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The March 21, 2013 federal budget introduced various specific tax measures aimed at both individuals and small businesses. Budget 2013 closed a number of tax loopholes, many of which will be discussed below; however, rather than summarize the entire 433-page budget document, this report will focus on a number of key elements that are of most interest to individuals and small businesses.

PERSONAL TAX CHANGES

First-Time Donor's Super Credit

Under the current rules, individuals can claim a non-refundable tax credit of 15% for the first $200 of annual charitable donations. That tax credit rate jumps to 29% for any donations above $200.

To encourage "new" donors to give to charity, the Budget proposes to introduce a temporary First-Time Donor's Super Credit (FDSC). The FDSC will be in the form of an additional 25% non-refundable tax credit for a "first-time donor" on up to $1,000 of donations.

A first-time donor is someone who hasn't claimed a donation credit after 2007. If you're married or living common law, neither you nor your spouse qualify if either of you has made a donation after 2007. While first-time donor couples can share the FDSC in a particular year, the total amount claimed can't exceed the maximum allowable credit.

As a result, a first-time donor will be entitled to a 40% federal credit for donations of $200 or less and a 54% credit for donations over $200 up to $1,000. Only cash donations will qualify for the FDSC as opposed to donations of property or donations "in-kind."

The FDSC is available for donations made on or after March 21, 2013. The credit can only be claimed once in either 2013 or any year until 2017.

Equity Monetization Arrangements

Occasionally, executives or other major shareholders that hold a concentrated position in a publicly traded company wish to diversify their investments but don't want to trigger a capital gain on the sale of such shares. Under an equity monetization arrangement, the investor would enter into a forward contract with a financial institution that would provide the executive with the right and obligation to sell the stock at a particular price at some future date. The executive would then borrow against the future value of that contract and use the borrowed funds to diversify their holdings. The maturity of the loan would generally be designed to coincide with the maturity of the forward contract.

The government is proposing to eliminate this type of planning by treating certain types of equity monetization transactions as a disposition for tax purposes, negating one of the primary advantages of such a strategy.

Converting Income to Capital Gains

The budget proposes new rules that would effectively eliminate the ability for investors to convert fully taxable ordinary income into tax-preferred capital gains, taxable at only 50% of your marginal tax rate.

The changes proposed will affect mutual funds that invest in a portfolio of bonds to earn interest income and then use forward derivative contracts to convert highly taxable distributions into distributions of capital gains. The net result is that in respect of forward agreements entered into on or after March 21, 2013, these funds will no longer be able to provide this tax advantage.

Insurance Strategies

The government is also closing tax loopholes on two complex life insurance strategies: leveraged insured annuities and 10/8 arrangements.

Leveraged Insured Annuities

Under a leveraged insured annuity strategy, an investor uses borrowed funds in connection with a lifetime annuity and a life insurance policy. The life insurance policy provides coverage for the entire lifetime of the individual, the death benefit under the policy equals the amount invested in the annuity, and both the policy and the annuity are assigned to the lender of the borrowed funds.

This strategy provides fixed and guaranteed income to an investor until the death of the individual, at which time the capital invested in the annuity is returned in the form of a tax-free death benefit.

Leveraged insured annuities have a number of tax benefits, including the tax-free accumulation of the income earned on the capital invested inside the life insurance policy, the tax deductibility of interest on the borrowed funds as well as a deduction on part of the capital invested for the policy premium. These are often held by private corporations such that the arrangement results in the elimination of tax on the retained earnings in the corporation by avoiding tax on the capital gains resulting from the deemed disposition on the death of the owner.

The budget proposes to eliminate "unintended tax benefits" by introducing new rules that would effectively take away most of the benefits of such a strategy.

10/8 Arrangements

Under a "10/8 arrangement," an individual purchases a life insurance policy for the purpose of borrowing against that policy and investing those proceeds in a portfolio of marketable securities.

In the 10/8 arrangement, the taxpayer pays tax deductible interest of 10% on the loan and is guaranteed to earn 8% tax sheltered income inside the policy. Variations of the arrangement use 9% and 7% respectively.

While the government has been challenging 10/8 arrangements under existing income tax rules, it felt that these challenges were "both time-consuming and costly" and as a result, is proposing new rules that will specifically put an end to 10/8 arrangements.

Labour-Sponsored Venture Capital Corporations Tax Credit

The budget announced that it will be phasing out its federal tax credit for investments in labour-sponsored venture capital corporations (LSVCC). While the credit will remain at 15% for 2013 and 2014, it will drop to 10% for 2015 and 5% for 2016. It will be completely eliminated for 2017 and subsequent years.

In addition, the government will immediately cease registering any new federal LSVCCs.

Stop International Tax Evasion Program

The Budget announced that the CRA is cracking down on offshore investments by launching the "Stop International Tax Evasion Program" ("SITEP") whereby it will pay a reward to any individual who reports incidents of "major international tax non-compliance" provided that the information leads to the collection of outstanding taxes due.

