CANADA AND THE U.S. – TWO COUNTRIES, ONE BORDER, DIVERGENT RULES ON WEALTH TRANSFERS

Author
Andreas A. Apostolides

Tags
Canada
Canadian Inheritance Planning
Capital Gains at Death
Departure Tax
Pipeline
P.U.C.

INTRODUCTION[1]

> *"ἅπανθ᾽ ὁ μακρὸς κἀναρίθμητος χρόνος φύει τ᾽ ἄδηλα καὶ φανέντα κρύπτεται. . . κοὐκ ἔστ᾽ ἄελπτον οὐδέν[.]"*
>
> – Sophocles, *Aias*[2]
>
> *"[Darling,] it's a Mr. Death or something [at the door] – he's come about the. . . reaping? I'm not sure we need any of that…"*
>
> – Monty Python, *The Meaning of Life* (1983)

Like a handful of industrialized countries,[3] Canada has no estate or inheritance tax, but the adage about death and taxes being inevitable is just as true as true for Canada as for anywhere else since Canadian capital gains tax applies to all transfers, including a deemed disposition of all one's assets at death.

In a prior *Insights* article, we focused on the unpredictable U.S. tax consequences when foreign trusts acquire a U.S. beneficiary;[4] we now look at U.S. income and estate tax implications of a common Canadian wealth transfer planning technique referred to as a pipeline. This article is designed to introduce readers to the structure in simple terms, including the inside/outside basis disparity created for heirs who acquire corporate stock from a Canadian decedent, and how the pipeline strategy ensures that a post-death distribution to a shareholder does not attract further Canadian tax.

---

1 The author thanks his colleagues, Henry Shew of Our Family Office Inc. in Toronto, as well as Nina Krauthamer and Stanley Ruchelman for their helpful comments and suggestions.

2 The quote by Ajax, the hero of the Trojan war in a play by Sophocles first performed in ca. 442 B.C., means that time brings all things out of darkness and buries them again, and so there is nothing that humans should not expect.

3 *E.g.*, Australia, New Zealand, Estonia, Mexico, Hong Kong/Macau, Singapore, Luxembourg, Norway, Portugal, Serbia, Slovakia, Sweden, Israel. All references to the "Code" and the sections thereof are to the U.S. Internal Revenue Code of 1986, as amended, and to Treasury Regulations, or "Treas. Reg. §" to applicable sections of the regulations enacted thereunder; unless specifically referenced as Canadian currency (C$), figures referred to by "$" herein refer to U.S. dollars.

4 See Nina Krauthamer, "Help – My Exclusively Foreign Trust Now Has a U.S. Beneficiary! What Are the Issues a Trustee Will Now Face in 2020?" *Insights* Vol. 7, No. 3. This is an updated version of the same article previously published by the American Bar Association in 2013.

We begin with a review of the U.S. and Canadian taxes applicable at death, in addition to the U.S.-Canada Income Tax Treaty (the "Treaty") which covers both income and estate taxes.[5]

BACKGROUND OF U.S. AND CANADIAN TAXATION OF DEATH — WHO OWES WHAT, WHEN?

Except as otherwise explicitly provided, the rules and rates discussed are applicable to individuals.

U.S. Income Tax

The U.S. currently taxes the income of its citizens and residents at progressive rates up to 37% on worldwide income, plus net investment income tax of 3.8% on select categories of passive income.[6]

State income tax is imposed on top of Federal tax on a flat rate or a graduated rate, typically not exceeding 10%.[7] In comparison to Canada's provinces and territories, which have a rule of convenience treating an individual as a full-year "factual resident" of the province where they reside on December 31 of a year,[8] an individual in the U.S. who moves from one state to another in the middle of the year is apt to be treated as a part-year resident in each of the states. Part-year tax returns will be filed in both states.

Nonresident, noncitizen ("N.R.N.C.") individuals are taxed only on U.S.-source fixed and determinable annual and periodic income[9] and effectively connected business income, which in certain circumstances may include foreign source income.[10]

As with individuals, U.S. estates must compute gross and net taxable income. For income tax purposes, an estate is domestic if it is not a foreign estate;[11] the Code provides that an estate is a foreign estate if its income is from sources outside the

---

5 The Convention Between the United States of America and Canada With Respect to Taxes on Income and Capital. See art. XXIX B (Taxes Imposed by Reason of Death), added by art. 19 of Protocol III, dated March 17, 1995.

6 In 2022, for a single filer the 37% maximum rate applies only to taxable income over $539,900, and for a married couple filing a joint tax return, $647,850.

7 There are exceptions. California's income tax tops out at a rate of 12.3%. New Hampshire taxes dividends and interest, only. Approximately eight states have no income tax, while another eleven permit counties and cities to impose income taxes. For New York City residents, the combined Federal, State and City income tax burden can reach close to 60%. See Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2021." Generally, double taxation is avoided where the same income is taxed by more than one state by claiming a tax credit in the state of residence. Where each of wo states claim that an individual is a resident of two states, there may be no remedy for double taxation of income derived from intangible property.

8 *"Your province or territory of residence . . ."*

9 Code §§861 and 871(a).

10 Code §§864(c)(4) and 871(b).

11 Code §7701(a)(30)(D).

United States not effectively connected with the conduct of a trade or business inside the United States.[12] The term "estate" is not statutorily defined.[13] Even if more than one will and multiple administrations are involved, the estate remains a unitary estate and must either be domestic or foreign, so cannot be both;[14] in addition, when the decedent is N.R.N.C. and the estate contains significant U.S. assets, determining whether it is domestic or a foreign may require careful analysis of the extent and duration of the U.S. administrator's duties.[15]

Three major aspects to consider relate to

- where the assets are located,
- the country in which the domiciliary administration is located, and
- the nationality and residency of the personal representative.[16]

In determining its net taxable income, a U.S. estate may claim a deduction for current distributions to beneficiaries,[17] who must pay tax on the income and gains embedded in the distribution as if received directly from the source, rather than through the trust.[18] If the estate is foreign and all income is from foreign sources, U.S. beneficiaries may owe no tax on distributions, depending on whether the distributions are out of what is referred to as "distributable net income," and the timing thereof.[19]

Typically, property distributions from an estate are free of income or inheritances taxes, although they must be reported if in excess of $100,000 from any single source that is not a U.S. person.[20] A special form is used, which is filed with the I.R.S. center in Ogden, Utah.[21] A U.S. recipient can face severe penalties if the inheritance is not timely reported or properly reported.[22]

---

12 Code §7701(a)(31)(A).

13 In *Commr. v. Beebe,* the First Circuit Court of Appeals has defined it as "property of all kinds held, under the provisions of the will, by any legal representative appointed by the probate court, by whatever name he may be called, whose duty it is to keep safely such property, and finally to distribute it under the direction of the probate court[.]" 67 F.2d 662, 664 (1st Cir. 1933), aff'g 26 B.T.A. 190 (1932), nonacq., XI-2 C.B. 11.

