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Highlights

Family Trusts and the Small Business Deduction – The Rules have Changed

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As a sequel to "A Right under a Contract, in equity or otherwise… Tax Planning around a Legal Fiction" (Brown and Kind) which examines how corporations may become associated as a result of granting a power of attorney to a beneficiary under a trust, or to any other person, this paper examines the potential impact of the associated corporation rules on Canadian-controlled private corporations when shares are held through a family trust or when trustees or beneficiaries of a family trust also control other corporations. Through the use of hypothetical examples, Brown and Kind demonstrate pertinent issues posed by the associated corporation rules and conclude with some potential solutions to addressing these issues.

Foreign Affiliate Dumping Rules — Traps for Trusts

James Murdoch & Julia Ji, *Thorsteinssons LLP*

This article examines foreign affiliate dumping ("FAD") rules under the Income Tax Act (Canada) in the context of draft legislation released on July 30, 2019. Although not yet enacted, these exceedingly complicated proposed rules would apply to transactions or events taking place on or after March 19, 2019. Murdoch and Ji review the existing FAD rules and discuss the proposed amendments to the FAD rules, including through the use of helpful diagrams and scenarios. The article concludes with the authors' recommendation that private companies obtain careful income tax advice prior to making foreign investments lest they unwarily fall into a tax trap.

Family Trusts and the Small Business Deduction – The Rules have Changed

Professor Catherine Brown & Abbey Lynne Kind, CPA, JD, Faculty of Law, *University of Calgary*

Overview

This paper addresses two simple questions — what are the potential tax consequences if shares of a Canadian-controlled private corporation ("CCPC") are held through a family trust and how have the rules changed?

This paper is a sequel to "A Right under a Contract, in equity or otherwise… Tax Planning around a Legal Fiction"[1] (Brown and Kind) which examines how corporations may become associated as a result of granting a power of attorney to a beneficiary under a trust, or to any other person.

Associated corporations, and in particular CCPCs that are associated, are subject to a number of provisions in the *Income Tax Act* (the "Act") that may limit access to the small business deduction ("SBD"). The two most generally known provisions are access to the $500,000 small business limit ("SBL") which must be shared by associated corporations and the reduction in the SBD limit[2] where the taxable capital of associated corporations exceeds $10 million.[3]

For many CCPCs, these limitations created few hardships. It was common for the passive assets of a corporation to be separated from the active business income assets, and for the investment income to be earned though a separate corporation. The entirety of the $500,000 SBL could be allocated to the associated corporation earning active business income. Provided the taxable capital of the two associated corporations did not exceed $10 million, the SBD limit of the corporation earning active business income would not be impacted. The rules have now changed.

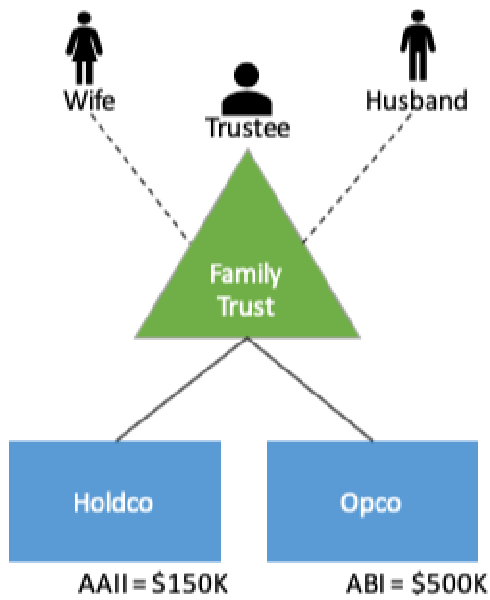
What has changed?

Starting in 2019, CCPCs are also subject to a grind on the SBL where adjusted aggregate investment income ("AAII") exceeds $50,000 (the "SBL grind"). This grind reduces the SBL when a CCPC earns more than $50,000 of AAII and completely eliminates the SBL when a CCPC earns $150,000 of AAII.[4] For the purposes of calculating the SBL grind, the total AAII of the corporation and all corporations with which it is associated at any time in the taxation year is included.[5] AAII for purposes of the grind is generally income from passive investment including interest, certain dividends, and taxable capital gains, with some minor modifications.[6]

Basic Concepts — Some Examples

The introduction of the SBL grind for AAII has obvious implications for family trusts that hold shares of a corporation earning passive investments (Holdco) and shares of a corporation earning active business income (Opco). Specifically, income generated by the passive investments held by Holdco may now jeopardize the SBL for Opco if the two corporations are associated through the trust, the trustee or the beneficiaries. This will require a careful review of many family trust structures to both prevent unintended tax consequences and, where necessary, unwind structures that are negatively impacted by the new provisions. It will also require a clear understanding of what constitutes AAII. Consider the following examples.

Example 1



In this example, Holdco and Opco are associated because the family trust (or the trustee) control both corporations. As regards Opco, ABI refers to active business income.

Previously, this association may not have been an issue. Now, due to the introduction of the SBL grind, the investment income earned in Holdco will jeopardize the SBD previously enjoyed by Opco. The SBL grind is based on the total AAII of all associated corporations.

As the AAII of Holdco will now affect Opco, the AAII of all associated corporations is of concern.

It will therefore be important to review the circumstances that may result in association when shares are held by a trust. These are not always intuitive. In this example, although the trust and the trustee control Opco and Holdco, the husband and wife also control both Holdco and Opco, both individually and as a group.

A beneficiary of a trust, is deemed to own a portion, or all of the shares, of a corporation held in the trust.[7] Paragraph 256(1.2)(f) determines whether, and in what proportion, shares held by a trust are deemed to be owned by each beneficiary. This determination is based on whether the beneficiary's share in accumulating income and capital is discretionary or non-discretionary.

