Federal Budget 2011

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The June 2011 federal budget reintroduced several specific tax measures aimed at families, students, charities, registered plans and small businesses. There were no changes whatsoever to the tax measures announced in the March 22, 2011 budget, which never passed before an election was called. Several of the measures discussed below, however, are retroactively effective as of the March 22nd date and will be specifically pointed out below. Rather than summarize the entire 374-page budget document, this updated report will focus on a few key elements that are of most interest to individuals and small businesses.

Families

Children's Arts Tax Credit

The 2011 budget proposes a new tax credit, similar to the Children's Fitness Tax Credit, called the Children's Arts Tax Credit. This will allow parents to claim a 15% non–refundable tax credit based on an amount of up to $500 in eligible expenses per child paid in a year.

The credit is available for each child, under 16 years of age at the beginning of the year, and who is enrolled in an eligible program of artistic, cultural, recreational or developmental activities. Parents of children under 18 years of age at the beginning of the year who are eligible for the Disability Tax Credit can claim a 15% non-refundable tax credit on an additional $500 disability supplement amount, provided at least a minimum of $100 has been paid in eligible expenses.

So, what qualifies?

The program must be either a weekly program lasting a minimum of eight consecutive weeks or in the case of children's camps, a program lasting a minimum of five consecutive days.

Examples of eligible activities include: art, chess, crafts, drama, Girl Guides, languages, music, painting, photography, pottery, public speaking, Scouts, sculpture, sewing and tutoring.

Either parent may claim the credit, or share the credit, provided that the total amount claimed is not more than the maximum amount that would be allowed if only one parent made the claim.

Family Caregiver Tax Credit

If you care for or provide support to a dependant with a mental or physical infirmity, including spouses, common-law partners and minor children, you will be able to take advantage of the newly proposed Family Caregiver Tax Credit.

This 15% non-refundable credit, which is proposed to begin in 2012, is based on an amount of $2,000 and can be claimed by caregivers as an enhanced amount under one of the existing dependency-related credits: the Spousal or Common-law Partner Credit, the Child Tax Credit, the Eligible Dependant Credit, the Caregiver Credit or the Infirm Dependant Credit.

The benefit of the credit is phased out based on the dependant's net income. Only one Family Caregiver Tax Credit is available for each infirm dependant. The amount is proposed to be indexed to inflation for 2013 and subsequent taxation years.

Medical Expense Tax Credit for Other Dependants

The Medical Expense Tax Credit (METC) allows individuals with significant medical expenses to claim a credit in respect of eligible expenses incurred by himself or herself, his or her spouse or common-law partner, or his or her children under 18 years of age.

Caregivers can also claim the METC for eligible expenses incurred in respect of a "dependent" relative if the caregiver pays medical or disability-related expenses of the dependent relative.

Who is a "dependent" relative?

A child who is 18 or older, a grandchild, parent, grandparent, brother, sister, uncle, aunt, niece or nephew, who is dependent on the taxpayer for support.

Under current rules, a caregiver may only claim the eligible expenses of a "dependent" relative that exceeds the lesser of 3% of the dependant's net income and an indexed dollar threshold ($2,052 in 2011), to a maximum of $10,000.

The 2011 Budget proposes to remove this $10,000 limit on eligible expenses that can be claimed under the METC in respect of a dependent relative. This is consistent with the normal METC rule, which has no maximum amount.

Students

Tuition Tax Credit – Examination Fees

Currently, tuition fees are eligible for a federal non-refundable credit of 15% of the amount paid. The 2011 budget proposes to amend the tuition tax credit to recognize exam fees paid to an educational institution, professional association, provincial ministry or other similar institution to take an exam that is required to obtain a federally or provincially recognized professional status.

Education Tax Measures – Study Abroad

The tuition tax credit is currently available to a Canadian student in full-time attendance at a university outside of Canada in a course leading to a degree only to the extent that the tuition fees are paid in respect of a course of at least 13 consecutive weeks.

Once this requirement is met, the student can also qualify for the education and textbook tax credits as well as be eligible to receive Educational Assistance Payments (EAPs) from a Registered Education Savings Plan (RESP).

Many programs at foreign universities, however, are based on semesters that are, in fact, shorter than 13 weeks, meaning that many Canadian students are denied the ability to claim tax credits or receive EAPs.

The 2011 budget proposes to change this requirement by reducing the minimum course-duration requirement that a Canadian student at a foreign university must meet from 13 consecutive weeks to three consecutive weeks.

Charities

Donation of Flow Through Shares

Among various charity measures in the 2011 budget, the change that may have the most significant effect on individual donors is in the area of flow-through share donations.

Over the past number of years, Canadians who wished to donate significant amounts to charity have been turning to flow-through shares as a means of funding their charitable giving at minimal cost.

Flow-through shares are essentially shares issued by oil and gas, mining and renewable energy companies that renounce or "flow-through" their exploration, development and project start-up expenses to investors, who can deduct these expenses personally on their own tax returns.

