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2014 Budget Resolutions 14 to 27: Graduated Rate Taxation of Trusts and Estates

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SELL NOW: HOW THE 2014 BUDGET MAY IMPACT SMALL BUSINESS OWNERS' EXIT STRATEGIES

— *Michael Goldberg, Minden Gross LLP*

Although to most of the world the federal Budget tabled on February 11, 2014 (the "Budget") may have seemed to be of limited consequence, there are many tax practitioners and clients who will be significantly affected by its content. From painful changes to the taxation of estates, to the elimination of immigrant trust planning, severe restrictions on both the offshore regulated "bank" exception and captive insurance programs, as well as a host of pending tightening measures that will impact multinational enterprises and the use of treaties, tax planners will definitely have their hands full.

However, for my clients, I see the biggest impact coming from the proposed consultation process to make changes to the taxation of eligible capital property ("ECP"). While at first glance, a move to coordinate the current ECP regime (the "Current Regime") with the existing capital cost allowance regime seems completely logical and relatively innocuous,[1] it is the change to how ECP is taxed upon its disposition that may cause owner-managers who are considering selling their businesses to start thinking about selling more seriously.

In this regard, for most owner-managers whose ECP has been internally generated and has been the subject of little, if any, eligible capital expenditure claims, the recapture element associated with the sale of ECP is usually not a big deal. However, for many clients, ECP and, in particular, goodwill, will be the single biggest asset that they will have to sell, and a shift from the Current Regime of taxing such income at 50% of the active business rate to the traditional capital gains regime applicable to other depreciable property (the "New Regime") may result in a significant loss of tax deferral in situations where the owner-manager has no personal need for the full amount of the proceeds of sale.

For example, assume that your client Ely is the sole shareholder of a Canadian-controlled private corporation, Ely's Caps Limited ("Ely Cap"), carrying on a hat business, and the goodwill of Ely Cap has recently been valued at $20 million. What would be the impact to Ely and Ely Cap under the Current Regime and under the New Regime, assuming that it is implemented as described in the Budget papers?

Under the Current Regime, if Ely Cap sold all its business assets (I'll assume that the remainder of its assets, inventory, etc. would be sold at cost), the $20 million of proceeds receivable for the goodwill would give rise to an addition to Ely Cap's "cumulative eligible capital" account of $15 million under paragraph (*e*) of the definition in subsection 14(5). Two-thirds of this amount, $10 million, would be included in Ely Cap's income and would be taxable at ordinary corporate rates pursuant to paragraph 14(1)(*b*). As a result, assuming that Ely Cap has otherwise used its $500,000 small business deduction in the year, in Ontario the $10 million of taxable income would be subject to corporate taxes at a rate of 26.5% for a total of $2.65 million of tax.

In addition, the sale would give rise to a $10 million addition to Ely Cap's capital dividend account ("CDA") (after the end of Ely Cap's current taxation year), which would allow Ely to remove $10 million of cash from Ely Cap for his personal use with no additional taxation.

If Ely wanted to remove the remaining $7.35 million of goodwill proceeds ($10 million net of the $2.65 million of corporate tax) for his personal use, Ely would likely do so by way of Ely Cap declaring eligible dividends on his shares of Ely Cap, which would result in him paying additional tax of 33.82%,[2] being approximately $2.485 million. If Ely were to do this, the total tax payable on a $20 million sale of goodwill would be approximately $5.135 million.

Under the New Regime, the full $20 million of proceeds would be subject to corporate capital gains tax rates, which in Ontario are currently about 23.08%; this would give rise to tax of slightly more than $4.615 million in the corporation. As was the case under the Current Regime, this sale would generate a CDA in Ely Cap of $10 million, which could be distributed to Ely tax-free. However, due to recent tax rate changes that have increased the tax rate for ineligible dividends to 40.13%, the integrated tax rate to remove the remaining goodwill proceeds of $5.385 million ($10 million less $4.615 million of corporate tax) from Ely Cap would increase the total tax payable on the sale of its goodwill (net of refundable taxes receivable by Ely Cap) to approximately $5.18 million.[3]

