FEDERAL BUDGET 2014

Jamie Golombek, CPA, CA, CFP, CLU, TEP
Managing Director, Tax & Estate Planning
CIBC Wealth Advisory Services
Jamie.Golombek@cibc.com

The February 11, 2014 federal budget included various tax measures that will affect individuals, registered plans, employers and trusts. Rather than summarize the entire budget document, this report, prepared from within the budget lock-up in Ottawa, will focus on a select number of key elements that are of most interest to individuals and small business owners.

PERSONAL TAX MEASURES

GST/HST Credit

Beginning with your 2014 tax return, you will no longer have to check the box on your T1 General personal tax return asking whether you want to apply for the GST/HST Credit. The GST/HST Credit is a non-taxable benefit that is paid to individuals based on their adjusted family net income. Instead, the Canada Revenue Agency (CRA) will automatically determine whether you are eligible to receive this credit. If you are eligible, the CRA will send you a notice of determination. 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.

Eligible Adoption Expenses Increasing to $15,000

Under the *Income Tax Act*, adoptive parents can claim a 15% non-refundable tax credit for eligible adoption expenses incurred with the completed adoption of a child under 18. Eligible expenses include not only fees paid to a licensed adoption agency, but other expenses such as mandatory immigration expenses related to the adopted child.

The current maximum limit is being increased to $15,000 for 2014 (from $11,774) to "better recognize the costs unique to adopting a child." This limit will be indexed to inflation after 2014.

Medical Expense Tax Credit

The Medical Expense Tax Credit (METC) is a non-refundable credit that provides tax relief of 15% of eligible medical expenses in excess of the lesser of 3% of net income or $2,171 in 2014. Two new eligible expenses are being added to the list of expenses for which an individual is entitled to the METC.

The first is amounts paid for the design and subsequent adjustment of an individualized therapy plan provided that the cost of the therapy itself would be eligible for the METC, such as applied behaviour analysis (ABA) therapy for children with autism, assuming certain conditions are met.

The second new eligible expense is for service animals specially trained to assist an individual in managing their severe diabetes. Eligible expenses for the METC will include the cost, care and maintenance expenses of the service animal as well as reasonable travel expenses to obtain the necessary training.

Acupuncturists' and Naturopathic Doctors' Services

Most medical and health-related services are exempt from charging GST/HST. In recognition of the fact that professional services of acupuncturists and naturopathic doctors are now regulated as a health profession in at least five provinces, Budget 2014 proposes that acupuncturists and naturopathic doctors be added to the list of health care practitioners whose professional services are exempt from charging the GST/HST, starting February 12, 2014.

Donations Made by Will / Beneficiary Designation

Current tax rules provide that if you leave money to a registered charity upon death, the donation is deemed to be made prior to your death with the result that the donation credit can be claimed on the terminal return for the year of death or the prior year. Similar rules apply if you leave your RRSP, RRIF, TFSA or life insurance policy to a charity by way of direct beneficiary designation.

On the other hand, donations made by your estate after you die can only be used by the estate to reduce any of the estate's tax payable.

Budget 2014 will provide additional flexibility in how donations made by will or beneficiary designation will be treated for tax purposes for deaths after 2015. Under the new rule, beginning in 2016, donations made by will and designation will no longer be deemed to be made by an individual immediately before the individual's death, but rather will be deemed to have been made by the estate at the time the property is donated to the registered charity.

The estate would then have the option to allocate the donation to the taxation year in which the donation is made, an earlier taxation year of the estate, or the last two taxation years of the individual who died.

REGISTERED PLANS

Pension Transfer Limits when Commuting a Pension Plan

If you leave a defined benefit pension plan, there are rules in the *Income Tax Act* that determine how much of your commutated value can be transferred tax-free into an RRSP.

A problem arises when an employee's commuted value is reduced due to the pension plan being underfunded at the time the employee leaves the plan. In such a case, the amount eligible for transfer to an RRSP is based on that lower commuted value payment, with the balance included in the taxpayer's income for the year in which it is received.