Beneficiary of a Discretionary Trust

Where a particular beneficiary's share of the accumulating income or capital depends on a person exercising, or failing to exercise, a discretionary power (referred to as a "discretionary trust"), that beneficiary is deemed to own *all* of the shares owned by the trust.[8] This applies to each beneficiary of the discretionary trust individually.

Beneficiary of a Non-discretionary Trust

Where there is no discretion as to a beneficiary's share of the income or capital of the trust, the beneficiary is deemed to own a proportionate share of the corporate shares owned by the trust. The proportion is calculated using each beneficiary's fair market value of the beneficial interest in the trust.[9]

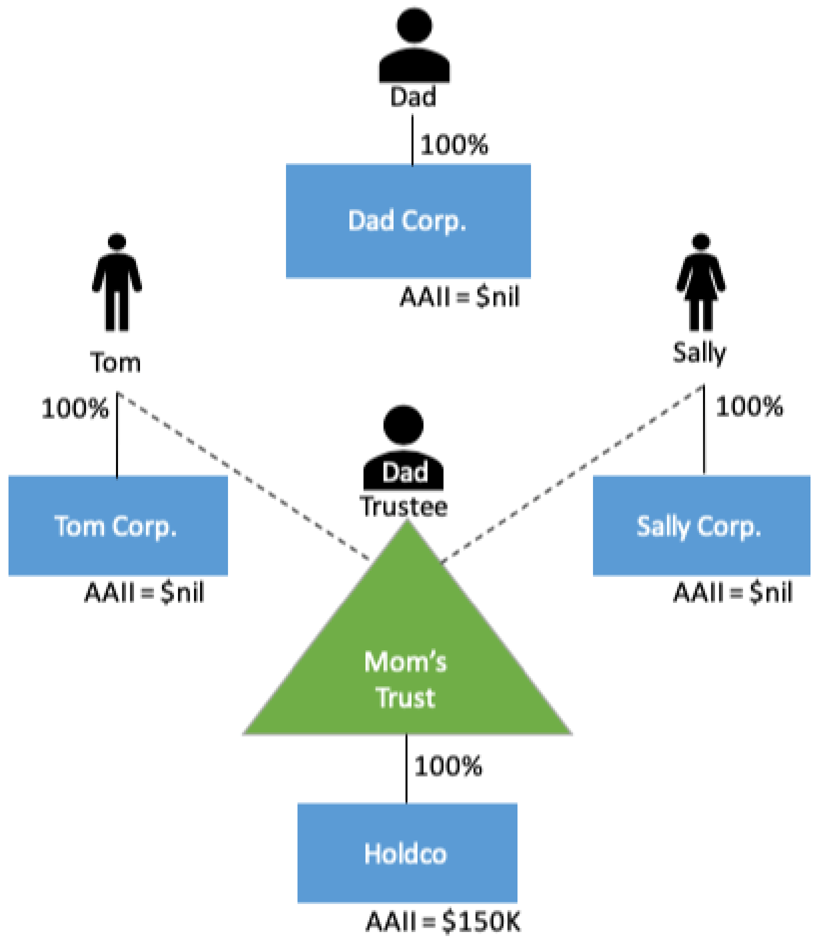
Whether the trust is discretionary or non-discretionary, in the above example Holdco and Opco will also be associated as a result of the application of these association rules.[10] If Holdco has $150,000 in AAII, both Holdco and Opco will have a SBL of Nil.

Association with Corporations Controlled by Beneficiaries Outside of the Trust

In addition to considering the association of corporations when shares are held by the family trust, one must also consider the association of these corporations with corporations controlled by the beneficiaries or trustees outside the trust. Association with these corporations will also have consequences for the SBL grind.

Example 2

In this example, assume Mom creates a discretionary family trust that holds 100% of the common shares of an investment corporation (Holdco). The trustee is Dad. Tom and Sally are the only beneficiaries (Tom and Sally are adult children of Mom and Dad). Tom, Sally and Dad each control their own CCPCs, Tom Corp., Sally Corp. and Dad Corp., respectively.



Tom and Sally are each, individually, deemed to own 100% of the shares of Holdco by virtue of subsection 256(1.2)(f)(ii). Therefore, as each Tom and Sally are deemed to control Holdco, Tom Corp. and Sally Corp. will each be associated with Holdco. Additionally, by virtue of subsection 256(2) (association through a third corporation), Tom Corp. and Sally Corp. are deemed to be associated with one another.

A trustee is also deemed to control a corporation controlled by a trust.[11] Therefore, Dad, as trustee of Mom's Trust, will also be deemed to control Holdco. Dad Corp. will be associated with Holdco as Dad controls (or is deemed to control) both corporations. Dad Corp. is also associated with each of Tom Corp.[12] and Sally Corp. by virtue of subsection 256(2) because of the common association with Holdco.

As Holdco has AAII of $150K, neither Tom Corp., Sally Corp., Dad Corp., or Holdco can utilize the SBD as the SBL grind eliminates the SBL for all of these associated corporations entirely (recall that the SBL grind is calculated considering the AAII of all associated corporations).

One might assume that the reduction of the SBL for Sally Corp and Tom Corp. will be cured by having Holdco make an election under subsection 256(2).[13] While it is true that for purposes of section 125, Tom Corp. and Sally Corp. would no longer be associated with each other, Holdco will remain associated with both corporations for the purposes of section 125. Therefore, Holdco's AAII would be included in the SBL grind calculation for Tom Corp. and Sally Corp. and Dad Corp. in this example and their respective SBL's will be zero.

However, assume instead that Holdco's AAII is $50,000 and that the AAII of Tom Corp. is $100,000. Since all four corporations are associated, the total AAII of $150,000 would operate to reduce the SBL of all four corporations to zero. However, if Holdco files a subsection 256(2) election with respect to Tom Corp. and Sally Corp., the position of Sally Corp. would improve considerably.

