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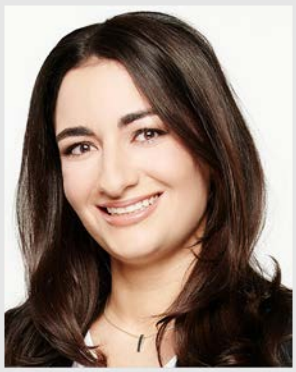
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In this article, the authors discuss enacted and pending proposals to amend Canada's tax laws in the international context, focusing on the effect the amendments may have on cross-border trust and estate planning and the risk of unintended consequences.

In 2018 and 2019, Canada's federal government introduced legislation intended to combat what it considers to be aggressive international tax planning. The new rules may present issues for cross-border trust and estate planning.

Notably, the 2018 legislative amendments to the cross-border anti-surplus-stripping rule in section 212.1 of the Income Tax Act (Canada) may frustrate some planning techniques aimed at avoiding double taxation when a Canadian trust or estate has nonresident beneficiaries.

Federal Budget 2019 proposes additional amendments that would fundamentally alter the scope of Canada's so-called foreign affiliate dumping (FAD) rules in section 212.3 ITA. In the estate planning context, a proposed ownership attribution rule would require careful consideration in some situations when a Canadian resident individual's estate has nonresident beneficiaries.

Pipelines and Nonresident Beneficiaries

Pipeline Transactions

A pipeline transaction is a common Canadian estate planning technique used to eliminate double taxation. Consider a situation in which Mrs. X, an individual resident in Canada, owns all the issued shares of Opco, a Canadian operating company. The shares have a high fair market value, low adjusted cost base, and low paid-up capital (PUC). On Mrs. X's death, the ITA will deem her to have disposed of her Opco shares at FMV — with tax to be paid on the capital gain — and to have reacquired those shares at an adjusted cost base equal to their FMV. Mrs. X's estate will have full basis in the Opco shares, which will still have low PUC. A similar result may arise on the 21st anniversary of a Canadian trust, at which time a trust is generally deemed to have disposed of its capital property at FMV.

Generally, a post-mortem pipeline transaction allows the basis created by the deemed disposition on death to be extracted as a tax-free return of capital. Canadian tax rules allow corporations to return capital to their shareholders without tax consequences to the extent that there is PUC in their shares. To implement the pipeline, the estate would transfer the Opco shares to a newly formed Canadian corporation (Newco) in consideration for shares of Newco, which would have high basis and high PUC, or a promissory note. Typically, this transfer should not trigger any tax because of the steppedup basis in the Opco shares. Subject to the possible application of antiavoidance rules intended to prevent some forms of surplus stripping — for example, subsection 84(2) and section 84.1 ITA — the Newco shares could be redeemed or the note could be repaid over time without triggering any shareholder-level tax. Thus, double tax is avoided.

The Canada Revenue Agency has repeatedly ruled favorably on pipeline transactions, including when there are nonresident beneficiaries, as long as certain administrative guidelines are followed.[1]

Section 212.1 and the 2018 Amendments

Section 212.1 ITA is a specific antiavoidance rule intended to prevent cross-border surplus stripping and the avoidance of Part XIII (nonresident) withholding tax. In general terms, it applies when a nonresident person (the vendor) disposes of shares of a Canadian resident corporation (the subject corporation) to another Canadian resident corporation (the purchaser) with which the vendor does not deal at arm's length and, immediately after the disposition, the subject corporation is connected with the purchaser. The subject corporation is connected with the purchaser if the purchaser controls the subject corporation or if the purchaser owns more than 10 percent of the votes and value of the subject corporation.

When applicable, section 212.1 ITA deems the vendor to have received a dividend in an amount equal to the excess of the FMV of any non-share consideration the vendor received over the PUC of the subject shares. The rules also "grind" the PUC of the shares — that is, they limit the PUC of any shares of the purchaser that are issued in consideration for the sale to the PUC of the subject shares. Accordingly, the pipeline planning that may be available to a Canadian resident is not available to a nonresident of Canada.