For tax purposes, flow-through shares are treated as having a tax cost or adjusted cost base (ACB) of zero when calculating any capital gain or loss from their ultimate disposition.

As a result, if an investor sells their flow-through shares, the full amount of the proceeds received becomes a capital gain. This essentially represents a partial recovery of the tax benefit provided by the government resulting from the deduction for the original tax cost of the shares, rather than a true economic gain resulting from an appreciation in the shares' value.

If an investor decides to donate the flow-through shares in-kind to a registered charity instead of selling them, the capital gain that would have arisen from a sale of the shares is completely tax-free. According to the government, this special exemption from capital gains tax on the donation of publicly listed securities allows donors "to avoid this second stage of the normal flow-through share rules."

To date, the Canada Revenue Agency has issued several favourable advance tax rulings on the legitimacy of such schemes, dating back to 2007, when the elimination of the capital gains tax on the donation of publicly traded shares to registered charities was introduced.

So, how good was it?

Let's say Jonathan, a top marginal rate Ontario taxpayer, purchases $10,000 of flow-through shares for which he gets a 100% tax deduction. This would save him about $4,600 at Ontario's top marginal rate of 46%, costing him only $5,400 for the shares. His ACB would be ground down to zero from $10,000.

Assuming, once the exploration is complete and the shares are marketable, the flow-through shares are still worth $10,000. Jonathan decides to donate them to a registered charity and gets a tax receipt for $10,000, worth 46%, for another $4,600 in tax savings. His capital gains tax was eliminated since he donated the shares to charity.

So, in total, for a cost of only $800 ($5,400 cost of the shares less the $4,600 donation tax credit), Jonathan has made a donation of $10,000 to charity.

In a move that is expected to preserve $185 million of forgone tax revenue over the next five years, the government is changing the rules and is proposing to allow the exemption from capital gains tax on donations of flow-through shares only to the extent that a flow-through investor's capital gain exceeds the amount paid for the shares, ignoring the deemed zero ACB of the flow-through shares.

So, following from the example above, if Jonathan were to buy $10,000 of flow-through shares issued today, his cost would still be $5,400, allowing for the flow-through deduction at 46%. Upon donation, his receipt would still be worth $4,600 (46% of $10,000), but his capital gains tax would be $2,300 (50% x 46% X $10,000) increasing the total cost of his donation from $800 to $3,100.

Registered Plans

RESPs – Asset Sharing Among Siblings

RESPs can be established as either an individual plan or a family plan. Often, parents or grandparents ("subscribers") who want to save for a number of their kids' post-secondary education will establish family plans which provide additional flexibility for the subscriber, by allowing the allocation of plan assets among the related children, subject to certain restrictions.

As an example, if one child doesn't pursue post-secondary education, RESP assets can be reallocated among his or her siblings who do go to school. Under current rules, all beneficiaries of a family plan must be connected to the original subscriber by blood or adoption and each beneficiary must be added to the plan before reaching age 21.

Aunts or uncles, for example, who want to save for a number of children through RESPs, but who are not considered "connected to the children by blood or adoption" can only do so through separate individual plans. To provide these subscribers of separate individual plans with the same flexibility to allocate assets among siblings as exists for subscribers of family plans, the 2011 budget proposes to allow transfers between individual RESPs for siblings, without any tax penalties and without triggering the repayment of Canada Education Savings Grants (CESGs), provided that the beneficiary of an RESP receiving the transfer of assets was under 21 when the plan was opened.

RDSPs – Shortened life expectancy

Registered Disability Savings Plans (RDSP), which were introduced in the 2007 budget, allow parents and others the option to contribute up to $200,000 towards the long-term financial security of a child with a severe disability. Investment income in an RDSP grows tax-free and can be supplemented with generous government credits and bonds in the form of the Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs).

RDSP contributions can attract up to $3,500 in annual CDSGs, depending upon the beneficiary's family income and the amount contributed, up to a lifetime limit of $70,000. In addition, CDSBs of up to $1,000 annually are provided to RDSPs for lower income families, up to a lifetime limit of $20,000.

One of the harshest criticisms of the RDSP system, as it was originally introduced, is what's become known as the "ten-year repayment rule." Under this punitive rule, all

CDSGs and CDSBs received by an RDSP in the preceding 10 years must be repaid to the government in the event of an RDSP withdrawal, or termination of the plan.

The 2011 federal budget proposes to allow RDSP beneficiaries who have shortened life expectancies to withdraw more of their RDSP savings by permitting annual withdrawals without triggering the 10-year repayment rule.

An election will be available to take advantage of this new rule. If the election is filed for a beneficiary with a shortened life expectancy, withdrawals made at any time following that election will not trigger the repayment of CDSGs and CDSBs provided that the total of the taxable portions of the withdrawals does not exceed $10,000 annually.

As a reminder, each withdrawal from an RDSP comprises a taxable portion and a non-taxable portion based on the relative proportions of taxable assets (including CDSGs, CDSBs and investment income and growth) and contributions.