As the Ely Cap example makes clear, there will be a small absolute tax cost of making a personal distribution of the corporate after-tax ECP proceeds under the New Regime of about $45,000 ($5.18 million - $5.135 million).[4] On the other hand, by leaving the ECP proceeds in excess of CDA amounts in a vendor corporation such as Ely Cap, it will be possible to enjoy some personal deferral of tax in both these cases. In particular, under the Current Regime, this deferral would be about $2.485 million ($5.135 million - $2.65 million)[5] and under the New Regime it will be reduced to about $565,000 ($5.18 million - $4.615 million).[6]

The "cost" of the loss of this deferral should not be understated since as a practical matter, most clients in Ely's situation and in situations involving far more modest sales than Ely's would likely not draw more than the CDA balance out of Ely Cap for a very long time, *if ever*. As a result, in many cases the corporate deferrals under both regimes will really amount to effective personal tax "savings" and the change from the Current Regime to the New Regime on a $20 million sale of Ely Cap's goodwill will "cost" Ely Cap nearly $2 million ($4.615 million - $2.65 million)[7] by forcing it to pay those additional corporate taxes in the year of the sale.

Some practitioners might take comfort that the proposal to create the New Regime in the Budget has been put forward as a "consultation" process. However, based on prior experience with the current government's consultation process (for example, in respect of the taxation of estates), the cynical side of me believes that practitioners should view the Budget announcement as fair notice that the New Regime will likely be enacted in the manner proposed — without grandfathering. As a result, given the potential cost to clients, I think this may be the time to ask them about their exit-planning decisions and consider whether now may be the time to sell.[8]

Michael Goldberg is a tax partner at Minden Gross LLP, MERITAS law firms worldwide and is the founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant, and real life tax situations for professional advisers who serve high net worth clients. Any errors or omissions are the author's sole responsibility.

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Notes:

1 In some cases, it may even be positive. For example, vendors with capital will now be able to offset capital gains on a sale of ECP against their capital losses, which would not have been the case under the Current Regime.

2 For simplicity, I have assumed that Ely pays tax at the top marginal tax rates in Ontario.

3 It is assumed that Ely Cap does not have a general rate income pool balance.

4 Determined by calculating the difference between the total integrated tax under the New Regime and under the Current Regime.

5 Determined by calculating the difference between the total integrated tax under the Current Regime and the corporate tax under the Current Regime.

6 Determined by calculating the difference between the total integrated tax under the New Regime and the corporate tax under the New Regime.

7 Determined by calculating the difference between the corporate tax under the New Regime and the corporate tax under the Current Regime.

8 Assuming the New Regime is legislated, expect a return to the old *status quo* of vendors having a very strong preference to sell shares (it appears that the capital cost allowance rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly less favourable variations for existing ECP, so that the New Regime should be relatively tax neutral for purchasers). Due to the low tax rates applicable to ECP sales, this may not have always been the case in the more recent past, even for vendors whose shares would otherwise have qualified for capital gains exemption treatment.

2014 BUDGET RESOLUTIONS 14 TO 27: GRADUATED RATE TAXATION OF TRUSTS AND ESTATES

The following is an excerpt from CCH's Budget Special Report No. 076H, which contains the Budget Plan and the Notice of Ways and Means Motion as well as commentary by Dentons LLP, Joseph Frankovic, and Wolters Kluwer CCH on the proposals. Copies of the Budget Special Report may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca.

Following an announcement made in the 2013 federal Budget that the government would "consult on possible measures to eliminate the tax benefits that arise from taxing at graduated rates grandfathered *inter vivos* trusts, trusts created by will, and estates (after a reasonable period of estate administration)" and the subsequent consultation paper released June 3, 2013, Budget 2014 includes measures which largely eliminate such benefits.

Trusts meeting the definition of "testamentary trust", which currently benefit from several tax preferences (including graduated rates and off-calendar year ends), will cease having access to such benefits, unless such trusts are "graduated rate estates", a new concept introduced in the Budget. Graduated rates will also continue to apply to testamentary trusts for the benefit of disabled individuals. Details regarding this exception will be released in the coming months.