14 See Rev. Rul. 64-307, 1964-2 C.B. 163 (involving two wills in two separate countries).

15 Rev. Rul. 62-154, 1962-2 C.B. 148, concluding that principles devised for "determining whether a trust is domestic or foreign, resident or nonresident, have equal application to questions concerning alienage and residence of estates[.]"

16 Nationality of the decedent and beneficiaries is not determinative. See Rev. Rul. 81-112, 1981-1 C.B. 598.

17 Code §661.

18 Code §662. Net investment income tax of 3.8% may also be applicable under Treas. Reg. §1.1411-3(e)(3)(ii).

19 Cf. Code §§643(a) & 662.

20 Code §6039F.

21 Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

22 The penalty is imposed at the rate of 5% per month of the unreported amount and is capped at 25%.

Qualifying long-term capital gain arising with respect to stock of a foreign corporation owned for longer than one year may be eligible for a reduced Federal income rate of tax that does not exceed 20%. The reduced rate may also apply to qualified dividends paid out of the corporation's earnings and profits.[23]

U.S. Gift & Estate Tax

U.S. Federal gift and estate taxes are excise or transfer taxes imposed on the fair value of transferred property, starting at 18% and swiftly rising to 40%. For U.S. citizens and domiciled individuals, the gross estate is reduced for administration and funeral expenses, claims against the estate, and certain unpaid mortgages on property included in the estate.[24] Tentative tax is computed at highly graduated rates,[25] but a unified credit is allowed, which is designed to offset tax on a lifetime exemption amount.[26] It applies against both estate and gift taxes and is adjusted each year to reflect inflation. The credit currently applies to the tax on amounts up to $12.06 million. Because the benefit is in the form of a credit rather than a deduction, the maximum rate of 40% applies to all amounts given away during life and at death once the credit has been fully utilized. The average rate of tax payable by U.S. estates in recent years after the credit and all deductions are factored in may be close to 17%.[27] In recent years, just over one half of one percent of U.S. decedents' death results in a taxable estate tax return being filed, and the Federal government collects less than 1% of its gross tax receipts from Federal excise taxes.[28]

The estate of an N.R.N.C. decedent enjoys a credit against the estate tax, but it is limited to the estate tax on $60,000,[29] except as provided by treaty.[30] No credit is allowed to reduce gift tax. While the estate of an N.R.N.C. individual is entitled to reduce the estate tax base for the claims and expenses listed above, direct tracing is not allowed. Rather, all assets and all claims and expenses must be reported on a global basis in a U.S. estate tax return. Only a proportional amount of global claims and expenses are allowed, reflecting the U.S. portion of the value of global assets.[31] Moreover, the deduction is allowed only if the executor files a true and accurate U.S. estate tax return[32] that specifies global assets, global values, and

---

23 Code §1(h)(11). The foreign corporation must be eligible for benefits under an income tax treaty with the U.S. including information-exchange program, or its shares must be readily tradable on an established securities market in the U.S.

24 Code §2053.

25 The first $1,000,000 of taxable value taxed at graduated rates totaling in $345,800. Additional taxable value is taxed at a flat 40% rate.

26 Code §2010.

27 According to the Americans for Tax Fairness, citing the Tax Policy Center of the Urban Institute & Brookings Institution.

28 See Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-52-15), March 16, 2015, at pp. 25, 28, available at www.jct.gov. In 1940, the percentage of total receipts was 5.4%.

29 Code §2102.

30 See, for example, paragraph 2 of Article XXIXB (Taxes Imposed by Reason of Death) of the Treaty.

31 Code §2106(b).

32 Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return.*

global expenses, thereby allowing the I.R.S. an opportunity to verify the percentage of global expenses claimed.

Interspousal gifts and bequests to a U.S. citizen spouse benefit from a 100% marital deduction, meaning they are exempt from Federal transfer tax, and the couple enjoys a combined credit of $24.12 million as of 2022.[33] The combined credit will increase with inflation. No gift tax marital deduction is allowed if the donee spouse is not a U.S. citizen. However, this is somewhat offset by the expanded annual exclusion, discussed below.

U.S. transfer taxes apply as follows:

- For donors who are N.R.N.C. individuals, U.S. gift tax applies only to transfers of U.S. situs real property and tangible personal property. Excluded are gifts of intangible property such as shares in U.S. corporations.
- For decedents who are N.R.N.C. individuals at death, U.S. estate tax applies to the extent it includes U.S. situs real property and tangible personal property, plus U.S. situs intangible property, which is not statutorily defined but includes shares in a U.S. corporation. Excluded are items of portfolio debt,[34] short-term original issue discount ("O.I.D.") obligations,[35] U.S. bank accounts not connected with a trade or business, life insurance policies owned by the N.R.N.C. individual,[36] U.S. Treasury securities, and U.S. government agency securities.[37]
- For U.S. donors and decedents, all gifts and bequests are subject to gift or estate tax, and benefit from the unified credit.

An exclusion from gift tax applies to all donors for the first $16,000 given to each separate recipient, each per year.[38] The amount is indexed for inflation. Spouses may elect to jointly split gifts even if made from the funds of just one of the spouses.[39]

In comparison to the objective residency test applicable for determining individuals' U.S. income tax liability,[40] or the multiple considerations discussed earlier which are factored into the decision as to whether an estate is domestic or foreign for Federal income tax purposes, the test of residency applicable for U.S. gift and estate tax is domicile – a squishy, court-made test that looks to one's permanent abode, where one intends to return when one is away.[41] While a N.R.N.C. decedent's estate

---

33 Gifts to a N.R.N.C. spouse benefit from a much smaller exemption of just $164,000 (on top of the $16,000 exclusion applicable to gifts to all recipients). Amounts are indexed for inflation and applicable for 2022.

