Federal Budget 2014 analysis

Given the government's intention to table a balanced budget in 2015, the 2014 budget was not expected to provide much personal tax relief. True to form, the budget provides a number of themes for the government's agenda, but delivers little in terms of tax reduction.

The budget follows through on an earlier proposal to eliminate graduated bracket treatment for testamentary trusts. It also delivered a surprise in going after immigration tax planning.

One positive item is the flexibility given to estates in managing the tax credits associated with charitable donations at and following a person's death.

This report focuses on specific budget elements that could affect Canadians' personal finances and investments. It was prepared by Doug Carroll, Invesco's Vice President of Tax and Estate Planning, from the budget lock-up in Ottawa.

1. Consumers first

One of the central themes in the budget is the need for fair treatment of consumers. The government recounted its past efforts in this area and expressed its continuing intention to address consumer concerns in some key areas.

- Cell phone charges – Proposals to strengthen competition, including legislation to reduce wholesale roaming rates and to enhance consumer protection and regulatory compliance
- Internet access – Improved access to broadband in rural and northern communities, targeting speeds of 5 megabits per second for up to an additional 280,000 Canadian households
- Cross-border price discrimination – Introduced legislation to address price discrimination – so called "country pricing strategies" – beyond what is justified by higher operating costs in Canada
- Pay-to-pay – Prohibited the banks' practice of charging fees to credit card clients who wish to receive their monthly statements in a printed format
- Banking powers of attorney – Enhanced disclosure by banks on the costs and benefits of using powers of attorney or joint accounts, particularly where seniors are concerned

While not specifically tax measures, these proposals will potentially have a financial impact on taxpayers as consumers of goods and services.

2. Estate donations – greater flexibility

Subject to certain limits, a charitable donations tax credit (CDTC) in respect of the eligible amount of the donation may be applied against the individual's income tax otherwise payable. The individual may claim a CDTC for the year in which the donation is made or for any of the five following years.

Where an individual makes a donation by Will, the donation is treated for income tax purposes as having been made by the individual immediately before the individual's death. Similar provisions apply where an individual designates, under a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Tax-Free Savings Account (TFSA) or life insurance policy, a qualified beneficiary as the recipient upon the individual's death of the proceeds of the plan or policy.

On the other hand, a CDTC available in respect of a donation made by an individual's estate may be applied against only the estate's income tax otherwise payable.

a. Greater flexibility for estate-related donations

Budget 2014 proposes providing more flexibility in the tax treatment of charitable donations made in the context of a death that occurs after 2015. Donations made by Will and designation donations will be deemed to have been made by the estate. The trustee of the individual's estate will have the flexibility to allocate the available donation among any of:

- the taxation year of the estate in which the donation is made;
- an earlier taxation year of the estate; or
- the last two taxation years of the individual

This measure will apply to 2016 and subsequent taxation years.

3. Graduated rate taxation of trusts and estates

As announced in last year's budget, the government took aim at the graduated tax treatment of trusts, and has generally followed through in the 2014 budget.

The government proposes applying flat top-rate taxation to grandfathered 1971 *inter vivos* trusts, trusts created by Will and certain estates. Subject to the implementation schedule and exceptions below, these trusts will no longer be entitled to:

- an exemption from the income tax instalment rules;
- an exemption from the requirement that trusts have a calendar year taxation year and fiscal periods that end in the calendar year in which the period began;
- the basic exemption in computing alternative minimum tax;
- preferential treatment under Part XII.2 of the *Income Tax Act*;
- classification as a personal trust without regard to the circumstances in which beneficial interests in the trust have been acquired;
- the ability to make investment tax credits available to a trust's beneficiaries; and
- a number of tax administration rules that otherwise apply only to ordinary individuals.

a. Full implementation 2016

Testamentary trusts that do not already have a calendar year taxation year will have a deemed taxation year-end on December 31, 2015 (or in the case of an estate for which that 36-month period ends after 2015, the day on which that period ends).

