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## "SAFE INCOME" DIVIDENDS NOW AUTOMATICALLY SAFE

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The 2015 Federal Budget contained significant amendments to section 55 of the *Income Tax Act* (Canada) (the "**Act**"). These amendments recently became law and will generally apply retroactively to dividends received after April 20, 2015[1].

### Section 55

Section 55 is an anti-avoidance provision that is intended to prevent "capital gains stripping" through the payment of inter-corporate dividends. Where the provision applies, subsection 55(2) operates to convert an otherwise tax-free intercorporate dividend into a (taxable) capital gain. The following very basic example illustrates the operation of subsection 55(2) of the Act.

Holdco intends to sell shares of its subsidiary corporation ("**Opco**") to an unrelated third party (the "**Purchaser**") for $100, which would result in a capital gain of $75 to Holdco. Opco operates an active business but has never earned any taxable income. Prior to the sale of Opco shares by Holdco, the Purchaser lends $75 to Opco. Opco then pays a $75 dividend to Holdco out of the borrowed monies from the Purchaser. In the absence of subsection 55(2) of the Act applying, this intercorporate dividend would be tax-free to Holdco pursuant to section 112 of the Act.

In this example, the dividend has the effect of reducing the fair market value of the Opco shares to $25, meaning that, when Holdco subsequently sells the Opco shares to the Purchaser for $25, Holdco does not realize a capital gain on the sale. This is the so-called "capital gain strip". In order to prevent such result, subsection 55(2) of the Act will generally re-characterize the dividend that Holdco receives from Opco as a capital gain.

There are some exceptions to the application of the rules in subsection 55(2), including an exception in the case of certain dividends between related corporations as well as another exception in the case of an arm's length split-up "butterfly reorganization". Where neither of these two exceptions apply with respect to a dividend, however, it is generally necessary to come within the "safe income" exception, discussed below.

### "Safe Income" Exception

The rules in section 55 recognize that not all intercorporate dividends will constitute a "capital gains strip". In particular, subsection 55(2) will not apply to re-characterize a dividend as a capital gain where the dividend does not exceed the amount of the corporation's "safe income" that is attributable to the share on which the dividend is paid. "Safe income" is the post-1971 after-tax retained earnings determined on a tax

[1] These amendments are contained in S.C. 2016, c. 7 (Royal Assent - June 22, 2016).

basis (and subject to certain adjustments in the Act). The significance of safe income and the operation of subsection 55(2) is illustrated in the following example.

An operating company ("**ACo**") has significant retained earnings and wishes to pay a dividend to its two shareholders, XCo and YCo, who each hold 50% of the common shares in ACo. The shareholder of XCo is Mr. X and the shareholder of YCo is Mr. Y. Mr. X and Mr. Y are unrelated persons and deal with each other at arm's length. As a result, XCo and YCo are each unrelated to each other and unrelated to ACo. Assume that the safe income of ACo is $100,000 and that it has available cash on hand of $150,000 from which it can pay a dividend.

If ACo were to pay a cash dividend of $150,000 (i.e. $75,000 to each of XCo and YCo), such dividend would be in excess of the safe income amount of $100,000 attributable to the shares in ACo. As a result, because the amount of the dividend exceeds the amount of safe income, the entire $150,000 dividend amount would be re-characterized pursuant to 55(2) and treated as a capital gain of $150,000 (i.e. a $75,000 deemed capital gain to each of XCo and YCo). This is the case even though only a portion of the amount of the dividend actually exceeded safe income[2].

In this example, one way to extract the safe income of ACo on a tax-free basis would be to break the $150,000 dividend into two separate dividends: a $100,000 dividend and a $50,000 dividend. The $100,000 dividend would not exceed safe income and would therefore not attract the application of subsection 55(2), while the $50,000 dividend would be subject to 55(2) and would be treated as a capital gain to XCo and YCo[3].

