CTF FCF CANADIAN TAX FOUNDATION FONDATION CANADIENNE DE FISCALITÉ
Canadian Tax FOCUS
LEADING TAX THOUGHT™

POST MORTEM PIPELINE FAILS FOR NON-RESIDENT BENEFICIARIES

On the death of the owner of a private company, taxes are payable on the deemed disposition of shares, and taxes are payable again on funds being withdrawn from the company. Pipeline transactions seek to avoid this second level of tax; however, where a non-resident beneficiary is involved, pipeline transactions no longer seem to work after the enactment of amendments to section 212.1 on December 13, 2018 (Bill C-86). The stated purpose of these amendments is far different, so this effect may be unintended. There may be reason to hope for a fix through corrective legislation or CRA interpretation.

In the 2018 Budget, the Department of Finance expressed concerns about cross-border surplus-stripping practices that circumvent section 212.1 (which is roughly the equivalent of section 84.1 for non-residents). Specifically, the concern centred around sophisticated transactions involving multinational companies whereby the application of section 212.1 was avoided through the use of trust and partnership intermediaries between the corporation and the non-resident. The enacted legislation introduces lookthrough rules on tiered partnerships and trusts: a non-resident person who is a member of a partnership or beneficiary of a trust is deemed to own the intermediary's shares on the basis of that person's relative FMV interest in those shares (subsections 212.1(5) to (7)).

Suppose that an estate has three beneficiaries—two are Canadian residents and one is a non-resident—and the will provides that the residue (the amount remaining after other claims are settled) is to be divided equally among the three beneficiaries. The estate owns shares of Opco with an ACB of $100,000 (from the deemed disposition at death) and PUC of $100. One-third of the shares are to go to each beneficiary. If a regular pipeline transaction is performed by the estate—involving the sale of the shares of Opco to a newly incorporated Holdco in exchange for a promissory note—there is a deemed dividend equal to $33,300 (one-third of the difference between the value and the PUC) to the non-resident beneficiary. This defeats the purpose of the pipeline transaction.

The deemed dividend occurs because the transaction satisfies the two conditions below (of which the latter results from the new amendments):

- For section 212.1 to apply, the non-resident person and Holdco must not deal at arm's length. This result is deemed by paragraph 212.1(3)(a) if the non-resident person is part of a group of fewer than six persons that controls both Opco and Holdco. At first, it seems that this condition is not met: the estate controls these two companies, and the non-resident person is not even a shareholder of either company; however, paragraph 212.1(3)(b) deems a beneficiary of a trust to own

the shares that the trust actually owns. (An estate is a trust according to subsection 248(1).) Thus, paragraph 212.1(3)(a) applies after all, and the non-arm's-length relationship of the non-resident person and Holdco is established.
- Another requirement for section 212.1 to apply is that the non-resident has disposed of Opco shares to Holdco. The new lookthrough provisions of subsections 212.1(5) to (7) put the non-resident person in the place of the estate, and hence this condition is satisfied.

Different results may occur for more complex provisions in the will concerning the distribution of shares to beneficiaries, as the following examples illustrate:
- Under a "hotchpot" clause the executor has the power to choose which assets go to each beneficiary under the will, taking into account the distribution of assets both inside and outside the estate. In this situation, the effect of subsection 212.1(7) (where its purpose test is satisfied) is that the non-resident beneficiary is deemed to have a 100 percent interest in the estate assets, tripling the deemed dividend to $99,900. This occurs even if that person does not receive the shares on which the dividend arises (the Holdco shares) and receives other property instead.
- There may be a provision in which the executor has the power to choose which assets go to each beneficiary, as long as assets are distributed under the will in certain proportions of value. (The purpose of such a clause might be, for example, to pass on the interest in the family business to the person who is actively involved in it.) In that case, subsection 212.1(7) does not apply but there is still a deemed dividend to the non-resident beneficiary of $33,300. Again, this applies regardless of whether that person receives the shares on which the dividend arises.

Henry Shew
Cadesky Tax, Toronto
hshew@cadesky.com

Canadian Tax Focus
Volume 9, Number 1, February 2019