2014 Federal Budget

2014 Federal Budget – February 11, 2014

A summary of the key tax measures that may have a direct impact on you.

On February 11, 2014, Federal Finance Minister Jim Flaherty presented the majority government's budget. The budget does not change federal corporate or personal tax rates.

Similar to last year's budget, many of the 2014 budget tax measures are aimed at tightening perceived loopholes or inequalities in various aspects of the tax system. Key measures include changes to the taxation of testamentary trusts and non-resident immigration trusts.

Prior to implementing any strategies contained in this article, individuals should consult with a qualified tax advisor, legal professional or other applicable professional.

While it has been the long-standing practice of the Canada Revenue Agency (CRA) to allow taxpayers to file their tax returns based on proposed legislation, a taxpayer remains potentially liable for taxes under current law in the event that a budget proposal is not ultimately passed. Therefore, if proposed legislation does not become law, it is possible that CRA may assess or re-assess your tax return based on existing legislation. It is recommended that you consult a professional tax advisor to assist you in assessing the costs and benefits of proceeding with specific budget proposals as they relate to you.

RBC Wealth Management

Personal Tax Changes

Graduated Rate Taxation of Testamentary Trusts

A testamentary trust is a trust or estate that is generally created on the day a person dies. It provides a means of transferring assets to a designated beneficiary or beneficiaries and can be used to address a wide range of estate planning objectives including increased control over when and how assets are distributed to beneficiaries and protection of assets from the beneficiaries' creditors.

Under current legislation, taxable income earned in a testamentary trust can be subject to the same graduated tax rates as an individual taxpayer. However, the basic personal exemption is not available when completing a tax return for any trust including a testamentary trust. Since the income earned within a testamentary trust is taxed on a separate tax return at graduated tax rates, an income splitting opportunity may arise for the beneficiary.

The 2013 budget announced the Government's intention to consult on possible measures to eliminate graduated tax rates that currently apply to testamentary trusts, certain estates and grandfathered inter vivos trusts. A consultation paper describing these measures was released on June 3, 2013 and closed for comments on December 2, 2013. The budget proposes to generally proceed with the measures described in the consultation paper.

Specifically, the budget proposes to apply flat top-rate taxation to these trusts for 2016 and subsequent taxation years, subject to two exceptions. First, 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. An estate will become subject to flat top-rate taxation at the end of the 36 month period. Second, graduated tax rates will continue to be provided in respect of testamentary trusts for the benefit of disabled individuals who are eligible for the federal Disability Tax Credit. More detailed rules regarding this exception are expected to be released in the coming months.

Pursuant to the proposed changes, testamentary trusts (other than estates for their first 36 months) and grandfathered inter vivos trusts, will be required to have a December 31 taxation year-end. Testamentary trusts that do not already have a calendar year-end will be deemed to have a year that ends 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). As well, these trusts (other than estates for their first 36 months), will now be subject to tax instalments and will lose the basic exemption in calculating alternative minimum tax. These measures will apply to the 2016 and subsequent taxation years.

Immigration (Non-Resident) Trusts

Individuals who are moving to Canada and have never been resident in Canada before can create a non-resident "immigration" trust in order to shelter their income and capital gains from Canadian taxation for the first 60 months of their residency in Canada.

The budget proposes to eliminate the 60-month exemption for immigration trusts, 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 February 11, 2014, the 60-month exemption applies in respect of the trust, and (ii) no contributions are made to the trust on or after February 11, 2014 and before 2015; or

- that end on or after February 11, 2014 in any other case.

Immigrant Investor Program

The Immigrant Investor Program was designed to increase economic benefit to Canada and to the provinces by attracting new immigrants with business experience and sufficient net worth to Canada. Under the program, investors and their families could apply for permanent residency in Canada by making a five year investment totalling C$800,000 in the Canadian economy.

The budget proposes to permanently cancel the federal Immigration Investor Program. A moratorium on immigrant applications under the program has been in place since June 2012.

The Government will introduce a new Immigrant Investor Venture Capital Fund pilot project, which will require immigrants to make significant investment in the Canadian economy.

Estate Donations

The budget proposes to provide more flexibility in the tax treatment of charitable donations made in the context of a death. Donations made by Will or by designation under a RRSP, RRIF, TFSA or life insurance policy will no longer be deemed to be made by an individual immediately before death. Instead, the donations will be deemed to be made by the estate at the time the donation is made to a qualified donee.