34 Debt of a domestic obligor in which the N.R.N.C. creditor owns greater than 10% equity interests does not qualify as items of portfolio debt.

35 Code §2105(b)(4).

36 Code §2105(a).

37 Code §2105(b).

38 Indexed for inflation amount under Code §2503(b) applicable for 2022.

39 Code §2513.

40 For income tax purposes, a non-citizen individual is a resident if green card test or the substantial presence test is met. Both are objective tests. Code §7701(b).

41 Code §2001(a); Treas. Reg. §20.0-1(b).

generally includes the same items as those of a U.S. domiciliary, only U.S. situs real and tangible property are included in the U.S. taxable estate.[42]

When property is transferred by gift, the U.S. tax basis of property in the hands of a donee is generally a carryover of the donor's basis.[43] When property is inherited, the U.S. tax basis generally equal to its fair market value on the date of decedent's death.[44]

Except for assets disposed of by the estate, which are valued using their disposition price, the Code permits the estate's representative to irrevocably elect to value the assets and compute tax based on their value six months after decedent's death.[45]

A special inheritance tax is imposed on a U.S. recipient of a gift or bequest from a covered expatriate meaning an individual who is no longer a U.S. citizen or a long-term permanent resident.[46]

The trio of tax regimes is completed by the generation-skipping transfer tax ("G.S.T."), beyond the scope of this article, applicable when a transferor seeks to avoid gift or estate tax by skipping generations.

"Canada does not have an estate or gift tax. However, gifts and bequests of certain appreciated capital property trigger a deemed disposition of the property for its fair market value, giving rise to capital gain to the donor in the case of a gift or the decedent if the property is held until the end of life."

Canada Income Tax

Canada does not have an estate or gift tax. However, gifts and bequests of certain appreciated capital property trigger a deemed disposition of the property for its fair market value, giving rise to capital gain to the donor in the case of a gift or the decedent if the property is held until the end of life. Canada taxes resident individuals on worldwide income at progressive rates that top out between 48% to 54%, depending on the province.[47] Nonresidents are subject to tax at identical rates on Canadian source income, which includes gain from the disposition of Canadian real property.

For Canadian income tax purposes, only one-half of net capital gain is included in taxable income. If the disposition results in a loss, the net capital loss can be carried back three years and forward indefinitely. Thus, for capital assets, the deemed disposition at death usually gives rise to taxable gain on one-half of the amount of gain recognized.

Rollover treatment is provided, however, for capital assets transferred to a spouse by gift or bequest. A special incentive applicable to "qualified property" also exempts up to C$913,630 of cumulative lifetime capital gains from taxable income.[48] Because a nonresident is taxed on disposition of Canadian-situs real property, and because rollover treatment is inapplicable unless both spouses are Canadian resident at the

---

42 Code §2103. See Treas. Reg. §20.2104-1(a)(1) & (2).

43 Code §1015(a).

44 Code §1014(a)(1).

45 Code §2032(a).

46 Code §2801.

47 The highest Federal tax rate is 33% and applies to taxable income over C$216,511 (in 2022). Provincial income taxes also apply based progressive rate structures of their own.

48 Indexed-for-inflation figure applicable in 2022. An exemption from deemed disposition treatment also applies to the sale of a principal residence.

time of decedent's death, the deemed disposition of such real property will give rise to tax.[49] Where a deemed disposition triggers tax the asset is acquired with basis stepped up to its fair market value thereafter.

Residency for Canadian tax is established under either of two alternative tests:

- The first is based on a common-law concept of residence, which looks to primary ties, such as having a home available, close family members living in Canada, and spending significant time in Canada, and secondary ties, such as club memberships and hobbies. It also considers ties to other countries. This test can be thought of as a center-of-vital interest test.
- The second is an objective test known as "the sojourning rule," similar to the U.S. substantial presence test, which asks whether the individual spent 183 days in Canada during the calendar year.

Canadian-resident recipients of a bequest generally have no taxable income and owe no tax upon receipt of the assets from the estate; however, if the assets are shares of a corporation, Canadian tax law principles treat the distribution of assets from the corporation as a further taxable event.

While the disposition technically occurs the instant before the property leaves the estate's hands, the tax reduces the value of the assets received by the beneficiaries. Generally, capital assets, such as shares of a corporation, already have been taxed on the date of death and the basis has been stepped up. As a result, there likely is no further appreciation to be taxed. However, a subsequent distribution of the assets may crystallize additional appreciation, which will be taxed. Nonetheless, the additional gain does not apply on distributions to Canadian resident beneficiaries. Instead, the law provides rollover treatment,[50] and the appreciation is preserved for future tax in their hands. Favorable rollover treatment does not extend to a nonresident beneficiary.[51] As a result, the estate is required to compute and withhold tax on the portion of any appreciation belonging to a nonresident beneficiary.

While not dealt with at length in this article, it's good to keep in mind that Canada imposes a departure tax, also involving the deemed disposition of certain categories of assets, when individuals give up Canadian tax residence. Also, to be kept in mind, some provinces impose prohibitive probate taxes, computed on gross estate value.

TREATY

As with all U.S. treaties, the Saving Clause preserves the right of the U.S. to tax U.S. citizens and residents determined under the Treaty as if the Treaty were not in effect. The Saving Clause typically is subject to certain exceptions, and a common exception relates to the foreign tax credit.

In the case of a U.S. citizen who is resident in Canada, the Treaty permits the estate of the deceased individual to claim a credit against U.S. estate tax for Canadian

---

49 See AGtax, (Feb. 12, 2014).

50 Subsection 107(2) of the Canadian Income Tax Act.

51 Subsection 107(2.1) of the Canadian Income Tax Act.

capital gains tax at death.[52] In each case, provincial death duties and probate taxes should be considered carefully.[53] Even where the U.S. or Canada might allow a credit under the Treaty for such taxes, states and provinces generally would not follow the national treatment.