If Tom Corp. is no longer associated with Sally Corp., Sally Corp.'s SBL will not be affected by the $100,000 of AAII in Tom Corp. Sally Corp.'s SBL grind will be calculated based on the $50,000 AAII of Holdco and would result in a SBL grind of zero. Tom Corp.'s SBL will still be eliminated entirely because the combined AAII of Tom Corp. and Holdco (which remain associated) is $150,000 and grinds Tom Corp.'s SBL to zero. Because Tom Corp. and Sally Corp. are no longer associated, Sally Corp. will have access to the full SBL.

Holdco should also file a subsection 256(2) election with respect to Sally Corp. and Dad Corp. to ensure that each has access to the SBD and with respect to Tom Corp. and Dad Corp. to ensure that Dad Corp. is not impacted by Tom Corp.'s AAII.[14]

Potential Solutions

The impact of the AAII grind on CCPCs whose shares are held by a family trust can be significant. A careful review of these structures should be undertaken. Thought should also be given to whether additional steps to reorganize family trust structures should be undertaken. Some suggestions and words of caution are provided below.

1. Spin off assets

The SBL grind is calculated based on the total AAII of associated corporations.

While a possible solution may be to transfer or loan assets earning AAII to another corporation that is not associated, this solution should be approached with care. The transfer may result in the application of the anti-avoidance rule in subsection 125(5.2) if the transfer is to a 'related' corporation.

The avoidance rule in subsection 125(5.2) deems 'related' corporations to be associated for the purposes of the SBL grind if the conditions in that provision are met. Specifically, where a corporation lends or transfers property (whether directly or indirectly and including by means of a trust) to a related corporation, and it can reasonably be considered that one of the reasons for the loan or transfer was to reduce the AAII amount that would otherwise be included in calculating the SBL grind (or taxable capital), the related corporation will be deemed to be an associated corporation for purposes of calculating the grind.

The language used in this anti-avoidance rule provides that the provision may apply if

> [i]t may reasonably be considered that 'one of the reasons' the loan or transfer was made was to reduce the AAII amount in respect of the particular corporation, or of any corporation with which it is associated.

This is much broader than the language "one of the main reasons" that is often found in anti-avoidance provisions.[15] It would also appear that the onus of proof is on the taxpayer once the Minister applies the anti-avoidance provision to objectively establish that none of the reasons for the transfer or loan was to reduce the SBL grind.[16]

It may be easy to overlook this provision when reviewing a family trust structure and assume that a transfer to a related corporation will solve the problem of the SBL grind. While "associated" corporations are often flagged when looking at a group of corporations, related corporations should also be carefully considered.

2. Unassociate the corporations

Another option may be to take steps to ensure that the corporations that are associated through a family trust or through the trust beneficiaries are unassociated. For example, if we return to our first example where a husband and wife are beneficiaries of a family trust that owns all of the shares of Holdco and Opco, an obvious solution is to roll out 76% of the shares of each corporation from the trust to each of the husband and wife respectively. This would result in the wife in our example owning 76% of Opco directly and 24% through the family trust. The husband would also own 76% of Opco directly and 24% through the family trust. As a result, the trust will no longer control Holdco and Opco. Further, the husband and wife who each now control one corporation, will not have sufficient cross ownership through the trust (24%) to cause Opco and Holdco to be associated. The potential savings per year for Opco based on Alberta tax rates will be $70,000 per year (in Ontario the potential savings will be $66,500).

The parties may want to consider an estate freeze at the same time and the issuance of a stock dividend in the form of a specified class of shares (subsection 256(1.1)) to the family trust. These shares will operate to preserve the current value of the underlying corporations in the family trust for each beneficiary but should not cause association problems (see subsection 256(1.2)). The common shares would then be rolled out of the trust to the respective beneficiaries.

An obvious disadvantage of this strategy is that the husband and wife no longer share equally in the future growth of both corporations.

3. Corporations earn income from a trust that carries on an active business of investing

A corporation that earns income from a trust that carries on an active business of investing will not be affected by the AAII grind.

The more adventuresome might consider the use of such an investment vehicle to earn what would otherwise be passive income. This may require the contribution of assets from more than one CCPC to meet the objective criteria (including hiring an investment advisor) that the trust is carrying on an active business and earning active business income.[17]

4. Inter-provincial planning

The impact of the AAII grind may also be reduced through inter-provincial planning. Two provinces have not matched the federal SBL grind rule: Ontario and New Brunswick. These provinces may be the preferred locale for corporations in order to take advantage of the lower tax rates. In these provinces, AAII in excess of $50,000 will not affect the provincial SBD.

The exact benefit achieved by avoiding the provincial SBL grind will depend on the differential tax rates between the specific provinces. For example, the annual tax savings for an Ontario CCPC that earns $500,000 of active business income and $150,000 of AAII that is not subject to an AAII grind at the provincial level is $41,500 in 2020.[18] The immediate savings are even greater in New Brunswick and will equal $57,500[19] in 2020.[20]

If undertaking any form of inter-provincial tax planning, provincial GAAR should be considered. While the Alberta Court of Appeal appears to have indicated that there is nothing inherently abusive in inter-provincial tax planning that includes "rate shopping" or shifting income between provinces,[21] the specific facts and relevant circumstance involved with such inter-provincial planning must be considered.[22]

Conclusion

This paper examines the potential impact of the associated corporation rules on CCPCs when shares are held through a family trust or when trustees or beneficiaries of a family trust also control other corporations. In the past, attention has been focused on the requirement to share the $500,000 SBL among the associated corporations and on the SBL grind where the taxable capital of associated corporations exceeds $10 million. As seen, there are new limitations on the ability to access the SBD as the result of the AAII grind. This will require a careful review of family trust structures to ensure that associated corporations are not adversely affected by the new provisions.