The budget proposes to allow the executor (liquidator in Quebec) of an individual's estate flexibility to allocate the available donation among:

- 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 deceased individual.

This measure will apply to charitable donations made in the context of a death that occurs for 2016 and subsequent years.

Pension Transfer Limits for Commutation of Underfunded DB Pension Plans

Individuals leaving a defined benefit (DB) pension plan (for example, due to termination, retirement or wind-up) may receive a cash-out payment from the plan reflecting the lump-sum value of their pension benefits. The income tax rules limit the amount of such payments that may be transferred tax-free (the "transferable amount") to a locked-in RRSP, RRIF or other defined contribution retirement savings vehicle. Generally, in situations where a plan member's commutation payment is reduced due to plan underfunding, the transferable amount is based on that lower commutation payment. The cash portion of the individual's commutation payment that exceeds the transferable amount must be included in the individual's income for the year in which it is received.

The budget proposes, for commutation payments made after 2012, that the maximum transferable amount for a plan member who is leaving an underfunded pension plan will be the same as if the pension plan were fully funded. This measure may result in restored RRSP contribution room for those individuals who received commutation payments from underfunded DB plans in 2013, such as wind-ups of Individual Pension Plans, or larger tax-free transfers (and therefore lower taxable cash distributions) for individuals leaving underfunded defined benefit plans going forward.

Tax on Split Income ("Kiddie Tax")

The *Income Tax Act* contains "tax on split income" or "kiddie tax" rules that limit income-splitting techniques that seek to shift certain types of income from a higher-income individual to a lower-income minor. The budget proposes to expand the definition of split income to 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).

For example, an individual operating a business or providing services might sell goods or services to third parties and have payment directed into a trust of which one or more of his or her children are designated as beneficiaries. The budget proposes this income will be taxed in the child's hands at the top marginal tax rate to preventing income splitting.

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

Farming and Fishing Businesses

Under the current rules, where an individual carries on a combination of a farming and fishing business as a sole proprietor, or through a partnership, the qualifying property must be used principally (generally interpreted as 50 per cent or more) in a farming or a fishing business to be eligible for the intergenerational rollover and the $800,000 Lifetime Capital Gains Exemption (LCGE). Similarly, for an individual's shares in a family corporation or interest in a family partnership to qualify for the intergenerational rollover and LCGE, all or substantially all (generally interpreted as 90 per cent or more) of the fair market value of the property of the entity must be used principally in a farming or a fishing business.

The budget proposes to extend eligibility for the intergenerational rollover and the LCGE to property used principally in a combination of farming and fishing. For example, property used 40 per cent of the time for farming, 35 per cent of the time for fishing, and 25 per cent of the time in a third business activity could not qualify for the rollover and the LCGE as either farming or fishing property under the current rules, but would qualify under the new proposed rules.

This measure will apply to dispositions and transfers that occur in 2014 and subsequent taxation years.

Amateur Athlete Trusts

Under the *Income Tax Act*, an amateur athlete who is a member of a registered Canadian amateur athletic association and 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, of which the amateur athlete is the beneficiary. Income contributed to an amateur athlete trust, as well as the investment income earned in the trust, benefits from a tax deferral up until a distribution is made from the trust or at latest, eight years after the last year an athlete ceases competing as a Canadian national team member.

The budget 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. This measure will apply in respect of contributions made to amateur athlete trusts after 2013. As well, individuals will be permitted to make an election to have income that was contributed to an amateur athlete trust in 2011, 2012 and 2013 also qualify as earned income. This election must be made in writing and submitted to CRA on or before March 2, 2015. Any additional RRSP contribution room resulting from the election will be added to the trust beneficiary's RRSP contribution room for 2014.

Mineral Exploration Tax Credit

The budget proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2015.

Medical Expense Tax Credit (METC)

The budget proposes that amounts paid for the design of an individualized therapy plan be eligible for the METC if the cost of the therapy itself would be eligible for the METC and certain conditions are met.

The budget also proposes to expand the list of expenditures eligible under the METC, to include costs associated with service animals specially trained to assist individuals with severe diabetes, such as diabetes alert dogs.