For individuals whose domicile lies in Canada, the following provisions may be extremely valuable:

- A direct transfer to a surviving spouse is eligible for a full marital deduction in the U.S., even if the recipient is not a U.S. citizen, provided a spouse would have been eligible for the credit under U.S. domestic law[54]
- A Canadian decedent with a U.S. taxable estate, because, for example, he owned a condominium unit in Florida or New York, is permitted the benefit of a unified credit against the estate tax on his U.S. property. For this purpose, the amount of the unified credit is prorated based to match the portion of the value of the decedent's global assets that comprised of U.S. situs assets[55]

To illustrate, suppose a Canadian decedent owns a New York City apartment worth \$3 million and Canadian assets worth U.S.D.\$9 million after conversion of non-U.S. assets from Canadian dollars to U.S. dollars. Assuming no lifetime gifts have been made involving U.S. real property or U.S. situs tangible personal property, the *pro rata* U.S. unified credit is computed as:

$$\frac{\$3{,}000{,}000}{\$12{,}000{,}000} \times \begin{array}{c}\text{credit on}\\ \$12{,}060{,}000\end{array} = \begin{array}{c}\text{credit on}\\ \$3{,}015{,}000\end{array}$$

Here, there should be enough available unified credit to cover 100% of the U.S. estate tax imposed on the New York City apartment. Absent an extension, Federal Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return Estate of Nonresident not a Citizen of the United States*[56] must also be filed within nine months of death where the value of U.S. situs assets exceeds \$60,000, a triggering amount that is unaffected by the Treaty.

---

52 See Code §2014, which in determining the allowable credit for foreign death taxes contains a proration approach similar to that used here.

53 Treaty, art. XXIV(7) states that income taxes paid or accrued to a Contracting State includes taxes owing to political subdivision if imposed in a manner that is not inconsistent with the provisions of the Convention and substantially similar to the Federal taxes addressed by the Convention. This rule matches U.S. domestic law which allows a foreign tax credit for income taxes imposed by a foreign country and its subdivisions. Treas. Reg. §1.901-2(g)(2) prior to March 7, 2022, and §1.901-2(g)(1) beginning as of March 7, 2022.

54 Treaty, art. XXIX B(3) & (4). The election made by executor filing a U.S. Federal estate tax return and irrevocably waiving the benefit of the domestic marital deduction, provided in addition that (a) the property passes to the surviving spouse within the meaning of U.S. domestic law, and would have qualified for marital deduction if the surviving spouse was a U.S. citizen, (b) the decedent was a resident of either the U.S. or Canada, or a citizen of the U.S. at death, (c) the surviving spouse is a resident of either the U.S. or Canada at the time of decedent's death, and (d) if both were U.S. residents on the date of decedent's death, at least one was a citizen of Canada.

55 Treaty art. XXIX B(2)(a) & (b).

56 United States Estate (and Generation-Skipping Transfer) Tax Return Estate of Nonresident not a Citizen of the United States.

The benefit of the Treaty is limited to U.S. estate tax imposed on transfers at death. It does not apply to lifetime gifts made while a Canadian tax resident who is not a U.S. citizen is resident in Canada.

In the example above, estate taxes imposed by states must not be ignored. In the above example, estate tax exposure may exist in New York State. State estate tax applies at graduated rates of up to 16% to resident decedents. The tax also applies to nonresidents holding New York situs real property and tangible personal property. However, the estate tax base looks only to New York State situs property.

If the decedent holds property not in excess of a basic exclusion amount, currently set at $6.11 million,[57] no estate tax is due. However, if the basic exemption is exceeded by 5% or more, the exclusion is completely eliminated.

Other Income – Article XXII

When a Canadian estate distributes appreciated capital property to a U.S. heir, the distribution is a deemed disposition. Under paragraph 1 of Article XII (Other Income) of the Treaty, both Canada and the U.S. may tax the other income when the taxpayer is a resident on one country and the income arises in the other country. When the income takes the form of a distribution by a trust or estate in one country (Canada) that is made to a resident of the other country (the U.S.), the tax in the source country (Canada) is capped at 15% of the gross amount paid. Because the taxable portion of the capital gain is reduced by 50%, the Canadian effective tax rate is 7.5%.

Other Matters

Although the Treaty addresses double taxation of cross border income through the allowance of a foreign tax credit, an individual departing Canada likely will face departure tax on certain categories of property. At that point, double taxation will not be incurred because a tax event exists only in Canada. In future years, the same asset may be sold while the individual is a resident of another country. Unless the other country allows the individual a step-up in basis for the property, the very same gain may be taxed a second time. Worse, the Canadian tax will have been paid prior to the establishment of tax residence in the new country. Consequently, it would not be surprising for tax authorities in the new country to assert that the Canadian departure tax paid prior to arrival is not available to provide relief.

In the context of a U.S. citizen who is a Canadian resident who returns to the U.S., the Treaty allows the individual to elect to treat the departure from Canada as a disposition for U.S. tax purposes. This accelerates the taxable event in the U.S. to the tax period in Canada. As a result, the individual will compute gain, source the gain in Canada, compute U.S. tax, claim a foreign tax credit for the Canadian tax paid, and obtain a step-up in basis when the asset is actually sold in a later year.[58]

Although the Treaty does not apply to gift tax, if a Canadian donor makes a gift to a U.S. tax resident, the same election apparently can be made, to treat a Canadian

---

57 Indexed for inflation amount applicable in 2022.

58 Treaty, art. XIII(7), added by Protocol IV, Sept. 21, 2007.

deemed disposition as a U.S. disposition (no U.S. tax due), so the donee can acquire the gift with basis stepped up to its fair market value.[59]

If payments or income items associated with a treaty claim exceed $100,000 and a U.S. Federal income tax return for the year in question is filed, then Form 8833, *Treaty-Based Return Position Disclosure* may be required to be attached.[60]

CANADIAN POST-MORTEM TAX PLANNING

Post-mortem Canadian tax planning relating to inheritance of shares in Canadian closely held corporations focuses on addressing an unintended glitch when a death triggers a deemed disposition of corporate shares (and step-up in basis at the level of the shareholder) in Canada but there is not a corresponding event inside the corporation permitting heirs to receive distributions free of Canadian income tax. The missing piece of the puzzle is referred to as paid-up capital ("P.U.C."). As a result, when subsequent distributions are received on the shares held by the heirs they will be fully taxed as a dividend (ordinary income) in their hands.

