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Chartered Accountants
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Fast Facts

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The Foreign Investment Entity Rules – Do They Apply to You?

If you hold foreign investments, you need to consider the impact of the Foreign Investment Entity (FIE) rules. These rules, proposed to be effective January 1, 2007, ensure that all foreign investments will be subject to Canadian tax, unless specifically exempted under the rules.

The legislation that implements these rules (Bill C-10) has been passed by the House of Commons and is currently held up in the Senate. If the government falls and an election is called before Bill C-10 is enacted, then a new government will have to reintroduce the FIE legislation for these rules to become law.

What Are the FIE Rules?

The FIE rules are comprehensive and extremely complicated. They will apply to Canadian residents who have a participating investment in a FIE. A FIE is defined to include any non-resident entity other than a partnership – for example, corporations, trusts, associations, funds, organizations, joint ventures, syndicates, and non-Canadian mutual funds are all non-resident entities that are potentially caught by the rules. In addition, if you hold a partnership interest, and that partnership holds any of the above investments, the partnership will have a FIE.

As the rules are intended to catch foreign “passive” investments rather than foreign active businesses, certain non-resident entities will not be considered to be a FIE. An entity where the carrying value of its investment property does not exceed 50% of the carrying value of all of its property is excluded, as is an entity where the principal business is not an investment business.

However, do not assume that you qualify for one of these exceptions without getting professional advice. For example, an investment business, which is caught by the new rules, includes a business the principal purpose of which is to earn dividends, interest, rents or royalties, or certain other types of income such as income from the insurance or reinsurance of risk, the factoring of accounts receivable and the profits from the disposition of investment property. In addition, under these rules, it is possible that an entity that is involved in the rental or

development of real estate outside of Canada would be considered to be an investment business and therefore the entity would be a FIE.

If you own a participating interest in a FIE, the rules will deem you to have received investment income each year which will be taxable in Canada. This will be the case even if you did not receive any income. You will have to use one of the following methods to calculate your income inclusion:

- *The Prescribed Rate of Return Method* – Under this method, which is the default method for determining the income inclusion under the FIE rules, a prescribed interest rate is applied to the designated cost of the investment. The prescribed interest rate is 2% greater than the 90 day T-Bill rate. The designated cost will generally be the fair market value of the investment at the end of the taxpayer’s last taxation year beginning before 2007 (December 31, 2006 for an individual).
- *The Mark-to-Market Method* – Under this method, you can elect to have the annual income inclusion be the increase in the fair market value of the investment (note that you can only elect to use this method if there is a readily obtainable fair market value for the investment).
- *The Income Accrual Method* – If the interest in the FIE is a capital property, you can elect to use the accrual method, which means that you can report as income for Canadian tax purposes your share of the actual income and capital gains earned by the FIE. However, this information must be available for you to be able to use this method.

What Should You Watch Out For?

If you have investments in any non-resident entity, you should contact your BDO advisor to determine the impact of the FIE rules. In particular, you should watch for the following:

- Investments in offshore investment funds where the fund is not widely held and not traded on a recognized stock exchange.

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- Investments in offshore investment funds where the fund is resident in a country that does not have a tax treaty with Canada (for example, funds resident in “tax haven” countries such as the Cayman Islands or Bermuda, as these countries do not have tax treaties with Canada) even if the fund is widely held and traded on a prescribed stock exchange.
 - Investments in any entity (other than a partnership) that is involved in the rental or development of real estate outside of Canada, unless the management of the properties is primarily supplied by employees of the entity or related entities. Note that it is common for the management of real estate investments to be subcontracted out to third parties which will likely mean, in these cases, that the investment will be subject to the new rules.
 - Investments in offshore life insurance policies. This could apply to you if you recently moved to Canada from another country and already had life insurance in place when you moved here.
 - A beneficial interest in a foreign trust. This could apply to you if a non-resident relative has contributed assets to a foreign trust for your benefit. Note that the estate of a deceased person is a trust, so a deceased relative leaving a portion of his estate to you could trigger the application of these rules. While an interest in a fully discretionary trust is exempt from the FIE rules, if the trust contains a

failure clause (a common clause contained in discretionary trusts that applies to determine who gets trust capital in the event that the trustees fail to exercise discretion to allocate the trust capital on the termination date of the trust), an interest in this trust is considered to be a FIE. If you are a Canadian resident and have made contributions to a foreign trust, the trust will likely be deemed to be resident in Canada and be taxable on its worldwide income.

The FIE rules, while comprehensive, will not catch all of your foreign investments. For example, the rules do exempt shares in publicly traded foreign companies which are involved in an active business, but provided the country has a prescribed stock exchange. Most of the US and major European stock exchanges are prescribed, but many of the junior exchanges and most stock exchanges in developing countries (e.g. China) are not prescribed. Also exempted are investments in foreign investment funds where the fund is resident in a country which has a tax treaty with Canada, the fund is widely held and units can be readily bought and sold by members of the public.

The FIE rules are extremely far-reaching and complicated. If you have investments in foreign entities, consult with your BDO advisor to determine the impact of these rules on your investments and how they should be reported in your Canadian income tax returns.

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