This includes, as discussed in the prior Article, the potential impact of powers of appointment on association.

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[1] Catherine Brown & Abbey Kind, "A Right under a Contract, in equity or otherwise... Tax Planning around a Legal Fiction" Thomson Reuters Federated Press: Personal Taxation & Estate Planning Journal Series, IX:1 (25 February 2020).

[2] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) as amended (the "Act"), defined in subsection 125(2). Unless otherwise indicated, all statutory references are to the Act.

[3] The SBL is reduced to zero when the combined taxable capital of associated corporations reaches $15 million.

[4] Subsection 125(5.1). AAII is defined in subsection 125(7) by modifying the definition of aggregate investment income ("AII") in subsection 129(4).

[5] Paragraph 125(5.1)(b).

[6] See definition of aggregate investment income in subsection 125(7).

[7] This is affected by a "look through" provision in the Act for the purposes of determining control under the association rules. See paragraph 256(1.2)(f).

[8] Subparagraph 256(1.2)(f)(ii).

[9] Subparagraph 256(1.2)(f)(iii).

[10] If the trust is a discretionary trust, subparagraph 256(1.2)(f)(ii) deems all shares to be owned by each of the beneficiaries of that trust. Both the husband and wife as beneficiaries are therefore deemed to individually control each of Opco and Holdco. Therefore, the two corporations are associated by virtue of subsection 256(1)(a). Association will also result if the trust is non-discretionary because the husband and wife are a "group" and together control both corporations (subsection 256(1)(b)).

[11] *Consolidated Holding Co. v. Minister of National Revenue* (1971), [1974] S.C.R. 419, 72 D.T.C. 6007 (S.C.C.) [*Consolidated Holdings*].

[12] The corporations are associated under paragraph 256(1)(c): Tom and Dad are related persons who each control a corporation (Tom Corp. and Holdco). Tom is deemed to own the requisite 25% cross ownership needed to associate the two corporations (paragraph 256(1.2)(f)).

[13] Form T2 Schedule 28.

[14] See CRA Views, Technical Interpretation (External) 2003-0038235 – *Association rules and subsection 256(2)* for the CRA's administrative position supporting the filing of more than one subsection 256(2) election where there are more than three corporations in a corporate group. See also CRA Views, Technical Interpretation (External) 2004-0108311E5 – *Associated Corporations*.

[15] Where the phrase "one of the main reasons" is utilized, the courts have held that the term "main" must be given its significance and that not every reason will meet this standard. While the phrase "one of the main reasons" requires that the reason be the "main" or "principal" reason, the phrase "one of the reasons" does not. See *Lenco Fibre Canada Corp. v. R.* (1979), 79 D.T.C. 5292 (Fed. T.D.) at para. 4, cited recently by *Prairielane Holdings Ltd. v. The Queen*, 2019 TCC 157 (T.C.C. [General Procedure]) at para. 23.

[16] The phrase "may reasonably be considered" is used in other sections of the Act and was defined by the Federal Court of Appeal (the "FCA") in *Wu v. R.* (1997), [1998] 1 C.T.C. 99 (Fed. C.A.) (F.C. – Appeal Division). As interpreted by the FCA, this phrase indicates that, once the Minister raises the anti-avoidance provision, "the onus is even greater on a taxpayer to produce some explanation which is objectively reasonable that none of the purposes" was as indicated by the Minister. See *Wu v. R.* at para. 6 interpreting subsection 15(1.1); see also *Prairielane Holdings Ltd. v. The Queen*, 2019 TCC 157 (T.C.C. [General Procedure]) at para. 18 interpreting subsection 256(2.1).

[17] While the income from a trust is ordinarily recharacterized as income from property by operation of subsection 108(5), this amount will not be included in the AAII calculation for purposes of the SBL grind for the corporate beneficiary. Such property income is explicitly excluded from AAII as it is "income that, but for paragraph 108(5)(a), would not be income from a property".
See the definition of AII in subsection 129(4). The relevant portion of the definition remains the same for AAII.

[18] The Ontario CCPCs $500,000 of active business income is taxed at the small business rate in Ontario (3.2% instead of 11.5%).

[19] In 2020, the corporate tax rate in New Brunswick is 14% for active business income not subject to the small business deduction and 2.5% for active business income that is subject to the small business deduction. This differential of 11.5%, when applied to $500,000, results in $57,500 of annual tax savings for a corporate income subject to tax in New Brunswick.

[20] One must also consider the impact on GRIP balances and NERDTOH or ERDTOH accounts (affecting the proportion of eligible vs. in-eligible dividends) and personal income tax rates. Income that is not subject to the SBD at the federal level will result in eligible dividends for federal tax purposes, but not for provincial tax purposes as the income would be subject to preferential tax rates at the provincial level.

[21] See *Husky Energy Inc. v. Alberta,* 2011 ABQB 268 (Alta. Q.B.), affirmed 2012 ABCA 231 (Alta. C.A.), application for leave to appeal to the Supreme Court of Canada was dismissed, see 34999. See also *Canada Safeway Ltd. v. Alberta*, 2011 ABQB 329 (Alta. Q.B.), affirmed 2012 ABCA 232 (Alta. C.A.), application for leave to appeal to the Supreme Court of Canada was dismissed, see 35003.

[22] It should be noted that corporations are subject to provincial tax based on the jurisdiction in which the income is earned. This may be more difficult to alter, especially where an active business is involved.