This measure will apply to 2016 and subsequent taxation years.

b. 36-month administration period for estates

As proposed in the consultation paper, graduated rates will apply for the first 36 months of an estate that arises on, and as a consequence of, an individual's death and that is a testamentary trust. If the estate remains in existence more than 36 months after the death, it will become subject to flat top-rate taxation at the end of that 36-month period.

c. Trusts for disabled individuals

In response to stakeholder submissions made during the consultation period in 2013, graduated rates will continue to be provided in respect of such trusts having as their beneficiaries individuals who are eligible for the federal disability tax credit.

This is an acknowledgement of the importance of graduated rate taxation of testamentary trusts as a tool to assist in preserving access by these individuals to income-tested benefits, in particular provincial social assistance benefits. Often called "Henson trusts," the key feature of these trusts is that the trustee has full discretion on the timing and amount of any distributions to the beneficiary. Many provinces exclude assets and income in such discretionary trusts when determining entitlement to provincial support. This has become a common planning recommendation for families with disability considerations.

Note as well that the original proposals would allow for the continuation of the preferred beneficiary election for trust income allocated to individuals who are eligible for the federal disability tax credit.

4. Non-resident trusts – "Immigration trusts"

If a person resident in Canada contributes property to a non-resident trust, deemed residence rules may apply to treat the non-resident trust as resident in Canada. A 60-month exemption from the deemed residence rules applies if the contributors to the trust are individuals, each of whom is resident in Canada for a total period of not more than 60 months (i.e., newly resident Canadians).

Budget 2014 proposes to eliminate the 60-month exemption from the deemed residence rules, including related rules that apply to non-resident trusts.

This measure will apply in respect of trusts for taxation years:

- that end after 2014 if (i) at any time that is after 2013 and before Budget Day the 60-month exemption applies in respect of the trust, and (ii) no contributions are made to the trust on or after Budget Day and before 2015; or
- that end on or after Budget Day in any other case.

To be clear, these are what are generally referred to as "immigration trusts," a commonly discussed planning tool for immigrants to Canada.

5. Tax on split income – "Kiddie tax" extended

The *Income Tax Act* contains a number of rules intended to reduce the ability of a higher-income taxpayer to split taxable income with lower-income individuals. In particular, the highest marginal tax rate (currently 29%) applies to "split income" paid or payable to a minor. This tax does not currently apply to situations where a minor is allocated income from a partnership or trust that is derived from business or rental activities conducted with third parties. For example, an adult could provide services to clients of a partnership of which the adult's minor child is a member.

Budget 2014 proposes that the definition "split income" be modified to include income that is directly or indirectly paid or allocated to a minor from a trust or partnership, if:

- the income is derived from a source that is a business or a rental property; and
- a person related to the minor
  - is actively engaged on a regular basis in the activities of the trust or partnership to earn income from any business or rental property, or
  - has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership).

This measure will apply to the 2014 and subsequent taxation years.

6. Select targeted personal income tax measures

A variety of measures are proposed, specific to certain constituencies:

a. Adoption expense tax credit

The current maximum amount adoptive parents may claim of eligible adoption expenses for this credit is $11,774. The budget proposes increasing this to $15,000 for 2014 and indexing the amount to inflation after 2014. You may recall that Budget 2013 extended the time period for expenses back to when an application is officially lodged.

b. Medical expense tax credit (METC)

The METC provides federal income tax relief equal to 15% of eligible medical and disability-related expenses in excess of a threshold that is the lesser of 3% of the taxpayer's net income and an indexed dollar amount ($2,171 in 2014).

Currently, the METC applies to therapy actually provided. In recognition that in some instances, effective therapy requires that a plan be designed to meet the specific needs of an individual (e.g., applied behaviour analysis therapy for children with autism), Budget 2014 proposes to allow the METC to apply to expenses incurred at the planning stage, and also for ongoing monitoring and adjustment. Generally, this would apply to plans prepared by an arm's length individual in the business of providing such services, where such a plan is required before accessing public funding or certain health professionals.