Prior to the recent amendments to section 55, another way to achieve essentially the same result was for the recipient corporation(s) (i.e. XCo and YCo in our example) to make a designation in their tax returns under paragraph 55(5)(f) of the Act for the year in which the dividend was received. Pursuant to this designation, the recipient

[2] It should be noted that another requirement for the re-characterization of the dividend into a capital gain pursuant to subsection 55(2) is that "one of the purposes" of the payment of the dividend must be (stated somewhat simply) to reduce the fair market value of XCo and YCo's shares of ACo or to increase the cost of property owned by XCo and YCo. While the payment of the dividend will certainly reduce the fair market value of XCo and YCo's shares of ACo and increase the cost of XCo and YCo's property, it might be contended that subsection 55(2) should not apply in this situation because neither of these results was "one of the purposes" of the dividend if the motivation for paying the dividend was to simply creditor-proof ACo by removing redundant excess cash. In order to avoid a potential CRA reassessment, however, many taxpayers ensure that their dividends are paid out of "safe income", without attempting to rely on the "one of the purposes" test.

[3] Because the calculation of safe income is somewhat complicated, a corporation that thought that it had (for example) $100,000 in safe income usually would not simply declare a $100,000 dividend, due to the fact that, if the CRA was of the opinion that the correct safe income amount was only $95,000 (for example), the entire $100,000 dividend would be subject to subsection 55(2). In such a situation the corporation would often declare a series of separate dividends (for example, one dividend of $50,000, one of $25,000, one of $10,000, and fifteen $1,000 dividends) just to help ensure that only those dividends that did exceed safe income would be subject to 55(2).

corporation(s) would designate the actual dividend received to be fictionally comprised of two (or more) separate dividends, totalling the amount of the actual single dividend that was paid. Only the fictionally separate dividend or dividends in excess of the safe income amount would be subject to re-characterization under subsection 55(2).

The making of a designation under paragraph 55(5)(f) had a potentially negative drawback, however, since it would alert the Canada Revenue Agency that there may be a question as to whether the entire dividend was paid out of safe income. As a result, many tax practitioners followed the practice of extracting safe income through the declaration and payment of a series of actual, separate dividends (as described in footnote 3) as an alternative to making a paragraph 55(5)(f) designation.

In an unexpected (but welcome) update, however, paragraph 55(5)(f) has been amended (effective for dividends received on and after April 18, 2016) to replace the designation mechanism with a rule that automatically deems a dividend to have been paid as two separate dividends: one that is considered to have been paid out of the amount of safe income that could reasonably be considered to contribute to a capital gain that could be realized on a disposition at fair market value of the share on which the dividend is received, and a second that is considered to be paid out of the amount (if any) in excess of safe income.

The amendment to paragraph 55(5)(f) means that it will no longer be necessary (and, indeed, no longer possible) for the recipient corporation to file a designation to preserve the safe income component inherent in a dividend. Instead, the safe income component of a taxable dividend is automatically preserved as a tax-free intercorporate dividend, with any part of the dividend that is in excess of safe income being potentially subject to conversion into a capital gain under subsection 55(2). This will now avoid the possibility of a taxable dividend being re-characterized, in its entirety, as a capital gain even where the amount of the taxable dividend may only be slightly greater than the amount of safe income.

The amendment to paragraph 55(5) will now simplify the planning in situations where the corporation intends to pay a dividend representing all or most of its safe income. It will no longer be necessary to structure a dividend as a series of separate dividend payments as a way of limiting potential exposure to re-characterization as a capital gain under subsection 55(2) where, for example, there is some doubt as to the amount of safe income. Likewise, a designation under paragraph 55(5)(f) will no longer be required (or possible) by the recipient corporation since the provision now automatically protects the safe income component of such dividend from re-characterization under subsection 55(2). This comes as a welcome amendment and will simplify the process of extracting safe income.