Generally, the measures announced in Budget 2014 will eliminate the ability of many trusts to use graduated rates of taxation and will instead put those trusts on equal footing with non-grandfathered *inter vivos* trusts, which are subject to tax on all income at the top rate applicable to individuals pursuant to section 122 of the *Income Tax Act* (the "Act"). Interestingly, the measures are not proposed to take effect until 2016 and later taxation years. This "phasing-in" period should give taxpayers ample opportunity to "unwind" complex testamentary trust planning that was undertaken under the existing rules; there is no grandfathering for trusts or estates established on or before Budget Day.

As noted, the new provisions will apply to the 2016 and subsequent taxation years.

Resolution 14

The time for filing an agreement to transfer a forgiven amount under the debt forgiveness rules is to be amended. As a result of the amendment, the time to file the agreement is extended to one year for individuals and graduated rate estates only; previously, testamentary trusts were entitled to the same filing period.

Resolution 15

Paragraph 104(23)(*e*) is to be repealed. The provision exempted testamentary trusts from the general requirement to pay income tax instalments, as mandated by the rules in sections 155, 156, and 156.1. Under current legislation, testamentary trusts are simply required to pay tax within 90 days after the end of each taxation year. Interestingly, the relief from instalments was not retained for testamentary trusts that meet the definition of "graduated rate estate". As a consequence, these trusts will be required to pay instalments in accordance with the rules of the Act and Canada Revenue Agency ("CRA") policy.

Resolution 16

Resolution 16 proposes to amend section 122 of the Act in two ways. First, an exception to the general rule that trusts are to pay tax at the top rate applicable to individuals (currently 29%) in subsection 122(1) is introduced in respect of a trust that is a "graduated rate estate". As discussed below, the term "graduated rate estate" is a proposed definition to be added to subsection 248(1) to allow for a 36-month administration period for estates that are testamentary trusts.

The second amendment to section 122 is the proposed repeal of subsection 122(2). This provision exempts "grandfathered" *inter vivos* trusts from the general rule providing for flat rate taxation in subsection 122(1). This exemption applies to certain trusts that were established before June 18, 1971 and that meet a number of other criteria. Generally, in order to maintain grandfathered status, a trust cannot have:

(i) lost its status as a trust resident in Canada at any time since June 18, 1971;

(ii) carried on an active business during the year in question;

(iii) received property by way of gift after June 18, 1971;

(iv) received a contribution (defined in section 94) after June 22, 2000;

(v) incurred, after June 18, 1971, any debt or other obligation to pay an amount to, or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length; or

(vi) received property after December 17, 1999 from another trust, where the other trust was subject to subsection 122(1) and no beneficial change in ownership of the property resulted on the transfer.

These "tainting" provisions, which are relevant to determining grandfathered trust status, will be irrelevant beginning in 2016, as the entire concept of a grandfathered *inter vivos* trust is to be eliminated.

Resolution 17

Subsection 127(7), as it currently exists, enables a testamentary trust (or an *inter vivos* trust for a communal organization which is deemed to be in existence by section 143) to allocate any or all of its investment tax credits arising in respect of certain acquisitions and expenditures in a particular taxation year to its beneficiaries, provided that it does so in a reasonable manner "having regard to all of the circumstances including the terms and conditions of the trust". Resolution 17 proposes to limit the availability of this provision to graduated rate estates (and the trusts subject to section 143).

Resolutions 18 and 19

Resolutions 18 and 19 propose to amend certain provisions related to the computation of alternative minimum tax ("AMT") under Division E.1 of Part I of the Act to reflect the elimination of graduated rate taxation for testamentary trusts other than graduated rate estates. Generally, the AMT requires a revised computation of income, which adds back a number of deductions allowed to individuals under other sections of the Act. The amounts added back are normally in respect of certain so-called "tax-preference" items (for example, income tax deductions related to some tax shelters and capital gains). Certain deductions are permitted in arriving at AMT payable (for example, personal exemptions). A basic exemption of $40,000 is allowed in computing the AMT of certain individuals.