These measures will apply to expenses incurred after 2013.

c. Farming and fisheries – Simpler access to lifetime capital gains exemption (LCGE) and intergenerational rollovers

The $800,000 lifetime capital gains exemption (LCGE) and intergenerational rollovers apply to certain farming or fishing property, shares or interests. Where property is used in a combination of farming and fishing, the property must be used principally (generally interpreted as 50% or more) in one of those activities. Budget 2014 proposes to allow the LCGE and intergenerational treatment where the property is used in a combination of farming and fishing.

d. Farming – Tax deferral on distressed livestock sales

Farmers who dispose of breeding livestock due to extreme weather conditions may be permitted to defer up to 90% of the sale proceeds from inclusion in their taxable income until the year following the sale. This has been available for cattle, goats, sheep and some horses. Budget 2014 extends this treatment to broader categories of horses, and now includes bees.

e. Search and rescue volunteers tax credit (SRVTC)

This 15% non-refundable tax credit is based on an amount of $3,000 for eligible search and rescue volunteers who perform at least 200 hours of volunteer search and rescue services in a taxation year. Note that the person may not be able to claim the credit if he or she provides services to the relevant organization, and that claiming the credit may disqualify the individual from claiming tax exemptions for volunteer-related public source honoraria.

f. Pension transfer limits – Underfunded pensions

Under the *Income Tax Act*, the pension transfer limit formula determines the portion of a lump-sum commutation payment from a defined benefit Registered Pension Plan (RPP), received by a plan member who is leaving the RPP, that may be transferred to a Registered Retirement Savings Plan (RRSP) on a tax-free basis (i.e., the transferable amount). The amount in excess is taxable in the year it is received.

In 2011, the government introduced a special rule that provides relief to members leaving a pension that is underfunded. Essentially the transferable amount is calculated in certain circumstances to allow a member leaving an RPP whose estimated pension benefit has been reduced due to plan underfunding. This allows for a greater amount to be transferred to an RRSP.

Budget 2014 proposes to allow this rule to apply in additional situations, including the windup of individual pension plans.

This measure will apply in respect of commutation payments made after 2012.

g. Amateur athlete trusts

A member of a registered Canadian amateur athletic association who is eligible to compete in international sporting events as a Canadian national team member is permitted to place certain income in an arrangement known as an amateur athlete trust. For tax purposes, amounts contributed to an amateur athlete trust are excluded from the income of the amateur athlete (the trust beneficiary) for the year in which the contribution is made. Since income that is contributed to an amateur athlete trust is exempt from income tax, it is not treated as earned income in determining an athlete's annual RRSP contribution limit.

Budget 2014 proposes to allow income that is contributed to an amateur athlete trust to qualify as earned income for the purpose of determining the RRSP contribution limit of the trust's beneficiary.

Invesco

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

7. GST/HST credit administration

The Goods and Services Tax/Harmonized Sales Tax (GST/HST) credit is a non-taxable benefit that is paid to individuals based on their adjusted family net income. An individual may apply for the GST/HST credit by checking the GST/HST credit application box on their annual income tax return. When an individual does so, the Minister of National Revenue is required to send the individual a notice of determination as to their eligibility for the GST/HST credit.

Budget 2014 proposes to eliminate the need for an individual to apply for the GST/HST credit and to allow Canada Revenue Agency to automatically determine if an individual is eligible to receive the GST/HST credit. A notice of determination will be sent to each individual who is eligible for the GST/HST credit. In the case of eligible couples, the GST/HST credit will be paid to the spouse or common-law partner whose tax return is assessed first.

Notices of determination will not be sent to ineligible individuals. An ineligible individual, however, will be able to obtain a notice of determination upon request, which will preserve their right to object to the determination.

This measure will apply in respect of income tax returns for the 2014 and subsequent taxation years.

TEFDBAE (03/14)