## GRADUATED RATE ESTATES — BENEFITS, POTENTIAL TRAPS, AND HOW TO MAKE SURE YOU QUALIFY

By Shaun M. Doody

### Introduction

Starting in 2016, the *Income Tax Act* (Canada) (the "**Act**") has introduced a new concept: the "graduated rate estate" (or "**GRE**"). Many tax benefits previously available to all estates are now restricted to GREs, so it is important for tax practitioners, accountants, clients, and executors to ensure that a given estate qualifies as a GRE if possible, both before death (i.e. when drafting wills and making other estate planning decisions) and also in administering the estate itself.

### Moving From "Testamentary Trusts" to GREs

The estate of a deceased individual is considered to be a trust for the purposes of the Act and is further considered to be a particular type of trust: a "testamentary trust". Until the end of 2015, any trust that qualified as a testamentary trust was eligible to receive certain tax benefits, including the ability to be taxed at the same marginal tax rates as individuals and the ability to have an off-calendar year-end. Trusts that did not qualify as testamentary trusts were taxed at the highest marginal rate, were required to have calendar year-ends, and did not receive any of the other preferences afforded to testamentary trusts.

In the 2014 Federal budget, however, the federal government introduced a new concept: the GRE. Most of the benefits that were previously enjoyed by all testamentary trusts would now only be available to a GRE, which is defined in the Act as the estate that arose on and as a consequence of the death of an individual if:

- that time is within 36 months after the date of death (this means that the estate will cease to qualify as a GRE after this period);
- the estate is a testamentary trust (one of the more important requirements for a trust to be considered to be a testamentary trust is that it can only have received property as a consequence of an individual's death; this means that any other contribution to a GRE will prevent it from qualifying as a GRE for that entire taxation year and all subsequent years);
- the individual's SIN is provided in the estate's tax return;
- the estate designates itself as the GRE of the individual in its tax return; and
- no other estate designates itself as the individual's GRE in its tax return.

If an estate satisfies the first two criteria, it is very important for executors and accountants to ensure that the estate satisfies the remaining three criteria when filing its returns, to ensure that it will qualify as a GRE. It should also be noted that, because a

GRE must be "the" estate of an individual, a separate testamentary trust established under a will (such as a spousal trust or a trust for a child) cannot be a GRE.

Although announced in the 2014 budget, these rules only came into effect as of January 1st, 2016. As of this date, the following benefits that were previously available to all testamentary trusts are now restricted only to GREs:

- income taxed at marginal tax rates (as opposed to the highest marginal rate);
- selecting a non-calendar year-end;
- claiming the $40,000 deduction for alternative minimum tax;
- avoiding the requirement to make installment payments;
- being able to carry back certain capital losses of the GRE to be applied to capital gains in the terminal return of the deceased; and
- flexibility with respect to the application of tax credits arising from charitable donations made by the GRE (this is discussed further below).

**How Do the Year-Ends Work? (and How to Have Four Tax Years in 36 Months)**

There is no grandfathering for pre-existing estates or testamentary trusts, meaning that all such estates and trusts are subject to the new rules as of January 1st, 2016. As a result, all estates in existence as at the end of 2015 that would not then qualify as GREs would have a deemed year-end on December 31st, 2015, and would be required to report income on a calendar basis going forward. Estates that had been in existence for less than three years as of the end of 2015 (and that would meet the other requirements for being a GRE listed above) could continue to report on a non-calendar year-end (and could continue to enjoy the other benefits of being a GRE) until they had exceeded their 36-month lifespan, at which point they would have a deemed year-end, would have a stub year until the next December 31st (during which time they would not qualify as a GRE), and would report income on a calendar basis from that point forward.

This can best be illustrated with examples.

*Example 1*

Bob died on March 10th, 2010. His executors have been filing tax returns for his estate since that time with March 9th year-ends. Because the estate has been in existence for more than 36 months by the end of 2015, it would have a deemed year-end on December 31st, 2015, meaning that it will have a stub return for the period of March 10th, 2015, to December 31st, 2015 (during which time it will still receive the benefit of the marginal tax rates, since the GRE rules only apply from 2016 onwards). From January 1st, 2016, onwards, it will have to file based on a calendar year-end (and will not receive any of the benefits of being a GRE).