In 2011, the government introduced a special rule to cover these situations, but only where an underfunded pension plan of an insolvent employer is being wound up. Budget 2014 proposes to extend this rule to any commuted value paid to a departing employee under the following conditions: the payment has been reduced due to plan underfunding and the reduction in the estimated pension benefit that results in the reduced commuted value payment is approved pursuant to the applicable pension benefits standards legislation.

The application of this rule must be approved by the CRA and will apply to commuted value payments made after 2012.

"Earned Income" for Amateur Athletes

While Budget 2014 doesn't propose to increase the general annual RRSP contribution limit (beyond the annual inflation adjustment), there is a favourable change that could help amateur athletes save for retirement.

The annual RRSP contribution limit is generally equal to 18 per cent of your "earned income" for the previous year up to a specified dollar limit ($24,270 for 2014), less any pension adjustment plus unused RRSP contribution room carried forward from prior years.

Under the *Income Tax Act*, an amateur athlete who is eligible to compete in international sporting events as a Canadian national team member, is permitted to place any endorsement income, prize money, or income from public appearances or speeches into an "amateur athlete trust."

For tax purposes, any amounts contributed to an amateur athlete trust are excluded from the athlete's income for the year in which he or she makes the contribution, and the investment income can grow tax-deferred while inside the trust.

When the funds are ultimately distributed from the trust, they must be included in the athlete's income in the year of receipt. All funds must be distributed within eight years after the last year in which the athlete competed.

Since income that the athlete contributes to an amateur athlete trust is exempt from current tax, it is not treated as *earned income* for the purposes of determining an athlete's annual RRSP contribution limit, resulting in a reduced amount of RRSP room that could otherwise have been available to the athlete.

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 athlete's RRSP contribution limit, effective for contributions made in 2014.

Athletes who contributed income to an amateur athlete trust in 2011, 2012 and 2013 can make a special election before March 2, 2015 to recognize income contributed in those years as earned income eligible to increase their 2014 RRSP contribution room.

TAX CHANGES FOR EMPLOYERS

Employers are required to withhold and remit source deductions (income tax, CPP contributions and EI premiums) on a regular basis. How often a business must remit is based on the employer's total average monthly withholding amount in preceding calendar years.

Regular Remitter

If an employer's average monthly remittance two years ago was less than $15,000, it is a regular remitter and must remit source deductions by the 15th day of the month following the month the deductions are made.

Quarterly Remitter

Small employers have the option of remitting source deductions quarterly. To qualify for quarterly remitting, an employer has to:

- Have an average monthly withholding amount of less than $1,000 in either the first or the second preceding calendar year;
- Have a perfect compliance history in the previous 12 months; and
- Have no outstanding GST/HST returns or T4 information returns for the previous 12 months.

Accelerated Remitter

An employer whose average monthly withholding amount from two years ago is significant may have to make accelerated remittances.

Threshold 1

This group includes employers who had a total average monthly withholding amount of $15,000 to $50,000 two calendar years ago. Amounts deducted or withheld in the first 15 days of the month are due by the 25th of the same month while amounts withheld from the 16th to the end of the month are due by the 10th day of the following month.

In order to reduce the tax compliance burden for these remitters, Budget 2014 proposes to increase the threshold level of average monthly withholdings at which employers are required to remit two times per month to $25,000 from $15,000.

Threshold 2

This group includes employers who had a total average monthly withholding amount of $50,000 or more two calendar years ago. Amounts are due by the third working day (not counting Saturdays, Sundays, or holidays) after the end of the following periods:

- From the 1st through the 7th day of the month;
- From the 8th through the 14th day of the month;
- From the 15th through the 21st day of the month; and
- From the 22nd through the last day of the month.

Budget 2014 proposes to increase the threshold level of average monthly withholdings at which employers are required to remit four times per month to $100,000 from $50,000.