Foreign Affiliate Dumping Rules — Traps for Trusts

James Murdoch and Julia Ji, *Thorsteinssons LLP*

Introduction

The foreign affiliate dumping ("FAD") rules under the *Income Tax Act* (Canada)[1] are a complex set of tax rules which may cause adverse tax consequences in certain circumstances where a Canadian resident corporation invests in a foreign affiliate.

Prior to the 2019 federal budget, most trusts and estates practitioners would have had little reason to give much thought to the FAD rules. Unfortunately, as this article will explain, proposed amendments to the Act mean that trusts and estates practitioners will increasingly find themselves dealing with situations where the FAD rules may apply.

This article is based on draft legislation released on July 30, 2019. These legislative proposals were subject to a comment period that expired on October 7, 2019. The Department of Finance has not provided any additional guidance following the release of the July 30, 2019 legislation and, at the time of writing this paper, it is unclear whether Finance will introduce further changes to the proposals based on feedback. Although the proposed amendments have not yet been enacted, it is proposed that they will apply to transactions or events taking place on or after March 19, 2019.[2]

Brief Overview of the Current FAD Rules

The FAD rules were first introduced in 2012. As enacted, the FAD rules only applied to a corporation resident in Canada (a "CRIC") that was controlled by a foreign corporation ("parent").[3] If the CRIC made an investment[4] in a foreign affiliate[5] ("FA"), the FAD rules would generally apply to deem the CRIC to have paid a dividend to its parent.[6] That deemed dividend would be subject to a 25% withholding tax under Part XIII of the Act,[7] or such lesser rate of tax as is prescribed by tax treaty entered into between Canada and the parent's country of residence. The FAD rules are highly complex and may result in other adverse tax consequences in addition to or instead of the deemed dividend referred to above.

The FAD rules include certain relieving provisions. For example, the withholding tax on a deemed dividend can, in certain circumstances, be avoided by electing to replace the deemed dividend with a reduction of the paid-up capital ("PUC") of the CRIC's shares held by the parent, or a reduction of the PUC of the shares of a related Canadian corporation held by the parent.[8] There are also exceptions where it can be demonstrated that the investment in the FA relates to a "closely connected business activity" of the CRIC,[9] or where the investment in the FA takes place in the context of certain corporate reorganization transactions.[10]

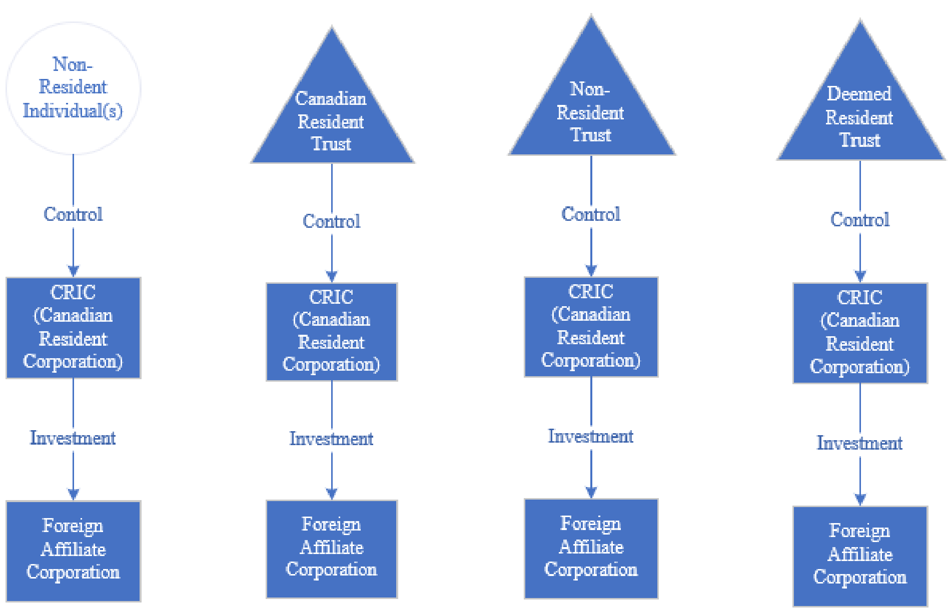
The FAD rules are premised on the basis that a non-resident parent who wishes to use property of a CRIC to invest in a foreign jurisdiction should distribute that property by way of dividend (and pay the applicable withholding tax) and then invest the property directly. To the extent the non-resident parent arranges for the CRIC to invest in the foreign jurisdiction, the withholding tax is deferred or avoided. The FAD rules are designed to prevent this deferral or avoidance of tax.

It is beyond the scope of this article to provide a detailed description of the operation of the FAD rules.[11] The purpose of this article is merely to identify the expanded circumstances in which the FAD rules may apply, assuming the amendments are enacted.

Proposed Amendments to the FAD Rules

As enacted, the FAD rules generally only apply to the following structure:

Under the proposed amendments, the FAD rules may apply to any of the following structures:



Parent is a Non-Resident Individual (or Group of Non-arm's Length Non-resident Individuals)

The proposed amendments change the meaning of "parent" from "non-resident corporation" to "non-resident person".[12] By virtue of this change, the FAD rules are extended to cover circumstances where the CRIC is controlled by a non-resident individual. In addition, the concept of a CRIC controlled by a "group of parents"[13] is introduced such that the FAD rules will now apply where a CRIC is controlled by a group of non-resident persons not dealing at arm's length.

Generally speaking, the FAD rules will apply in the same manner as under the existing rules as if the CRIC were controlled by a non-resident corporation, i.e., a dividend will be deemed to be paid to the non-resident individual subject to withholding tax under Part XIII, provided that the CRIC would have the ability to elect for a PUC reduction. Where the CRIC is controlled by a group of parents, the deemed dividend will be allocated among the group in accordance with the relative fair market value of their shareholdings.[14]

Parent is a Canadian Resident Trust

The proposed change to the meaning of "parent" from "non-resident corporation" to "non-resident person" together with application rules which have the effect of looking through trusts to their beneficiaries,[15] mean that a CRIC may be subject to the FAD rules if it is controlled by a Canadian resident trust with one or more non-resident beneficiaries.

