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Mr. Angelo Nikolakakis & Mr. Ken Griffin
Co-Chairs
The Joint Committee on Taxation of
The Canadian Bar Association
66 Slater St., Suite 1200
Ottawa ON K1P 5H1

and

The Chartered Professional Accountants of Canada
277 Wellington St. W.
Toronto ON M5V 3H2

Dear Messrs. Nikolakakis and Griffin:

Cross-Border Surplus Stripping & Graduated Rate Estates

I am writing to advise the Joint Committee that a matter has been raised with officials of the Tax Legislation Division regarding the application of paragraph 212.1(6)(b) of the *Income Tax Act* (the “Act”) to a graduated rate estate (as defined in subsection 248(1) of the Act) with one or more non-resident beneficiaries.

As you are aware, section 212.1 is intended to prevent a non-resident shareholder from entering into transactions that would allow that shareholder to extract free of income tax the corporate surplus of a Canadian resident corporation in an amount that exceeds the paid-up capital (“PUC”) of that shareholder’s shares, or to artificially create cross-border PUC in excess of the PUC of those shares. In general, section 212.1 applies if a non-resident person disposes of shares of a corporation resident in Canada (the “subject corporation”) to another corporation resident in Canada (the “purchaser corporation”) with which the non-resident person does not deal at arm’s length and, immediately after the disposition, the subject corporation is connected with the purchaser corporation (*i.e.*, connected within the meaning assigned by subsection 186(4) of the Act with certain variations). When applicable, this cross-border anti-surplus-stripping rule can result in the non-resident person being deemed to have received a dividend to the extent that the value of the non-share consideration exceeded the PUC of the subject corporation shares transferred, or can suppress the PUC that would otherwise have been created as a result of the transactions.

In Budget 2018 (February 27, 2018), the Government proposed measures to ensure that this rule could not be frustrated by transactions involving partnerships or trusts. Draft legislative proposals were released for public consultation on July 27, 2018. In this consultative draft, a partnership's disposition of shares of a corporation resident in Canada was to be allocated to its members, based on the relative fair market value of their interests. Legislative amendments were included in *Budget Implementation Act, 2018, No. 2*, and, effective for dispositions after February 26, 2018, the look-through rule for dispositions of shares, enacted in paragraph 212.1(6)(b) of the Act, is applicable to dispositions of shares by partnerships as well as by Canadian resident trusts, including graduated rate estates.

In communications with officials of the Tax Legislation Division, concerns were expressed regarding the application of the look-through rule in paragraph 212.1(6)(b) to a Canadian resident graduated rate estate with one or more non-resident beneficiaries. Specifically, there is concern that this look-through rule will reduce the ability of such an estate to implement certain post-mortem tax planning transactions that are commonly undertaken.

We understand that this post-mortem tax planning is generally implemented by the graduated rate estate selling the shares of a Canadian resident corporation ("Canco") held at death to a new Canadian corporation ("NewCanco") in exchange for a promissory note equal to the graduated rate estate's adjusted cost base ("ACB") in the Canco shares (which ACB is generally equal to the fair market value of the Canco shares at the deceased's date of death). Our further understanding is that, under this post-mortem tax planning, tax is generally payable in respect of the deemed disposition of the Canco shares on the deceased's death, and not payable in respect of the corporate surplus that is eventually extracted by the graduated rate estate through the repayment of the promissory note.

With the application of paragraph 212.1(6)(b), when the graduated rate estate disposes of the Canco shares to the NewCanco, each holder of an interest in the trust (*i.e.*, each beneficiary) is deemed, for the purposes of subsections 212.1(1) and (1.1), to have disposed of their proportionate interest in the Canco shares to the NewCanco and to have received their proportionate share of consideration from the NewCanco. In general, under paragraph 212.1(6)(b) of the Act, each beneficiary of the graduated rate estate that implements this post-mortem tax planning is treated, for the purposes of subsections 212.1(1) and (1.1), as having implemented it directly, based on the relative fair market value of their interest in the estate.

Where the conditions of subsection 212.1(1) are satisfied, each non-resident beneficiary is deemed to have received a dividend from the NewCanco to the extent that the non-resident beneficiary's proportionate share of the promissory note from the NewCanco exceeds the PUC of the non-resident beneficiary's proportionate interest in the Canco shares transferred to the NewCanco. As a result, tax is payable in respect of this deemed dividend to the non-resident beneficiary.

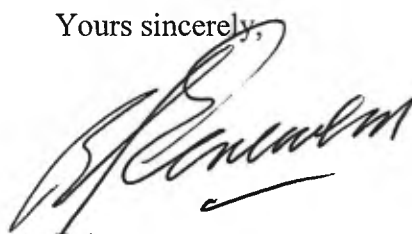
Our Comments

We agree that the application of paragraph 212.1(6)(b) of the Act can give rise to results in the context of graduated rate estates that are not consistent with current tax policy. Therefore, we

are prepared to recommend to the Minister of Finance that the Act be amended to exclude, from the application of paragraph 212.1(6)(b), dispositions of shares by a Canadian resident graduated rate estate of an individual who was resident in Canada immediately before the individual's death, provided that those shares were acquired by the estate on and as a consequence of the individual's death. We also intend to recommend that this proposed amendment apply to dispositions after February 26, 2018.

While we cannot offer any assurances that either the Minister of Finance or Parliament will agree with our recommendations, we hope that this statement of our intention is helpful.

Yours sincerely,

A handwritten signature in black ink, appearing to read "B. Ernewein", with a horizontal line underneath.

Brian Ernewein
Assistant Deputy Minister – Legislation
Tax Policy Branch