The pipeline addresses the P.U.C. deficiency through the issuance of a promissory note, which allows shareholders (or the estate) to receive the underlying asset without paying an additional level of tax. It is one of two techniques devised to address a problem that Canadian practitioners understand as an inside/outside basis disparity issue. The other technique, referred to as a subsection 164(6) loss carryback,[61] eliminates the decedent's share-level tax. It requires Can-Co to redeem high-basis shares, generating a loss which is carried back to the decedent's terminal tax return, erasing the capital gain that resulted in the increased basis to begin with. While Canada generally permits amended returns to be filed for a period of up to 10 years, a loss carryback must instead be claimed within one year.[62] Although either technique may be available with respect to the same entity, it generally would not make any sense to do both – each involves accepting tax at one level to avoid it at another; if within the one-year window to carryback, the adviser can assist in selecting the best approach to address the two-tier issue.

To understand how the pipeline addresses this inadvertent glitch, we review an example, involving a Canadian decedent, a U.S. heir ("A") and a Canadian heir ("B"), and the issuance of a promissory note to alleviate the P.U.C.-related problem.

---

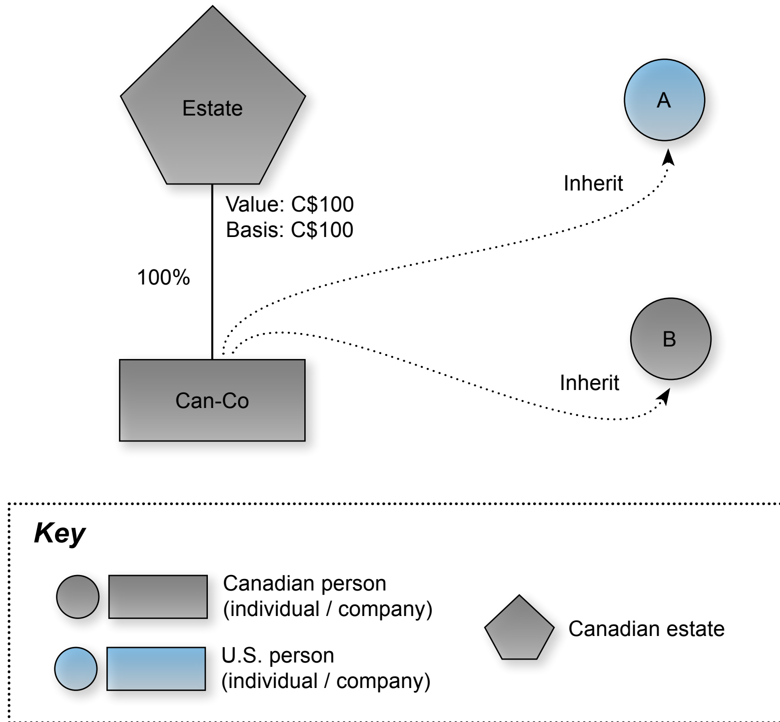
59 See Department of the Treasury Technical Explanation of the Protocol, art. 8(3), dated July 10, 2008.

60 Treas. Reg. §301.6114-1(a)(1) & (c)(2); in Canada there are a variety of forms which may be required, and which in each case should be checked with a Canadian practitioner.

61 This refers to the Canadian Income Tax Act provision permitting the carryback. For a fuller description see Cadesky Tax, "Post Mortem Pipeline Transactions."

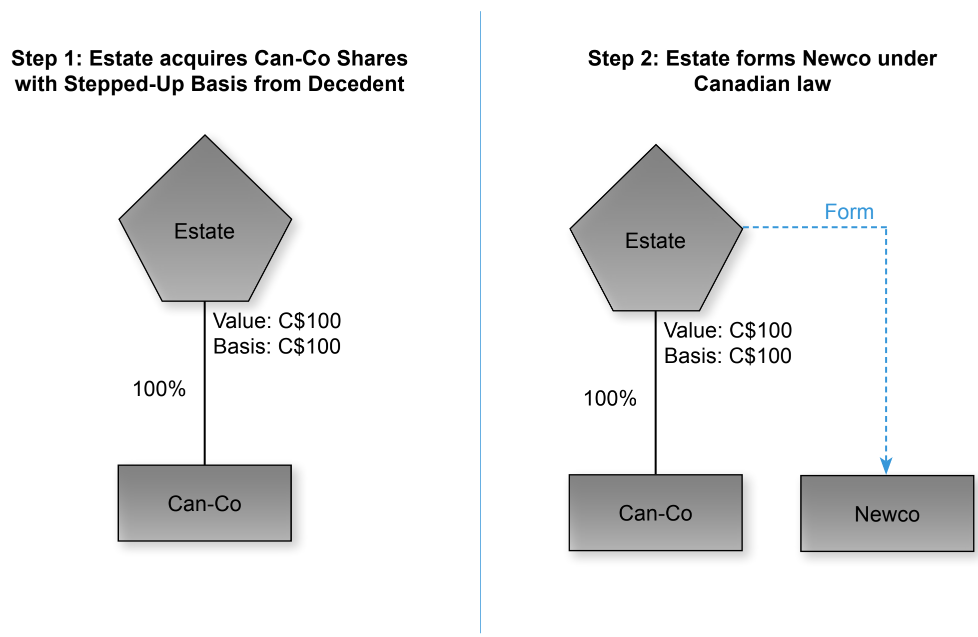
62 This is not the same as the general three-year loss carryback rule. The condition to perform a subsection 164(6) transaction is that the estate (or the graduated rate estate) has to do the redemption within the first year of the estate's taxation year.

Figure 1 – No Planning

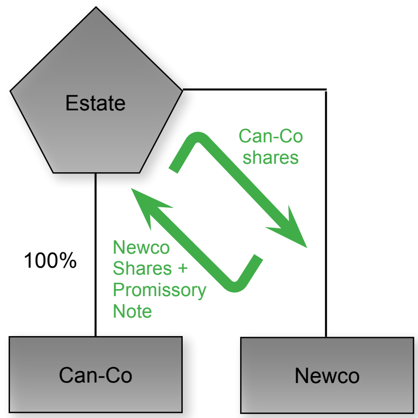


The pipeline is shown below.