These measures will apply to expenses incurred after 2013.

Adoption Expense Tax Credit

The budget proposes to increase the maximum amount of expenses for which the adoption expense tax credit can be claimed from $11,774 to $15,000 to help make adoption more affordable for Canadian families. This change will apply to adoptions finalized after 2013.

Search and Rescue Volunteers Tax Credit

The budget proposes a new search and rescue volunteers tax credit to recognize the important role played by search and rescue volunteers. The non-refundable tax credit will be based on an amount of $3,000 for eligible ground, air and marine search and rescue volunteers who meet certain criteria.

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

Donations of Ecologically Sensitive Land

To permit donors to take greater advantage of tax assistance and to encourage larger donations, the budget proposes to extend the carry-forward period to ten years for donations of ecologically sensitive land, or easements, covenants and servitudes on such land for donations made after February 10, 2014.

Donations of Certified Cultural Property

Gifts of certified cultural property are measured at fair market value for the purpose of determining the donation tax credit. The budget proposes to limit the value of such a gift to its cost to the donor if the property was acquired as part of a tax shelter gifting arrangement. This measure will apply to donations made after February 10, 2014.

Business Tax Changes

Remittance Thresholds for Employer Source Deductions

The budget announces changes to source deductions for employee's income tax, Canada Pension Plan contributions and Employment Insurance premiums. The frequency of employer remittances is based on average monthly withholdings from two calendar years ago. In order to reduce the tax compliance burden for businesses to prepare, file and pay taxes, the budget proposes to reduce the maximum number of payments by increasing the threshold level of average monthly withholdings.

Consultation on Eligible Capital Property

The eligible capital property (ECP) regime governs the tax treatment of eligible capital expenditures that are generally of an intangible nature. Eligible capital expenditures include the cost of goodwill when a business is purchased.

The budget announces the intention to consult on possible measures to replace the ECP regime with a new class of depreciable property that will be subject to the capital cost allowance (CCA) rules.

Please contact us for more information about the topics discussed in this article.

Thin Capitalization Rules – Back-to-Back Loans

Both the thin capitalization rules and the Canadian non-resident withholding tax rules govern the tax treatment of certain interest payments made by Canadian taxpayers to non-resident persons.

The thin capitalization rules are intended to limit the deductibility of interest on debts owing by corporations and trusts to certain specified non-resident persons where the amount of debt exceeds a 1.5 to 1 debt-to-equity ratio. In addition, Canadian withholding tax generally applies to interest paid or credited by a Canadian resident to a non-arm's length non-resident.

The budget proposes to introduce anti-avoidance rules ensuring that non-residents cannot avoid Canadian withholding tax or the thin capitalization rules by entering into back-to-back loan arrangements with third-party financial intermediaries to effectively make indirect loans to their Canadian subsidiaries.

The measure related to the thin capitalization rules will apply to taxation years that begin after 2014, and the measures in respect of Canadian non-resident withholding tax apply to amounts paid or credited after 2014.

Other Changes

FATCA - Update on Automatic Exchange of Information for Tax Purposes

The U.S. Foreign Account Tax Compliance Act (FATCA) is legislation that seeks to identify U.S. persons who evade U.S. taxes by placing assets in foreign (non-U.S.) accounts – either directly or indirectly through foreign entities such as corporations and trusts. The legislation would require foreign (non-U.S) financial institutions to report directly to the U.S. Internal Revenue Service (IRS) information about financial accounts held by U.S. persons, which includes U.S. citizens living abroad.

Canada and the U.S. signed an Inter-Governmental Agreement (IGA) on February 5, 2014 to improve international tax compliance and to implement the Foreign Account Tax Compliance Act (FATCA). Under the IGA, Canadian financial institutions will report to the CRA information in respect of U.S. persons. The CRA will report information to the IRS under the Canada-U.S. tax treaty and will be subject to its confidentiality safeguards.

A variety of registered accounts (RRSP, RRIF, RESP, RDSP, TFSA) will be exempt from reporting by financial institutions. While certain accounts are exempt from reporting under this agreement, the agreement will not affect the personal tax reporting obligations of U.S. persons. It is important that U.S. persons consult with a qualified cross-border tax professional to understand their U.S. reporting obligations.

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