In the example above, assume that Mrs. X had three children who were equal beneficiaries of the estate, and one of whom was a nonresident of Canada. Further, assume that the estate received a promissory note on the transfer of the Opco shares to Newco. Before the 2018 amendments, section 212.1 ITA would not normally have been a concern because the estate would typically be considered a Canadian resident trust for tax purposes. However, the 2018 amendments introduced a new look-through rule in subsection 212.1(6) ITA that would subject Mrs. X's pipeline planning to section 212.1 ITA.

The government first alluded to the new rule in the 2018 budget, presented to the House of Commons on February 27, 2018, which included a proposal under the heading "Combatting Aggressive International Tax Avoidance" to:

> prevent unintended, tax-free distributions by Canadian corporations to nonresident shareholders through the use of certain transactions involving partnerships and trusts.

But the government did not release draft legislation or offer any other details about the measure. The new look-through rule (in its current form) first appeared in draft legislation released on October 25, 2018. It received royal assent on December 13, 2018, and it applies retroactively to dispositions occurring after February 26, 2018.

In general terms, new paragraph 212.1(6)(b) ITA provides that if a trust or a partnership (each considered a conduit), other than a nonresident trust, disposes of shares of a Canadian resident corporation to a purchaser, then:

- each holder of an interest in the conduit is deemed to have disposed of the shares to the purchaser in proportion to the FMV of their interest in the conduit; and
- each holder of an interest in the conduit is deemed to have received non-share consideration from the purchaser in an amount equal to the holder's proportionate share of the FMV of the non-share consideration that the conduit received from the purchaser for the shares.

Applying new paragraph 212.1(6)(b) ITA to our example, if the liquidators of the estate implemented a pipeline transaction in relation to all the shares of Opco, the estate's nonresident beneficiary would be deemed to have disposed of

[1] *See, e.g.*, Canada Revenue Agency, "2011 STEP — Q.5 — Post-Mortem Planning and 84(2)," 2011-0401861C6 (June 2, 2011); CRA, "Post-Mortem Pipeline," 2016-0670871R3 (2017); and CRA, "Ss. 164(6) Carry-Back and Post-Mortem Pipeline," 2015-0569891R3 (2015).

33.33 percent of the Opco shares to Newco and to have received non-share consideration from Newco in an amount equal to 33.33 percent of the FMV of any promissory note that the estate received from Newco. The nonresident beneficiary would face Part XIII withholding tax on a deemed dividend at a rate of 25 percent (subject to possible reduction based on a tax treaty) to the extent that 33.33 percent of the FMV of the promissory note exceeded 33.33 percent of the (low) PUC of the Opco shares.

If the liquidators of the estate and the directors of Newco were in the unfortunate position of having implemented the pipeline after February 26, 2018, they might have discovered — upon the release of the draft legislation on October 25, 2018 — that they had inadvertently missed the remitting and reporting deadlines for the Part XIII tax, potentially leaving Newco subject to interest and penalties. This would be the case even if the pipeline had been implemented for the benefit of the Canadian resident beneficiaries only, and other measures, such as loss carryback planning, had been implemented for the nonresident beneficiary.

The 2018 amendments have been heavily criticized by the Canadian tax community, both for inappropriately (and perhaps unintentionally) affecting routine post-mortem planning and for their retroactive application to pipelines that were implemented during the eight months between budget day and the release of the first draft legislation that could have alerted taxpayers and their advisers to the potential issue and allowed them to consider alternatives.[2]

FAD and Nonresident Beneficiaries

The FAD Rules

Canada implemented the FAD rules to combat the erosion of its tax base that might occur when a corporation resident in Canada (CRIC) that is controlled by a nonresident invests in a foreign affiliate using borrowed or surplus funds. The rules were designed to address perceived base erosion opportunities available to Canadian subsidiaries of multinational enterprises.[3]

In very general terms, when the FAD rules apply, they typically suppress PUC that would otherwise be created by the investment and deem a dividend to have been paid by the CRIC to the controlling nonresident. The amount of the deemed dividend is equal to the amount by which the investment exceeds the suppressed PUC, and it is subject to Part XIII withholding tax at a rate of 25 percent (subject to possible reduction based on a tax treaty).