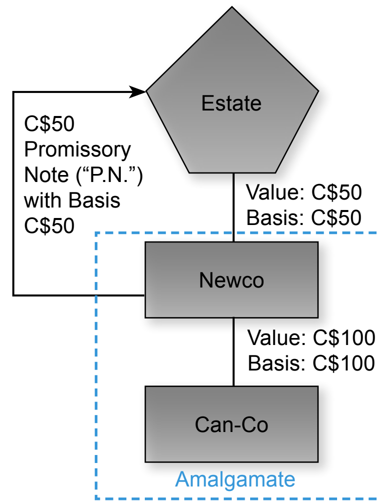
Figure 2 – How to Do a Pipeline in 6 Easy Steps…



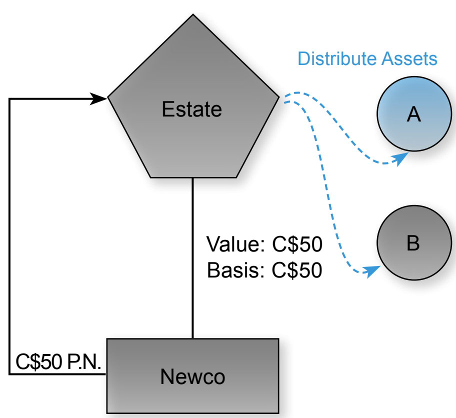
Step 3: Estate transfers Can-Co to Newco in Rollover Exchange for Consideration that is Part Stock and Part Promissory Note



Step 4: Can-Co and Newco are Amalgamated Under Canada Law

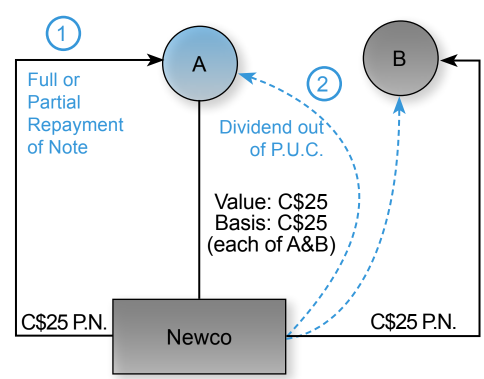


Step 5: Newco Distributes Assets to the Beneficiaries



* *On or prior to the distribution, the promissory note can be reissued as two smaller notes*

Step 6: Ways for Beneficiaries to Receive Value from Newco (Mostly) Free of Further Canadian Tax: (1) Repayment of Note or (2) Distribution (if out of P.U.C.)



The Fix Involves Doing the Following:

1. The estate owns decedent's Can-Co's shares with basis equal to their fair market value.

2. The estate forms a new legal entity ("Newco") under Canadian law, which may be capitalized partly with debt and partly equity – here we assume 50/50.

3. Newco acquires all of Can-Co's outstanding shares from the estate in exchange for a promissory note with face value C$50 and its own common voting stock, which is treated as a partial tax-free rollover exchange.

4. Newco and Can-Co may be amalgamated under Canadian law; The basis of the amalgamated Newco remains at C$50 and Newco continues to owe the Estate a C$50 promissory note.[63]

5. The estate distributes both the note and shares to the heirs, A and B, without a taxable inclusion to the Canadians (B); no U.S. income or estate tax results to A. If as here, there are two beneficiaries, the C$50 promissory note must be issued as two smaller notes with a face value of C$25.

6. At the shareholders' option, Newco may repay its notes. The shares will continue to be in high basis, but with minimal P.U.C.[64]

TAX CONSEQUENCES FOR A U.S. HEIR

While the pipeline will help to address the Canadian two-tier tax problem, now that the heirs have received the stock, what other U.S. and Canadian tax rules should be kept in mind?

Receiving the bequest of Canadian corporate stock in the U.S. won't directly give rise to U.S. tax, however there are a number of considerations and caveats, some of which are listed below. And, apart from receiving the dividends paid by Newco, and considering the U.S. and Canadian tax rules applicable, there are U.S. anti-deferral tax regimes to consider – these may treat A, the U.S. heir, as owning a portion of Newco's stock from a date earlier than when the bequest is received, during the pendency of the Canadian estate. The anti-deferral regimes may not only require additional U.S. reporting by A to the I.R.S., but also give rise to actual income inclusions.

There are also U.S. reporting obligations at the time the stock is actually received by A, which can be prohibitive to get wrong.

A should keep in mind at a minimum the following rules.

---

63 An alternative variant of the pipeline transaction has Can-Co redeem stock generating distributable surplus, which ultimately may give rise to P.U.C.

64 Canadian tax practitioners are generally aware of the potential risk that subsection 84(2) can apply to pipeline transactions. Essentially, subsection 84(2) may deem the tax-free nature of the repayment of the promissory note into deemed dividends. The Canada Revenue Agency has released administrative guidelines that allow pipeline transactions not to fall under subsection 84(2) as long as certain steps have taken place. These steps include running the operating business for at least one year, and only progressively repaying the promissory notes.

Canadian Tax

Estate Withholding on Subsequent Appreciation

While Canadian resident heirs are eligible for rollover treatment with respect to capital appreciation at the time the estate distributes the assets, A is not; thus, the estate is required to withhold from A's portion an amount sufficient to cover Canadian capital gain tax at a rate of 7.5%. Suppose Newco is initially worth C$50 on the date of death, and has appreciated by 20% by Step 5, then it is worth C$60, meaning C$10 of appreciation will be allocated 50/50 between A and B; A's 7.5% tax on C$5 will be C$0.375. Practically, it may be easiest for the U.S. beneficiary to provide a personal note to the estate and pay the C$0.375 once Newco makes any payment to A. Though, timing is of the essence because the withholding tax is due on the 15th of the following month of the distribution.

Income Tax Act, Subsection 212.1(6) Look-Thru Rule

Another lurking Canadian tax trap relates to a special provision of the Income Tax Act referred to as section 212.1, enacted to address certain cross-border "surplus stripping" transactions, whereby nonresident shareholders succeeded in extracting earnings from Canadian corporations in excess of P.U.C. without any Canadian tax. In its 2018 Budget, the Canadian government proposed a new look-through rule under subsection 212.1(6), which has the effect of attributing to any nonresident beneficiaries all activity of the estate during the administration period; through interaction with other provisions of the Income Tax Act, the result is that – in the facts above – if Newco's note (A's portion, worth C$25) exceeds A's P.U.C. (which would be essentially nil) such amount would be treated as an ordinary dividend out of Newco's earnings and profits to A, and A would be taxed; in this case, as A is American, the Treaty provides a beneficial 15% withholding rate rather than the maximum 40-49% domestic rate for non-eligible dividends.[65]

As it is understood that the Department of Finance is apprised of this unintended consequence and will not enforce the look-through rule for routine pipeline planning,[66] it is possible for A to avoid this problem, but it's strongly advisable to obtain a seasoned Canadian tax adviser's input before implementing the transaction to understand and confirm A's eligibility for the non-application relief.