*Example 2*

Linda died on July 7th, 2014. Her executors have been filing tax returns for her estate since that time with July 6th year ends. Because the estate has not been in existence for more than 36 months by the end of 2015, the executors will be able to file tax returns electing for the estate to be a GRE (assuming that it meets the other criteria for being a GRE) in its tax years ending July 6th, 2015, July 6th, 2016, and July 6th, 2017. The estate will then have a stub year-end running from July 7th, 2017, to December 31st, 2017, during which time it will not receive the benefits of being a GRE. From January 1st, 2018, the estate will have to file based on a calendar year-end and will not receive any of the benefits of being a GRE.

*Example 3*

As mentioned above, a GRE can exist for up to 36 months. This does not necessarily mean, however, that a GRE will have exactly three taxation years during this time. If the executors select a year-end for the estate that is before the one-year anniversary of the taxpayer's death, the GRE will actually have four tax years within those 36 months.

Assume that Tina died September 15th, 2015, and the executors elect for the estate's year-end to be July 14th. The estate's first taxation year will run from September 15th, 2015, to July 14th, 2016. The estate will then have two additional tax years ending July 14th, 2017, and July 14th, 2018. During all three of these taxation years the estate will be able to benefit from being a GRE. Because the estate has not yet passed its 36-month deadline, however, it will be able to have a fourth taxation year, running from July 15th, 2018, to September 14th, 2018, at which point it will have a deemed year-end as a result of it reaching the end of its 36-month window. During this stub year, the estate can still continue to qualify as a GRE. It will then have a stub year running from September 15th, 2018, to December 31st, 2018 (during which time it will not be a GRE), and will then report income based on calendar year-ends from that point onwards.

As mentioned, such an arrangement essentially results in the estate benefitting from four sets of marginal tax rates instead of three. If the estate is able to earn sufficient income in each of those four taxation years (which can include income resulting from the disposition of capital property) it will pay less tax (as a result of the extra years' worth of marginal rates) than it would have if it had chosen a year-end exactly one year from the date of death.

**Charitable Contributions — New Rules for GREs**

Prior to 2016, the Act generally provided that the tax credit arising from charitable gifts made in a person's will could be applied in the terminal taxation year of the deceased or in the immediately previous year. Starting in 2016, however, estates that qualify as GREs are subject to a new set of rules that in many ways provides more flexibility (but in some ways can be somewhat problematic).

For individuals dying after 2015, the rule is generally that charitable gifts made in the individual's will are deemed to have been made by the GRE. The availability of the tax credit, however, depends on when the executors actually complete the gift (i.e. actually transfer the property to the recipient charity). If the gift is made within the first 36 months after death (and assuming that the estate qualifies as a GRE during the year in which the gift was made), the tax credit can be claimed by the GRE in any one or more of the year of donation, in any previous year of the GRE, in the subsequent five years of the estate, or in either of the individual's last two taxation years. If an estate does not qualify as a GRE at the time of the donation, however, the tax credit arising from the donation will only be able to be used by the estate itself, even if the donation was made within the estate's first 36 months.

Acting on comments from the tax community that it might be difficult to complete a gift within that timeframe (if an estate is subject to litigation, for example), the government released draft legislation in January of 2016 that proposes to largely extend these rules to donations made by an estate in months 37-60, as long as the estate would have qualified as a GRE at the time of the donation except for the fact that it had exceeded its 36-month window. The tax credit arising from such donations can only be claimed, however, in the year of donation, the subsequent five years of the estate, or the individual's last two years (i.e. the credit cannot be claimed in a previous year of the estate, including the time that it was a GRE).

**Conclusion**

Starting in 2016, the taxation of estates has undergone a substantial change. It is important that the GRE concept be considered both when working with a client to plan their estate as well as when administering the estate of a deceased client. Having an estate qualify as a GRE can often mean significant tax savings; because these new rules are often complex (the discussion above is merely an overview) it is usually a

good idea to seek professional advice in any situation where there is any question as to whether an estate so qualifies.