the 'resident portion').

Property not part of the resident portion is included in the non-resident portion. The non-resident potion is deemed to be held by a separate NRT, which will not be subject to Canadian tax (unless it earns income in Canada that is otherwise subject to Canadian tax).

The electing trust will be required to file a Canadian tax return in respect of the resident portion. We understand that the non-resident portion trust will be required to file a Canadian tax return if it earns Canadian source income.

Joint and several liability

A Canadian employer that is a resident contributor and any 'resident beneficiaries' will be jointly and severally, or solidarily, liable with the NRT in respect of the NRT's tax liabilities.

Resident beneficiary

A resident beneficiary must be:

- a beneficiary of the NRT
- not a 'successor beneficiary,' and
- a resident of Canada at the end of the NRT's tax year

but only if there is a 'connected contributor' to the NRT.

Connected contributor

A connected contributor generally is a person (including a person that has ceased to exist) who contributed property to the NRT at a time that was not a 'non-resident time.'

Because a Canadian employer will have (or been deemed to have) made contributions to the NRT at a time when it was resident in Canada, it will be considered to be a connected contributor. As a result, employee participants in the global equity plan likely will be considered resident beneficiaries and therefore will be jointly, severally and solidarily liable for the taxes payable by the NRT.

Recovery limit

This liability will be limited to the person's 'recovery limit' if:

1. either (i) the person is a resident beneficiary, or (ii) the person's contributions (or contributions of non-arm's length persons) to the NRT do not exceed the greater of:
    - $10,000, and
    - 10% of the total amount of all contributions made to the NRT before that time
2. all Form T1141 returns reporting contributions made by the person to the NRT were filed on time

(unless the contributions, and contributions of non-arm's length persons, do not exceed $10,000); this is an annual filing requirement even in years when no additional contributions are made, and

3. it is reasonable to conclude that all transactions or events (including those in a series of transactions or events) that were undertaken at the person's direction or with their acquiescence were not for the purpose of enabling the person to avoid or minimize any joint and several liability

Very generally, the recovery limit of an employee participant who is a resident beneficiary should equal the total amount that the person has or will receive from the NRT, less any previous recovery and any tax payable on amounts received from the NRT.

A Canadian employer's liability as a resident contributor can be limited to the total amount contributed or deemed to be contributed to the NRT.

However, because the first test above includes contributions of non-arm's length persons and most or all contributors to the NRT likely will be non-arm's length to the Canadian employer, it may be difficult for a Canadian employer to be protected by the recovery limit.

Electing contributors

If a Canadian employer elects to become an 'electing contributor,' a portion of the NRT's income will:

- be included in its income
- not be taxable to the NRT

This portion is based on the ratio of the Canadian employer's total contributions to all contributions by resident and connected contributors.

A Canadian employer that makes this election will no longer be subject to joint and several, or solidary, liability with the NRT.

Because income in the resident portion of an NRT is taxed at 42.92%, and the combined federal and provincial/territorial corporate tax rate in Canada ranges from 25% to 31%, it probably makes sense to make this election.

The election can be made only for taxation years ending after March 4, 2010. Income earned in previous taxation will be taxed in the NRT.

Filing requirements

The tax return filing deadline for NRTs is:

- June 26, 2014, for 2007 to 2012 taxation years
- March 31 of the following year (March 30 in a leap year) for 2013 and later taxation years

Resident contributors are required to file Form T1141 to report their contributions for the 2007 and later tax years. Employees are required to file Form T1142 to report any distribution received.

The information returns and forms will be considered to be filed on time if they are filed by a taxpayer's return due date for 2013, which is:

- for employees, April 30, 2014
- for Canadian corporations, no later than six months after the end of the corporation's taxation year that includes June 26, 2013

Next steps for employers

Employers should consider whether the new NRT rules apply to their global equity plan. If the rules apply, you will want to mitigate their impact.

In particular, you should take the following steps:

1. review whether any foreign trusts in your corporate group provide benefits to Canadian employees
2. determine whether the foreign trust may be exempt from the NRT rules, or is deemed to be resident in Canada and liable to pay tax on its worldwide income
3. consider whether the NRT should elect to have only its resident portion taxed in Canada
4. consider whether the resident contributor/Canadian employer should elect to have the NRT's income included in its own income and taxed at corporate rates
5. ensure that the NRT tracks property in the resident portion (if an election has been made) and files annual tax returns
6. ensure that the electing contributor includes the appropriate portion of the NRT's income in its annual tax return
7. ensure that resident contributors file Form T1141 to report contributions to the NRT
8. ensure that employee beneficiaries file Form T1142 to report distributions from the NRT

Let's talk

For a deeper discussion of how the NRT rules might affect your business, please contact either of the following:

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