BMO NESBITT BURNS

2014 Federal Budget Review

February 11, 2014

On February 11, 2014, Finance Minister James Flaherty unveiled his 10th Federal Budget entitled "The Road to Balance: Creating Jobs and Opportunities". The Budget continues with the themes of recent budgets, including measures aimed at strengthening the Canadian economy through job creation and training and reducing the deficit with a forecasted return to a balanced budget in the near future.

In terms of income tax proposals, the Budget does not change corporate or personal income tax rates. As in other recent budgets, the government continues to focus on measures to maintain the integrity of the tax system and combat international aggressive tax avoidance and from a business income tax perspective, a significant overhaul of the eligible capital property regime governing the tax amortization of intangible property (such as business goodwill) is proposed.

From a personal tax perspective, which is the focus of this review, most of the proposals relate to maintaining tax fairness and integrity and minor tweaks of existing targeted measures were introduced, including the added flexibility proposed in obtaining the tax benefits of charitable donations made upon or after death. Notably, the Budget also seeks to curtail the benefits of "immigrant trusts" and it outlines the government's intention to proceed with the changes originally proposed in last year's budget which will eliminate the access of testamentary trusts to the graduated marginal tax rates, with limited exceptions.

The most significant income tax measures affecting individuals are summarized below. Note that the measures introduced are only proposals at this stage and may not ultimately be enacted into law. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.

Summary of Personal Income Tax Proposals

The 2014 Federal Budget focused on a number of smaller personal tax initiatives and tweaked some existing measures including the following:

Adoption Expense Tax Credit (AETC)

The maximum claim for the 15% non-refundable AETC has been increased to $15,000 in 2014, which will be indexed for inflation in subsequent years.

Medical Expense Tax Credit (METC)

Eligible expenditures have been expanded to include amounts paid to design a qualifying individualized therapy plan as well as costs associated with service animals specially trained to assist in managing severe diabetes, effective after 2013.

Search and Rescue Volunteers Tax Credit (SRVTC)

Eligible search and rescue volunteers may claim a new 15% non-refundable tax credit based on an amount of $3,000 in 2014 and later years.

Mineral Exploration Tax Credit for Flow-Through Investors

Eligibility for this tax credit has been extended for one year to flow-through agreements entered into on or before March 31, 2015.

Farming and Fishing Businesses

Eligibility is enhanced for the intergenerational rollover and the $800,000 Lifetime Capital Gains Exemption for shares or interests where the corporation or individual carries on both a farming and a fishing business.

Pension Transfer Limits

The Budget expands the circumstances in which the maximum transferable amount of a lump-sum pension commutation payment for a plan member who is leaving an underfunded defined benefit Registered Pension Plan (RPP) will be calculated as if the RPP were fully funded.

Tax on Split Income (Kiddie Tax)

To maintain the integrity of this anti-avoidance rule, the definition of split income is expanded for 2014 and later years to include income derived from any business or rental property that is paid or allocated to a minor from a trust or partnership if a person related to the minor is actively and regularly engaged in the income-earning activities and has an interest in the partnership.

Proposals Affecting Trusts

Non-Resident (Immigrant) Trusts

The Canadian tax legislation contains rules to prevent the use of non-resident trusts to avoid Canadian tax, by potentially deeming these trusts to be resident in Canada. Currently, these rules can exclude contributions to a non-resident trust by individuals resident in Canada for less than 60 months (which are typically referred to as "immigrant trusts"). However, to maintain the fairness and integrity of these rules, the Budget proposes to eliminate this 60-month exemption, generally effective after budget date or following the trust's 2014 taxation year.

Testamentary Trusts

A common estate planning strategy involves the use of a "testamentary trust" created at death (typically in the deceased's Will) to achieve income splitting tax benefits since this type of trust is currently able to access the graduated marginal tax rates available to an individual. In contrast, a trust created during lifetime (an "inter-vivos" trust) pays federal tax at the flat (top) rate of 29% (except certain "grandfathered" inter-vivos trusts created before June 18, 1971).

However, as noted in our 2013 Federal Budget Review, the government has become concerned with the growth in the tax-motivated use of testamentary trusts and announced its intention in last year's budget to review and consult on possible measures aimed at eliminating the special tax benefits that arise from taxing the income of testamentary trusts (and certain grandfathered inter-vivos trusts) at the marginal tax rates. Following a consultation period which ended in December 2013, today's Budget reaffirms the government's intention to proceed with the measures outlined in the consultation paper originating from last year's budget. Most notably, these measures include the application of the flat top tax rate to income taxed within a testamentary trust effective for 2016 and subsequent taxation years.

However, the 2014 Budget proposes two exceptions to the imposition of the flat top tax rate. Firstly, to recognize the period of time it may take to administer an estate, the first 36 months of a deceased individual's estate that is a testamentary trust will be eligible for the marginal tax rates, but the flat top tax rate will apply at the end of this 36-month period. Secondly, in response to the concerns expressed in the consultation period regarding the possible loss of income-tested benefits by disabled individuals (such as provincial social assistance payments), graduated marginal tax rates will continue to apply for testamentary trusts whose beneficiaries are eligible for the federal Disability Tax Credit.

The Budget also proposes to eliminate some of the other special tax treatments accorded to testamentary trusts, such as the exemption from income tax instalments and the exemption from the requirement to have a December 31 taxation year-end.

Proposals Affecting Charitable Giving Strategies

Donations of Ecologically Sensitive Land

The Budget proposes to extend the carryforward period for donations of ecologically sensitive land to 10 years (from the current 5-year carryforward period).

Estate Donations

Donations made by an individual to a registered Canadian charity (or other qualified donee) are eligible for a donation tax credit, based on the fair market value of the donated property at the time of the donation. The donation tax credit can be claimed by the individual in the current year or any of the five subsequent taxation years.

A special provision within the current tax legislation allows specific donations made pursuant to a Will to be deemed to have been made by the individual immediately prior to his or her death, even though the actual transfer may occur during the estate administration. This treatment can be beneficial in allowing a donation tax credit to reduce taxes otherwise payable at death in the individual's terminal tax return (or in the year preceding death). Similar provisions apply where an individual designates a qualified donee as a beneficiary under an RRSP, RRIF, TFSA or life insurance policy.

However, donations made by an individual's estate (which are not pursuant to the terms of the Will) do not qualify for this treatment and can currently only be applied against the estate's income tax otherwise payable, which may not be sufficient to allow the full benefit of the donation tax credit to be realized. Accordingly, the 2014 Federal Budget proposes to allow more flexibility in the tax treatment of charitable donations in the context of a death occurring after 2015. Specifically, a donation made by Will (and designated donations) will no longer be deemed to be made immediately before death. Instead, these donations will be deemed to have been made by the estate at the time the specific property is donated to the qualifying donee. Furthermore, the estate trustees will also have the flexibility to apply the donation tax credit (from a qualifying donation made within 36 months of death) amongst any of :

(i) the taxation year of the estate in which the donation is made;
(ii) an earlier taxation year of the estate; or
(iii) the last two taxation years of the deceased individual

within the existing annual donation credit limits.

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details.

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