More specifically, proposed subsection 212.3(26) provides that for purposes of determining control, it shall be assumed that:

1. A trust is a corporation with a single class of 100 issued voting shares;[16]
2. Each beneficiary holds shares equal to their *pro rata* fair market value interest in the trust;[17] and
3. In the case of a discretionary trust, each beneficiary is deemed to own a 100% interest in the trust unless "it cannot reasonably be considered that one of the main reasons for the discretionary power is to avoid or limit the application of" the FAD rules.[18]

As a result, each non-resident beneficiary of a discretionary trust is considered to be a "parent" who controls the CRIC, unless it cannot reasonably be considered that one of the main reasons for the discretionary power is to avoid or limit the application of the FAD rules.[19]

One would expect that in most circumstances it will be possible to demonstrate that the discretionary trust was not established with a purpose of avoiding the FAD rules. However, in the context of discretionary trusts, the application of the look-through rule remains uncertain. It should be noted that even where the CRIC is controlled by a Canadian resident trust and there is no FAD avoidance motive, there is no rule which simply "turns off" the application of the FAD rules. Rather, the look-through still requires the beneficial interest of the non-resident beneficiary to be valued relative to the beneficial interests of all other beneficiaries. This is intended to be more lenient than the rule which applies in the case of non-resident trusts (described below) whereunder the non-resident beneficiary is deemed to control 100% of the shares of the deemed corporation.[20] However, it arguably creates more uncertainty by requiring a valuation of each and every beneficial interest in a discretionary trust.

The original view of the Canada Revenue Agency (the "CRA") on the valuation of discretionary trust interests was that the fair market value of an interest in a discretionary trust was generally indeterminate due to the discretionary power of the trustee.[21] In 2003, the CRA shifted its position and stated:

> It would be unreasonable to conclude that the FMV of an interest in a discretionary trust holding property with significant value has no value simply because it is difficult to measure. In absence of any term of the trust that would direct the trustees to favour one beneficiary over another, the even-handed principle would suggest that value of each beneficiary's interest was approximately equal.[22]

Subsequently, the CRA stated that it "does not have a general valuation position or policy with respect to the valuation of an interest in a discretionary trust" and that "each situation must be judged on its own merits".[23]

The jurisprudence on the valuation of discretionary interests in trusts does not provide any obvious assistance to the taxpayer attempting to value each beneficial interest in a trust. The CRA's 2003 statement, quoted above, cited *Sagl v. Sagl*[24] in support of their "equal" valuation approach. *Sagl* was a family law case and was followed in *Kushnir v. Lowry*,[25] but more recent cases have taken very different approaches. For example, in *Dillon v. Dillon,*[26] the court held that the discretionary interest was "incapable of valuation" because of the discretionary nature of the trust which rendered the husband's interest as a "mere hope" and not an entitlement.[27] In *Mudronja v. Mudronja*[28], the court assigned a nominal value of $1 to an interest in a discretionary trust and in *Kochar v. Kochar*[29] the court determined the value as nil. Most recently, the Supreme Court of Canada in *S.A. v. Metro Vancouver Housing Corp*.[30] determined that an interest in a discretionary trust was not an asset for purposes of determining the beneficiary's entitlement to a means-tested rent subsidy.

Based on the above jurisprudence, and as acknowledged by the CRA, there is no single accepted methodology for valuing an interest in a discretionary trust. As a result, the application of the FAD rules to CRICs controlled by Canadian resident discretionary trusts with one or more non-resident beneficiaries will be a matter of significant uncertainty.

Parent is a Non-Resident Trust

The proposed change to the meaning of "parent" from "non-resident corporation" to "non-resident person" means that a CRIC will be subject to the FAD rules if it is controlled by a non-resident trust. However, the operation of the FAD rules may not be entirely straightforward, particularly in the case of non-resident discretionary trusts, due to the effect of the look-through rule in subsection 212.3(26).

The FAD rules appear to be intended to apply to a CRIC directly controlled by a non-resident trust or deemed to be controlled (indirectly) by a non-resident beneficiary as a result of the look-through rule in subsection 212.3(26). The question has been raised as to whether the look-through rule may be relieving in the case of a non-resident trust with no non-resident beneficiaries. In their May 24, 2019 submission to the Department of Finance, the CBA/CPA Joint Committee stated:

> While not entirely clear, we believe that under the proposals, a CRIC that is controlled by a non-resident trust would not be subject to the proposed FAD rules if the trust's controlling beneficiaries are residents of Canada, in accordance with subsection 212.3(15), as proposed to be amended.

Proposed subsection 212.3(15) provides limited relief from the application of the FAD rules in certain circumstances where ultimate control rests with a Canadian resident. However, it is not clear to us why the Joint Committee might have thought it would provide relief in a situation where a CRIC was controlled by a non-resident trust if the trust's beneficiaries are residents of Canada. Proposed subsection 212.3(15) will provide relief in the following circumstances:

(i) where the CRIC is controlled by more than one non-resident person by virtue of tiered ownership, the non-resident person or persons controlling the immediate parent are deemed not to control the CRIC – note this does not relieve the CRIC from the application of the FAD rules, it just clarifies which parent is considered to have control;[31] and

(ii) where the CRIC is controlled by a non-resident corporation that is itself controlled by a Canadian resident corporation (provided the Canadian resident corporation is not controlled by non-residents) — this would not prevent a non-resident trust from being considered a non-resident person controlling a CRIC unless, perhaps, the controlling beneficiaries of the non-resident trust were Canadian resident corporations (who were not controlled by non-residents).[32]

It may be that the non-resident trust would not be considered to have control of the CRIC due to the effect of the look-through rule in proposed subsection 212.3(26), following the Federal Court of Appeal decision in *Parthenon Investments*.[33] In that case, the Federal Court of Appeal disregarded the mid-tier control of a corporation by a non-resident corporation, where the non-resident corporation was itself controlled by a Canadian resident. The effect of the decision was overridden by the enactment of subsection 256(6.1) which allowed for simultaneous control. Arguably, subsection 212.3(26) does not apply to deem a trust to be a corporation for purposes of subsection 256(6.1). In this case, it could be argued that the rule in *Parthenon Investments* applies for purposes of disregarding the mid-tier control by the non-resident trust. If the above analysis is correct, which is far from certain, it was almost certainly not intended by Finance.