The proposed amendments in Resolutions 18 and 19 are related to the basic exemption. Under Resolution 19, section 127.53 will be repealed. This eliminates the definition of "basic exemption" currently found in that section and also the ability of certain trusts to "share" the basic exemption by filing an agreement with the CRA.

The $40,000 basic exemption will now be contained in section 127.51 itself, which is the provision by which an individual's minimum amount is computed. As a result of this proposed amendment, the $40,000 exemption will only be available to individuals (other than trusts) and graduated rate estates. Testamentary trusts that are not graduated rate estates will not be entitled to the basic exemption. The amount of the exemption will not be adjusted.

Resolutions 20 and 21

Under subsection 152(4.2), the Minister of National Revenue has the discretion to reassess or redetermine the tax liabilities of a taxpayer beyond the normal reassessment period in order to give the taxpayer a refund or to reduce taxes payable for the taxation year in question upon the taxpayer's request. This rule currently applies to individuals (other than trusts) and testamentary trusts. Resolution 20 will eliminate the ability of testamentary trusts to grant the Minister this authority. Instead, only individuals (other than trusts) and graduated rate estates will be so entitled.

Resolution 21 provides for a related amendment to paragraph 164(1.5)(*a*) in respect of the Minister's authority to refund overpayments to certain taxpayers where the relevant tax return was filed more than three but less than ten calendar years after the end of the taxation year.

Resolution 22

Subsection 165(1) sets out the limitation period for filing a notice of objection under the Act. Generally, the limitation period is 90 days after the date of sending the notice of assessment to which the objection pertains. This is extended for individuals (other than trusts) and testamentary trusts under paragraph 165(1)(*a*) to the later of the 90-day period and the day that is one year after the filing-due date of the individual for the year in question. Resolution 22 eliminates the extension for testamentary trusts and limits its application to individuals (other than trusts) and graduated rate estates.

Resolution 23

Resolution 23 proposes to eliminate the preferential treatment for testamentary trusts under Part XII.2 of the Act and provide the preference instead to graduated rate estates. Part XII.2 was enacted to prevent a non-resident from avoiding tax through the use of a trust to earn income from a business carried on in Canada or from a disposition of taxable Canadian property. It applies where, among other requirements, there is a "designated beneficiary" as defined in subsection 210(1). Under current legislation, a testamentary trust is excluded from being a designated beneficiary. Resolution 23 will limit this exemption to graduated rate estates. The other exemptions to the definition of "designated beneficiary" are not being amended.

Testamentary trusts are also currently exempt from Part XII.2 tax under paragraph 210(2)(*a*). This exemption is being amended and will only be available to graduated rate estates.

Resolution 24

Resolution 24 contains a number of proposed amendments to section 248 consequential on the elimination of graduated rate taxation for testamentary trusts and estates (and grandfathered *inter vivos* trusts).

First, an amendment to the definition of "personal trust" in subsection 248(1) is proposed to eliminate the reference to a "testamentary trust" in paragraph (*a*) and to replace it with a reference to a "graduated rate estate". Second, an amendment to paragraph (*b*) of the definition of "personal trust" is proposed to eliminate references to *inter vivos* trusts and "beneficial interest" and will instead apply now to any trust, provided that no capital interest or income interest in the trust was acquired for consideration payable directly or indirectly to the trust, or to any person who has made a contribution to the trust by way of transfer, assignment, or other disposition of property. This eliminates the preference previously afforded to testamentary trusts that qualified as personal trusts irrespective of the circumstances in which beneficial interests in the estate were acquired.

The most significant amendment to subsection 248(1) as regards these rules is the introduction of the concept of a graduated rate estate. In order to qualify as a graduated rate estate (which, pursuant to the proposed amendment contained in Resolution 16, is exempt from flat top-rate taxation and can therefore enjoy the benefits of graduated rates), an estate must meet three tests simultaneously:

(i) the estate must have arisen on or as a consequence of a death;

(ii) the time must be no more than 36 months after the death; and

(iii) the estate must be, at that time, a testamentary trust.