---

65 The rate varies depending on the province. Detailed explanation of this trap can be seen in Henry Shew, "Post Mortem Pipeline Fails For Non-Resident Beneficiaries," Canadian Tax Foundation (2019) 9:1 Canadian Tax Focus – Feb. 2019.

66 A number of letters have been written to the government to inform it that pipeline planning should be exempt from section 212.1(6)(1); while no Canadian tax rule has been promulgated in consequence of that correspondence, we understand that there is a general understanding among practitioners that the Canadian Revenue Agency ("C.R.A.") will not enforce the look-through rule for participants in a pipeline if the estate completes all distributions prior to three years after the decedent's death. See Brian Ernewein, "Cross-Border Surplus Stripping & Graduated Rate Estates" (stamped Dec. 2, 2019). See also description of Department of Finance's response in Henry Shew, "Finance Revives Post Mortem Pipeline For Non-Resident Beneficiaries," Canadian Tax Foundation (2020) 10:1 Canadian Tax Focus – Feb. 2020. A "graduated rate estate" refers to a Canadian estate that meets the three-year requirement aforementioned.

U.S. Tax

Anti-Deferral Regimes

Under the facts above, A ultimately acquired 50% of Newco; because the remaining 50% would be attributed to non-U.S. persons (B), Newco would not be a controlled foreign corporation ("C.F.C."), or one in which U.S. persons each owning at least 10% by vote or value, collectively own more than 50%. However, supposing A were fortunate enough to inherit a controlling stake from his generous Canadian uncle, A could walk into a very costly U.S. tax reporting problem. In such case, Newco would be a C.F.C. and would be subject to the anti-deferral regimes and reporting that is applicable to such entities known of as "Subpart F" and global intangible low-taxed income ("G.I.L.T.I.").

Here 50% ownership was not met, but if Newco earns at least 75% passive income or at least 50% of its assets are investments producing passive income, then it would be a passive foreign investment company ("P.F.I.C."), and A would be required to take certain inclusions into income.

The penalties for missing informational reporting can be prohibitive:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, which each U.S. 10% owner in a C.F.C. is required to attach to their personal income tax return for every year in which there is at least a day of ownership, start at $10,000 per entity per year, accruing every 30 days up to a maximum of $60,000 per entity per year.[67]
- If Newco is characterized as a P.F.I.C. because A owns not more than 50%, Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* would be required.[68]
- Form 8938, *Statement of Specified Foreign Financial Assets*, may be required unless the P.F.I.C. interests were reported on Form 8621.

More insidiously retroactive ownership to the date of death could apply for anti-deferral inclusion purposes and required U.S. tax reporting.[69] While applied routinely

---

67 That's before considering missed anti-deferral income, for which penalties and interest could be applicable, including the penalty for substantial understatement, which applies if the taxpayer understates income by the greater of 10% of the amount required to be shown on the return, or $5,000.

68 There is no specific automatic monetary penalty for missing Form 8621, but penalties and income for a resulting understatement would remain applicable – and unless reasonable cause could be demonstrated A's failure to attach either Form 5471 or 8621 keeps the statute of limitations open on the entire tax return. Code §6501(c)(8).

69 See Code §§318(a)(2)(A) and 958(a)(2) ("stock owned, directly or indirectly, by or for a . . . foreign trust or foreign estate (within the meaning of section 7701(a)(31) shall be considered as being owned proportionately by its . . . beneficiaries."); Code §958(b)(2) provides that if the estate owns more than 50% of the combined voting power of all classes of stock entitled to vote, it shall be treated as owning 100%. See Treas. Reg. §1.958-1(d)(2), Ex. 3. In the case of foreign trusts, the I.R.S. may require stock to be attributed to U.S. beneficiaries using actuarial principles; the question is whether interests in a foreign estate can and should be submitted to a similar analysis.

to foreign trusts, the question is whether the I.R.S. would extend such rules to a foreign estate.

Acquisition Year Reporting

In any case, A must remember that in the first year in which she or he acquires at least 10% of Can-Co and/or Newco, A is required to report his or her interest in each of those entities on a Form 5471 as a "Category 3" filer.[70] In such case, assuming A's ownership is projected back to the date of death, A may also consider that no separate, indirect acquisition of C.F.C. occurred on the incorporation of Newco, as it may be viewed for U.S. income tax purposes as Can-Co's successor.[71]

U.S. Reporting of Foreign Bequest – Form 3520

In the year in which A actually receives Newco's stock, A is required to report the receipt of the bequest because it is valued more than $100,000. Congress has enacted a painful stick to urge compliance with this requirement under Code §6039F, which may be more costly than Canada's anti-surplus-stripping "look-through" rule – the penalty for failing to report foreign gifts or bequests on Form 3520 is 25% of the value of all property received. Such reporting is done using Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and must be mailed by the same date as A's regular income tax return for the year in which the bequest is received to the I.R.S. Ogden Service Center.[72]

Finally, once A has acquired Newco's stock, what happens next? Various considerations, including those relating to subsequent distributions by Newco, are addressed in the section below.

"On the Canadian side, while cross-border interest may be eligible for 0% withholding, dividends are withheld at rates of up to 15%; and under debt/equity and thin capitalization principles Newco's debt can be only safely increased up to a point."

WHAT HAPPENS AFTERWARD?

Ownership and Disposition of Newco

If Newco's income is subject to U.S. anti-deferral regimes, A may receive dividends out of "previously-taxed income" without further U.S. tax – keeping in mind that Canadian analysis of the same distributions is required. Interest will be taxed, but repayment of principal is not.