Assuming the FAD rules permit simultaneous control of a CRIC by more than one "parent", i.e., both by the non-resident trust and by one or more non-resident beneficiaries, it will be necessary to determine to which parent a dividend is deemed to be paid. Fortunately, there is no risk of a deemed dividend being duplicated — in the case of more than one parent, proposed paragraph 212.3(2)(a) clearly divides the deemed dividend among the parents.[34] However, if both the beneficiaries and the trust itself are included in a "group of parents", the effect of the rule would be to treat all of the non-resident beneficiaries, and the trust itself, as owning all of the shares of the CRIC. This could lead to bizarre results, particularly when the trust and the beneficiaries are resident in different jurisdictions.[35] This result may be modified by proposed paragraph 212.3(15)(b). That provision provides that a non-resident person is deemed not to be a member of a particular group of non-resident persons not dealing at arm's length that controls the CRIC if the non-resident person is a member of the group "solely because it controls, or is a member of a group that controls, another member of the particular group." In this case, the beneficiaries of the trust are deemed to control the trust by virtue of the look-through rule in subsection 212.3(26). As such, they may be considered to be members of the particular group because they control the trust (another member of the particular group). However, they also control the CRIC and, as such, it is not clear that they are members of the group solely because they control the trust.[36]

Parent is a Deemed Resident Trust

A non-resident trust may be deemed resident in Canada for certain purposes of the Act, by virtue of section 94.[37] The application of the proposed FAD rules must be considered where a CRIC is controlled by a deemed resident trust because section 94 does not deem such a trust to be resident in Canada for all purposes of the Act.

Subparagraph 94(3)(a)(viii) deems a non-resident trust to be resident in Canada for purposes of "determining the liability of the trust for tax under … Part XIII on amounts paid or credited… to the trust." The FAD rules are contained in Part XIII, but section 94 does not deem the non-resident trust to be resident in Canada for purposes of applying the FAD rules. For purposes of applying the FAD rules, a deemed resident trust will be considered a non-resident person. As such, the deemed resident trust may be considered a non-resident person that controls a CRIC, or a member of a group of non-resident persons who do not deal at arm's length who controls the CRIC. This would give rise to the potential application of the FAD rules to the extent the CRIC makes an investment in a FA.

In the event a CRIC is deemed to pay a dividend to the deemed resident trust, the trust will not be liable for Part XIII tax on the amount of the dividend, because the trust is deemed resident in Canada for purposes of determining the liability of the trust for tax under Part XIII on amounts paid or credited to the trust. Subsection 212(2) imposes a tax under Part XIII only on non-resident persons who receive (or are deemed to receive) a dividend from a CRIC.

However, paragraph 94(4)(c) provides that a deemed resident trust is not deemed resident in Canada for purposes of determining the liability of a person that would arise under section 215. Section 215 imposes the withholding and remittance obligation on the payor of the dividend (or deemed payor of the deemed dividend).

The effect of these rules appears to be that the FAD rules impose a withholding and remittance obligation on the CRIC in the case of a dividend deemed to be paid to a deemed resident trust. The deemed resident trust would not be liable for the tax and could claim a refund for the withheld tax when it files its T3 tax return. This is subject to the discussions above in respect of non-resident beneficiaries.

Conclusion and Takeaway

The extension of the FAD rules to CRICs controlled by non-resident individuals, and especially to CRICs controlled by trusts, including Canadian resident trusts, provide another reason for private companies to obtain careful income tax advice before making foreign investments. In their counter-intuitive application and mind-boggling complexity, the FAD rules create the conditions for a serious and costly tax trap for the unwary.

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[1] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "Act"). All statutory references herein are references to the Act.

[2] Canada, Department of Finance, July 30, 2019 draft legislation (intended for the 2019 Budget second bill).

[3] Paragraph 212.3(1)(b) requires a CRIC to be controlled by a non-resident parent and for one of the below requirements to be met: (i) the parent owns shares of the CRIC that give it 25% or more of the voting rights, or have a fair market value of 25% of all the shares of the CRIC; (ii) the investment is an acquisition of preferred shares of a subject corporation that is not a wholly-owned corporation; or (iii) under an arrangement, a person or partnership (other than the CRIC or a person related to the CRIC) has material risk of loss or opportunity for gain or profit in respect of a property reasonably related to the investment.

[4] Pursuant to subsection 212.3(10) this includes a share subscription or capital contribution by the CRIC in the FA, a loan from the CRIC to the FA or other acquisition of debt by the CRIC from the FA (subject to certain exceptions), any benefit conferred by the CRIC on the FA, including debt forgiveness and any obligation of the FA assumed by the CRIC or incurred by the CRIC on behalf of the FA.