As a result, total annual withdrawals can exceed $10,000 due to the non-taxable portions.

Once an election has been made, no further contributions to the plan will be allowed, and no new CDSGs or CDSBs will be paid into the plan. After the death of the beneficiary, any CDSGs and CDSBs remaining in the plan that were received by the plan within the preceding 10 years must be repaid.

RRSPs/RRIFs – Anti-avoidance rules

Taking a page out of the TFSA playbook, the federal government is cracking down on perceived RRSP and RRIF (which for simplicity, we'll refer to in this section as "RRSP") schemes and abuses. One such example is the so-called "RRSP strips", which purport to enable you to withdraw money from your RRSP tax-free. While the government has successfully challenged a number of these schemes in Tax Court, they continue to be marketed to innocent taxpayers, often resulting in punitive results.

Under existing TFSA anti-avoidance rules, an "advantage" is a benefit obtained from a transaction that is intended to exploit the tax attributes of a TFSA, such as shifting returns from a taxable investment to a TFSA investment.

TFSA advantages are subject to a tax equal to their fair market value, which should act as a deterrent to such transactions. RRSP advantages will include:

- RRSP strip transactions;
- Benefits derived from transactions that would not have occurred in a regular, open market between arm's length parties;

- Payments to an RRSP for services rendered, such as dividends paid by a corporate client of an individual on a special class of shares held by the individual's RRSP, in lieu of the individual receiving remuneration for services provided to the company;
- Investment income tied to the existence of another investment. For example, two securities issued "in tandem" where one is held inside an RRSP, the other outside, with the intended goal of "streaming" the total investment return disproportionately to one of the securities, and
- Swap transactions, in which property is transferred between an RRSP and an individual's non-registered account (other than a contribution or withdrawal).

As with TFSA advantages, the federal budget proposes to tax any RRSP advantage at 100% of the fair market value of the benefit, which should effectively put an end to these types of tax planning schemes.

These measures are generally retroactive to March 22, 2011, except for the measure relating to swap transactions, which is effective from July 1, 2011, as previously announced.

Small Businesses

Individual Pension Plans (IPPs)

IPPs are defined benefit Registered Pension Plans (RPPs) established for small business owners and their spouse or other family member that are employed by the business.

The federal budget proposes two new tax measures that will apply specifically to IPPs.

Minimum Withdrawals

Some business owners have established IPPs as a transfer vehicle to receive the commuted value of their pension under a defined benefit RPP. In these cases, the plan terms of the IPP are designed to provide a much less generous pension in respect of past service, based on minimal employment earnings with the new employer sponsor or a lower benefit formula.

As a result, much of the IPPs value is "pension surplus," which is not subject to any withdrawal requirements such that the business owner can defer more of their retirement savings, for longer periods of time than otherwise possible for other RPP members or RRSP investors.

The budget therefore introduces a new rule that will require an IPP to pay out to a member, each year after the year in which he or she turns 71, the greater of the regular pension amount payable under the IPP terms and the minimum amount that would be required to be paid from the IPP to the member if the member's share of the IPP assets were held in a RRIF.

According to the government, "This requirement will establish reasonable limits on deferrals of tax on IPP savings and generally ensure that such savings are received as income throughout the retirement period of the member, consistent with the basic purpose of RPPs."

These rules will begin in 2012.

Contributions for Past Service

The amount you can contribute to a defined benefit plan, including an IPP, is directly tied to the RRSP contribution limits. As a result, an IPP member's annual RRSP contribution limit is reduced by the estimated amount of annual saving in his or her IPP.

When a small business owner sets up an IPP, he or she often is given the option to make a contribution in respect of past service. To do so, however, the employee must either give up accumulated RRSP contribution room for earlier years or, to the extent that the employee has made RRSP contributions in those previous years, to withdraw a portion of RRSP assets to fund the IPP.

An employee who switches from RRSP savings to IPP savings later in their working career is able to make a past service contribution to the IPP which can be much greater than the amount the employee is required to reduce their RRSP assets or accumulated RRSP contribution room.

Under the new proposed rule, which is effective for past service contributions made on or after March 22, 2011, the cost of funding past service under the terms of an IPP must be first satisfied by transfers from RRSP assets, or a reduction in the IPP member's accumulated RRSP contribution room before new past service contributions will be permitted.

Employee Profit Sharing Plans

Finally, a heads up is warranted to business owners who use Employee Profit Sharing Plans (EPSPs). EPSPs allow business owners to share the profits of their business with their employees.

It's becoming more popular for business owners of small, closely-held companies to direct these plans towards members of their families with the intent of reducing or deferring taxes on these profits. Employers are also using EPSPs to avoid making Canada Pension Plan contributions and to avoid paying Employment Insurance premiums.

While no changes have been formally announced in this budget, the government did indicate that it "will review the existing rules for EPSPs to determine whether technical improvements are required in this area."

Before introducing any new rules governing EPSPs, however, the government will undertake stake-holder consultations.

Employers with existing EPSPs should watch for further news in this regard.

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