On the Canadian side, while cross-border interest may be eligible for 0% withholding, dividends are withheld at rates of up to 15%; and under debt/equity and thin capitalization principles Newco's debt can be only safely increased up to a point. Assuming A qualifies as a resident of the U.S. under the Treaty, A is entitled to be withheld at a rate of no more than 15% on dividends paid by Newco to the extent

---

70 For this purpose, special attribution rules must be considered, which compute one's ownership as including the interests of siblings; therefore, if B is A's non-resident brother or sister, each of A and B potentially could be treated as having first acquired 100% of Can-Co, and then later, of Newco.

71 Either under the court-made liquidation/reincorporation doctrine or by viewing the upstream non-insolvent amalgamation as a tax-free liquidation under Code §332 – *cf.* Treas. Reg. §1.332-2(d) and *Kansas Sand & Concrete, Inc. v. Commr.*, 462 F.2d 805 (10th Cir. 1972).

72 Both the promissory note and Newco stock are required to be reported, together with their respective fair market value on that date in Part IV (lines 54 and 56).

they represent distributions out of Newco's earnings; no withholding should apply if a distribution is made out of P.U.C. (which is understood to be minimal in this scenario), and if there is a sale of Newco's shares resulting in capital gain, as a U.S. resident under the Treaty A should not be subject to Canadian capital gains tax withholding.[73]

However, Canadian withholding rate on dividends falls to 5% under the Treaty if the recipient is a corporation in the other Contracting State owning 10% of the payor's voting stock.[74] Consequently, A may wish to consider setting up a wholly-owned U.S. corporation to acquire A's Newco interests ("Holdco"); Holdco would be eligible to make an S election and be treated as a flowthrough, avoiding a second layer of U.S. tax, and A will subsequently benefit from the 5% rate.[75] While A could simply accept the 15% rate and apply for a foreign tax credit for the full amount, a cashflow issue arises when A is withheld on by Canada but must wait till after year-end to apply for a U.S. foreign tax credit.[76] The S corporation significantly mitigates this problem.[77]

The S election is made by mailing or faxing Form 2553, *Election by a Small Business Corporation*, to the I.R.S. For a calendar year corporation if made by March 15 the S election may be effective retroactive to January 1.

In addition to attending to the State and local tax ramifications of the structure,[78] care should be taken with regard to Code §1374 built in gain upon acquisition of Newco's stock by Holdco, if there is appreciation after the date of death. Attention must also be paid to shareholder-level U.S. income tax costs arising on exit from the structure by A; if A bequeaths the property, in order for the heirs to acquire Newco with basis stepped up to its fair market value, prior action to liquidate Holdco is necessary.

Care should be taken if A sells or gifts the shares at a later date, if Newco's stock is

---

73 Treaty art. XXII(4). This assumes that Newco is not a taxable Canadian property which would otherwise provide taxing rights to Canada. To obtain this benefit in Canada, A may have to provide Newco with a duly completed Form NR301 and Newco, as the payor, may be required to complete Form NR4.

74 If the distribution is neither a dividend or a tax-free return of capital out of P.U.C., *i.e.*, a capital gain for Canadian purposes, it should not be withheld on.

75 See Treaty, art. X(2)(a), as amended by arts. 2 & 5(1) of Protocol IV. In providing look-through rules at art. IV, paragraphs (6) and (7) for certain fiscally transparent entities including S corporations, the technical explanation indicates Canada will continue to allow benefits to S corporations under the Treaty in their own right. See also Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada, prepared by the Joint Committee on Taxation, July 10, 2008.

76 A applies for a foreign tax credit by attaching Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* to her or his personal income tax return, generally for the year in which the dividend is received.

77 Generally, A would apply for a foreign tax credit for the 5% or 15% withholding tax by attaching Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* to her or his personal income tax return. There is an irrevocable election to claim credits on the accrual basis by checking the "Accrued" box in Part II, which imparts on the taxpayer a duty to make certain adjustments later.

78 If A is resident in New York, for example, an S election may be made for New York State using Form CT-6, *Election by a Federal S Corporation to be Treated As a New York S Corporation*, but New York City does not recognize it.

taxable Canadian property.

Waiver of Inheritance

Suppose that after learning about all the above U.S. and Canadian tax consequences, A decides he has no interest in his Canadian uncle's generosity?

Canadian law permits a beneficiary to waive all rights to their inheritance. No filing is required, and the waiver is retroactive to the date of death provided the beneficiary has derived no benefits from the assets.[79] A witnessed written agreement signed by the beneficiary acknowledging the waiver may be advisable, though there is no prescribed form. A qualified disclaimer under U.S. tax law achieves a similar result – the beneficiary is treated as never having received property.

To qualify under the U.S. disclaimer provisions, A should scrupulously abide by the procedural steps outlined in the Code and Treasury Regulations.

The conditions for a qualified disclaimer are as follows:

- The refusal must be in writing.
- The written refusal must be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is nine months after the later of
  - the day on which the transfer creating the interest in such person is made, and
  - the day on which such person attains age 21.
- The person that wishes to disclaim must not have accepted the interest or any of its benefits.
- As a result of such the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either of the following persons:
  - The spouse of the decedent.
  - A person other than the person making the disclaimer.[80]

Once a witnessed Canadian letter or agreement has been executed in Canada, presumably after the uncle's death but before A has received a distribution,[81] a copy of the letter should be brought back to the U.S. and mailed to the Canadian executor

---

79 See Hull & Hull LLP, "What Is A Disclaimer."

80 Code §2518(b); Treas. Reg. §25.2518-2(a).

81 There is some ambiguity as to whether the waiver may be made at any time before the terminal date or only within the nine-month window beginning on the date of death. Treatises sometimes refer to a "9-month window", but the law most likely should be applied literally. For a law school professor's very conservative opinion, see William Schwartz, "Effective Use of Disclaimers", B.C.L.. Rev. Vol. 19:3, Art. 7, discussing the changes introduced by the Tax Reform Act of 1976.

or administrator - creating an unambiguous document for both U.S. and Canadian purposes which shows that A has renounced all interests in the estate. The use of registered mail with proof of delivery is strongly recommended.[82]

In real life, the Canadian and cross-border implications of every case must be thoroughly evaluated with input from a seasoned practitioner because a pipeline's effectiveness is sensitive to the client's unique facts.

[82] Caselaw indicates that the timely mailing rules of Code §7502 apply, meaning registered mail enables the sender to treat the postmark date as the delivery date, and hence also the date of the waiver. A scan of the mailed waiver, together with the certified mail slip, should be retained by A for future reference.