This is not a complete list: the types of transactions which may be considered an "investment" are exceedingly broad. The FAD rules would also apply if the CRIC made an investment in a FA of a corporation that does not deal at arm's length with the CRIC.
[5] The definition of "foreign affiliate" is defined in subsection 95(1) in respect of a taxpayer resident in Canada (i.e., only a Canadian resident can have a foreign affiliate) and refers to a non-resident corporation under which the taxpayer holds a minimum specified percentage of the equity. The determination of foreign affiliate status is complex, but generally requires the Canadian resident to hold at least 1% of a class of shares of the non-resident corporation; and together with related persons, to own no less than 10% of a class of shares of the non-resident corporation.
[6] Pursuant to paragraph 212.3(2)(a).
[7] Pursuant to subsection 212(2).
[8] Pursuant to paragraph 212.3(7). The reduction of the PUC of the shares of the CRIC or related corporation reduces the ability of the parent to receive the return of its investment in the CRIC tax-free.
[9] Pursuant to subsection 212.3(16). This exception provides relief from the application of the FAD rules where the investment by the CRIC in a FA is demonstrated to be an investment of the CRIC and not of its parent.
[10] Pursuant to subsection 212.3(18). This exception provides for two situations where an investment made by a CRIC should be exempt from the application of the FAD rules: (i) a related party acquisition; and (ii) certain rollover transactions.
[11] For a detailed review of the FAD rules prior to the proposed amendments, see Ian Bradley, "International Tax Planning – Living with the Foreign Affiliate Dumping Rules", *Canadian Tax Journal* Issue No. 4 (2013) 1147 – 1166.
[12] Proposed paragraph 212.3(1)(b).
[13] Proposed paragraph 212.3(1)(b) stipulates that a group of non-residents not dealing at arm's length with each other is referred to as the "group of parents".
[14] Proposed paragraph 212.3(2)(a).
[15] Pursuant to proposed subsection 212.3(26).
[16] Proposed subparagraph 212.3(26)(a)(i).
[17] Pursuant to proposed subparagraph 212.3(26)(a)(ii).
[18] Pursuant to proposed paragraph 212.3(26)(c).
[19] Control includes indirect control: *Vineland Quarries & Crushed Stone Ltd. v. Minister of National Revenue* (1966), 66 D.T.C. 5092 (Can. Ex. Ct.), affirmed (1967), 67 D.T.C. 5283 (S.C.C.).
[20] In the original March 19, 2019 draft legislation which accompanied the 2019 federal budget materials, a non-resident beneficiary was deemed to own 100% of the shares of the deemed corporation regardless of any avoidance motive. The avoidance motive requirement was added in respect of Canadian resident trusts in the July 31, 2019 draft legislation.
[21] CRA Views, 9213470 – "Fair market value in a fully discretionary trust", September 1992.
[22] CRA Views, 2003-0181465 – "Fair market value of an interest in a discretionary trust", April 2003.
[23] CRA Views, 2004-0062291E5 – "Discretionary interest in a non-resident trust", March 2004.
[24] *Sagl v. Sagl*, 1997 CarswellOnt 2144, [1997] O.J. No. 2837 (Ont. Gen. Div.).
[25] *Kushnir v. Lowry*, 2004 CarswellOnt 530, [2004] O.J. No. 375 (Ont. S.C.J.).
[26] *Dillon v. Dillon*, 2014 ONSC 2236 (Ont. S.C.J.).
[27] *Ibid*. at para 293.
[28] *Mudronja v. Mudronja*, 2014 ONSC 6217 (Ont. S.C.J.).
[29] *Kochar v. Kochar*, 2015 ONSC 6650 (Ont. S.C.J.).
[30] *S.A. v. Metro Vancouver Housing Corp.*, 2019 SCC 4 (S.C.C.).
[31] Proposed subparagraph 212.3(15)(a)(i). The rule is clearly not intended to relieve from the application of the FAD rules as it does not apply if it would otherwise result in no non-resident person controlling the CRIC. A similar rule is contained in proposed subparagraph 212.3(15)(b) to clarify which non-resident person should be considered in control in tiered structures involving a group of non-resident persons.
[32] Proposed subparagraph 212.3(15)(a)(ii).
[33] *Parthenon Investments Ltd. v. R.*, [1997] 3 C.T.C. 152 (Fed. C.A.).
[34] Where there is more than one non-resident beneficiary of a non-resident discretionary trust, proposed subsection 212.3(26) will deem each beneficiary to control the CRIC. In this case, the CRIC is not controlled by one non-resident person but will be controlled by a group of non-resident persons. Proposed paragraph 212.3(2)(a) will prorate the amount of the dividend based on the fair market value of the shares of the CRIC that are held (indirectly, as a result of the deeming rule in subsection 212.3(26)) by the beneficiary. Although the discretionary beneficiary is deemed to own all of the shares, so is each other discretionary beneficiary. As such, the effect of the formula in paragraph 212.3(2)(a) would appear to be to divide the amount of the deemed dividend equally between each non-resident discretionary beneficiary.
[35] Consider a trust resident in a jurisdiction with which Canada does not have a Tax Treaty with three discretionary beneficiaries all residents in the United Kingdom. The deemed dividend would presumably, be subject to 15% withholding tax in respect of three-quarters of the dividend, and 25% withholding tax in respect of one-quarter of the dividend. We do not believe Finance intended

this result. It would be surprising if the Department of Finance were prepared to extend Treaty relief to dividends deemed paid to an offshore trust simply because the trust had beneficiaries resident in a Treaty jurisdiction.

[36] This interpretation of paragraph 212.3(15)(b) would treat the whole deemed dividend as paid to the trust, thereby avoiding any argument that the dividend is subject to Treaty relief on the basis of the residence of the beneficiaries.

[37] Section 94 applies to a non-resident trust if it has a "resident contributor" or a "resident beneficiary". The defined term "resident beneficiary" requires the non-resident trust to have a "connected contributor". Generally speaking, these rules require a contribution to be made to the trust by a person who is or was a resident of Canada.

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