Absent enactment of the pending amendments, the FAD rules only apply to CRICs that are controlled by a nonresident corporation or a related group of nonresident corporations.

The 2019 Amendments

The 2019 amendments propose to broaden the scope of the FAD rules to apply not only to CRICs controlled by nonresident corporations, but also to CRICs controlled by nonresident individuals (that is, natural persons or trusts) or by a non-arm's-length group of nonresident persons. The proposal would fundamentally change the basic fact pattern to which the FAD rules can apply.[4] As proposed, the 2019 amendments would apply to transactions or events that occur after March 18, 2019.

Of particular relevance in the trust and estate planning context are special proposed rules that would be used to determine whether persons are related to — and therefore not at arm's length with — each other and whether one person (or group of persons) controls another person. Proposed paragraph 212.3(26)(a) ITA would treat each trust as a corporation with a single class of 100 voting shares, and it would allocate ownership of those shares to the beneficiaries in accordance with their proportionate interests (based on FMV) in the trust. When a Canadian resident trust in which a nonresident person holds a majority interest (determined based on FMV) controls a CRIC, the proposed rules would

[2] *See, e.g.*, Marshall Haughey, "Pipelines and Non-Resident Beneficiaries," 27(3) *Canadian Tax Highlights* 7 (Mar. 2019); and Alexander Demner and Kyle B. Lamothe, "Section 212.1 Lookthrough Rules Create Issues for Trusts With Non-Resident Beneficiaries," 19(2) *Tax for the Owner-Manager* 2 (Apr. 2019).

[3] *See* Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "Foreign Affiliate Dumping, Derivative Forward Agreement and Transfer Pricing Amendments Announced in the 2019 Federal Budget" (May 24, 2019).

[4] *See id*.

deem the nonresident person to control the CRIC, and the FAD rules could apply to an investment the CRIC makes in a foreign affiliate.

Apparently, the Department of Finance was concerned about taxpayers using discretionary trusts to avoid the expanded application of the FAD rules by taking the position that the FMV of a beneficiary's interest under a discretionary trust is nil or nominal and, therefore, claiming that the proposed ownership-attribution rule would not apply. In response to this concern, paragraph 212.3(26)(c) ITA — as initially proposed in the 2019 Budget on March 19, 2019 — would have treated a beneficiary as though it held a 100 percent interest in the trust for purposes of applying the ownership attribution rule when the beneficiary's share of the trust's income or capital depended on any person's exercise of any discretionary power.

Proposed paragraph 212.3(26)(c) ITA faced heavy criticism from the tax community for, among other things, its potential to apply the FAD rules in clearly inappropriate circumstances. For instance, the proposed rule could have resulted in the FAD rules applying to a downstream investment in a nonresident corporation by a family-controlled Canadian private company when voting control of the company rested in a discretionary trust and the founder's nonresident children or grandchildren were among the beneficiaries.[5]

Seemingly in response to these criticisms, in draft legislation released on July 30, 2019, the Department of Finance narrowed the scope of proposed paragraph 212.3(26)(c) ITA by subjecting it to an antiavoidance purpose test. Specifically, the rule would apply unless:

- the trust is resident in Canada; and
- it cannot reasonably be considered that one of the main reasons for the discretionary power (for example, of the trustees) is to avoid or limit the application of, *inter alia*, the FAD rules.

The narrowing of the scope of proposed paragraph 212.3(26)(c) ITA is a welcome change, and it does alleviate some concerns about the inappropriate application of the FAD rules in the trust and estate planning context. However, taxpayers and tax practitioners should be mindful of the 2019 amendments and the potential application of the FAD rules when a Canadian corporation with foreign subsidiaries is controlled by a Canadian resident trust or estate with nonresident beneficiaries. ■

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[5] *See id.*