There are two notable elements of this requirement. The 36-month limitation is effectively a concession by the government to allow a limited amount of time under which a new estate can be administered without being subject to flat rate tax. That is, graduated rate estates are effectively being treated as an extension of the recently deceased taxpayer so that his or her assets can be dealt with in a reasonable amount of time without unduly subjecting the income of those assets to more tax than the individual would have paid had he or she lived. Upon the expiration of the 36-month period, proposed amendments to subsection 249(1) of the Act in Resolution 25 will have the effect of "converting" the estate's taxation year to a calendar year.

The other notable element of the "graduated rate estate" definition is that in order for an estate to qualify as such it must at all times be a "testamentary trust" as defined in subsection 108(1) of the Act.

Generally, a trust is a testamentary trust if it arose on the death of an individual and as a consequence of that death, with certain exceptions, which typically apply where there have been additional transfers to the trust after the original contribution that arose on the death of the individual. This definition is unchanged by Budget 2014.

Essentially, the preferences previously afforded to testamentary trusts and estates (and grandfathered *inter vivos* trusts) are being limited in their application solely to graduated rate estates, which by definition cannot exceed 36 months in duration.

The fourth amendment to section 248 in Resolution 24 is the elimination of the reference to paragraph 122(2)(*f*) in subsection 248(25.1) (which deals with certain trust-to-trust transfers). This repeal is consequential to the proposed elimination of subsection 122(2) in Resolution 16, which previously provided the rules allowing for grandfathered *inter vivos* trusts.

Resolutions 25 and 26

Resolution 25 proposes to amend the Act to require that all trusts, other than graduated rate estates, use a calendar year end for tax purposes. Under subsection 249(1) of the Act, certain limitations are imposed on the definition of a "taxation year". For individuals, generally, a calendar year is required. One exception to that rule under current legislation is for testamentary trusts, which are generally entitled under paragraph 249(1)(*c*) to use an off-calendar year end (subject to the limitation in paragraph 249.1(1)(*d*) that the period not be longer than 12 months). Resolution 25 proposes to limit this entitlement to graduated rate estates only.

Resolution 25 also proposes to introduce new subsection 249(4.1). Proposed subsection 249(4.1) generally has two implications. First, all trusts that are trusts created by will or estates that arose on and as a consequence of the death of an individual will be deemed to have a taxation year end at the end of the day December 31, 2015 (unless the trust or estate is a graduated rate estate, which are subject to a special rule, as discussed below). This rule relates to the coming into force provisions of these new rules, which generally apply for 2016 and subsequent taxation years. Any testamentary trusts (other than graduated rate estates) that are using off-calendar year ends at that time will have a deemed year end and will thereafter be required to compute their obligations under the Act on the basis that they have a calendar year end.

The second implication of proposed subsection 249(4.1) is to deem a graduated rate estate to have a year end upon the loss of graduated rate estate status. Following that deemed year end, which will occur generally on the date that is 36 months after the death of the testator (or some earlier period if the graduated rate estate is "tainted"), the trust will by definition no longer be a graduated rate estate and therefore will be required to use a December 31 year end going forward.

Resolution 26 proposes a consequential amendment to paragraph 249.1(1)(*b*) to give effect to the elimination of off-calendar year ends for testamentary trusts and the ability of a graduated rate estate to use an off-calendar year end.

Resolution 27

Resolution 27 provides the ability to make additional modifications to the Act and the *Income Tax Regulations* to give effect to the proposals regarding graduated rate taxation of trusts. It appears that this resolution is being included in the absence of a specific legislative amendment to preserve graduated rate taxation of testamentary trusts beyond the 36-month period in which the trust is a graduated rate estate for testamentary trusts that benefit disabled individuals. In the Supplementary Information accompanying the Notice of Ways and Means Motion, this policy objective was identified as arising during the consultation period and the government pledged that graduated rates will continue to apply to such trusts. It is expected that such an exemption will be provided prior to 2016, when these rules come fully into force.

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For Wolters Kluwer Limited

Robin Mackie, Director of Editorial
Tax, Accounting, and Financial Planning
(416) 228-6135
email: Robin.Mackie@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting, and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

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Wolters Kluwer Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

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