The reward, which is payable only after taxes have been collected, can be as high as 15% of the federal tax collected.

Revised Form T1135

If you own foreign property costing more in total than $100,000 at any time during the year, you must file a "Foreign Income Verification Statement" (Form T1135). Foreign property includes foreign bank accounts, foreign non-personal real estate, and foreign stocks (but not Canadian mutual funds or segregated funds with foreign holdings) held in non-registered Canadian brokerage accounts.

Currently, Form T1135 only requires general information as to where the foreign property is located and what income is generated from that property. The CRA will be revising this Form and require taxpayers to provide more detailed information regarding each foreign investment, including: the name of the specific foreign institution or other entity holding funds outside of Canada, the specific country to which the property relates and the foreign income generated from the property.

Beginning with the 2013 tax year, the CRA will remind taxpayers, on their Notices of Assessment, of their obligation to file Form T1135 if they have checked the "Yes" box on page one of their tax returns, indicating that they own foreign property with a total cost of more than $100,000.

The CRA is also developing the ability to file the T1135 form electronically.

Testamentary Trusts

Testamentary trusts are trusts created upon death, generally by will. These trusts calculate tax using the graduated tax rates applicable to individuals as opposed to other trusts, such as inter-vivos trusts, which pay federal tax at the highest marginal rate of 29 per cent.

The taxation of testamentary trusts at graduated rates allows the beneficiaries of those trusts to effectively access more than one set of graduated rates and is often recommended as a post-mortem tax planning strategy.

The government announced that it is "concerned with potential growth in the tax-motivated use of testamentary trusts and the associated impact on the tax base" and as such, intends to launch a consultation on possible changes to the tax law to eliminate the tax benefits that arise from taxing testamentary trusts at graduated rates.

Deduction for Safety Deposit Boxes Fees

Under the current tax rules, you can deduct expenses incurred for the purpose of earning business or investment income such as interest expense on money borrowed for investment purposes. These expenses are known as "carrying costs."

The cost of renting a safety deposit box has traditionally been a deductible expense as a carrying cost. The budget proposes that the cost of renting a safety deposit box will no longer be deductible, beginning in 2013, justifying this change by saying that "taxpayers using safety deposit boxes are increasingly likely to be using the boxes for personal purposes (e.g., to safeguard valuables), rather than for an income-earning purpose."

SMALL BUSINESS CORPORATE TAX CHANGES

Lifetime Capital Gains Exemption

The Lifetime Capital Gains Exemption (LCGE) allows owners of small businesses, farmers and fishers to realize up to $750,000 of capital gains tax-free on the sale of qualified small business corporation (QSBC) shares and qualified farm and fishing property.

The budget proposes to increase the LCGE by $50,000 to $800,000, starting in 2014. In addition, the LCGE will be indexed to inflation for taxation years after 2014 and the increase in limits will also be available to those who have previously used their full $750,000 exemption.

Dividend Tax Credit

Corporate income is subject to two levels of tax: once when the income is earned inside the corporation and a second time when the after-tax income is paid out to the shareholder.

The dividend tax credit (DTC) is intended to compensate the shareholder for the corporate income taxes paid by providing a credit for those corporate taxes paid such that double taxation is avoided.

The actual mechanism for doing so involves "grossing-up" the actual dividends received which acts as a proxy for pre-tax corporate profits and then provide the DTC to individuals in recognition of corporate-level tax paid.

The purpose of the gross-up/DTC system is to treat the individual as if he or she had earned the corporate income directly and eliminate double taxation.

The tax system has two gross-up factors and DTC rates depending on what corporate tax rate was paid by the corporation. For most public corporations, which pay tax at the general corporate tax rate, dividends that are paid out are referred to as "eligible dividends" since they are eligible for a higher DTC. Private corporations, on the other hand, who earn income taxed at the lower preferred small business corporate tax rate pay "non-eligible dividends," known as such since they are *not* eligible for the enhanced, higher DTC.

Under the current gross-up/DTC system, shareholders are actually overcompensated for income taxes presumably paid by their corporations. This phenomenon is often referred to as "over-integration." As a result, a shareholder who receives dividend income from a corporation is actually in a better tax position than if the individual had earned the income directly.

To fix this, the budget proposes to adjust the gross-up and dividend tax credit for dividends paid after 2013, as indicated in the chart below. The net result will be higher taxes on non-eligible dividends, starting next year.

	2013	2014+
Non-eligible dividend	$1,000	$1,000
Gross up	$250	$180
Taxable dividend	$1,250	$1,180
Federal tax (29%)	$363	$342
Dividend tax credit	($167)	($130)
Net federal tax	$196	$212
After-tax proceeds	$804	$788
Top federal marginal tax rate on dividends	19.58%	21.22%

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