Both these changes will apply starting in 2015.

TRUSTS

Elimination of Immigration Trusts

An "immigration trust" is a non-resident trust generally set up by wealthy immigrants moving to Canada as a way to shelter investment income from Canadian taxation during their first five years of Canadian residency. It is often set up in a tax haven, where no local taxes are imposed and takes advantage of a specific exception in the *Income Tax Act* to the non-resident trust rules that exist to generally prevent Canadians from setting up offshore trusts to avoid paying Canadian tax.

Under the tax law, if a Canadian resident contributes property to a non-resident trust, the "deemed residence rules" could apply to treat the non-resident trust as resident in Canada and thus subject to Canadian taxation.

A five-year exemption from these deemed residence rules applies if the contributors to the trust are individuals who have been residents in Canada for less than a total of 60 months. If the exemption applies, the trust is not subject to Canadian taxation on its foreign-source income. Canadian residents who are not new immigrants cannot take advantage of this tax holiday with the result that the five-year exemption for immigrants raises "tax fairness, tax integrity and tax neutrality concerns."

Budget 2014 will remove the five-year exemption from the deemed residence rules, effectively eliminating immigration trust planning immediately. For immigration trusts currently in existence, 2014 will be the last year these trusts can avoid Canadian taxation.

Elimination of Graduated Tax Rates for Testamentary Trusts

Background

A testamentary trust is a type of legal arrangement in which one person, typically known as the estate trustee, holds and manages the deceased's property for the benefit of someone else, known as the beneficiary. A testamentary trust also includes an estate, which arises upon death and generally lasts until the executor distributes the assets to the beneficiaries who are inheriting under the will of the deceased.

For tax purposes, both trusts and estates are considered to be individuals and must file returns that require them to pay tax on the trust's taxable income. In 2014, testamentary trusts and estates pay tax at graduated tax rates starting at 15% federally for income under about $44,000 and ultimately rising to 29% once income reaches about $136,000. Each province other than Alberta, which has a 10% flat provincial tax, also applies its own set of graduated tax rates to the testamentary trust's income.

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 an often recommended post-mortem tax planning strategy.

Example

Suppose your will leaves all funds to your spouse who pays tax at the highest marginal rate in Ontario in 2014. If your spouse were to invest the inherited funds in a non-registered account that earned $100,000 of ordinary income, your spouse would pay tax of almost $50,000. If instead your will directed that the funds be put into a testamentary trust for the benefit of your spouse, the trust would pay about $30,000 of tax on $100,000 of ordinary income in 2014. Graduated rate taxation in a testamentary trust could, therefore, yield tax savings of about $20,000 for the year. Current law allows the annual savings to continue indefinitely.

Federal Budget 2013 & Consultation Paper

In last year's federal budget, the government announced that it was "concerned with potential growth in the tax-motivated use of testamentary trusts and the associated impact on the tax base." As such, it announced a consultation process to review proposed changes to the tax law that would eliminate the tax benefits that arise from taxing testamentary trusts at graduated rates.

In June 2013, the government published a consultation paper proposing several changes to the taxation of testamentary trusts and estates. The government cited the use of multiple testamentary trusts, tax-motivated delays in completing the administration of estates, and avoidance of the old age security (OAS) clawback as offensive testamentary trust planning that may have sparked the proposed changes. As a result, the consultation paper announced the government's intention to eliminate a number of tax benefits that are currently available to testamentary trusts and estates. As expected, many of the proposals in the consultation paper have been incorporated into Budget 2014.

Budget 2014 Changes

Under Budget 2014, graduated rate taxation for testamentary trusts and estates will be significantly curtailed.

Starting in 2016, flat top-rate taxation at 29% federally would apply to testamentary trusts created by wills as well as to estates "after a reasonable period of administration" of 36 months. Consequently, the benefits of graduated rate taxation would generally be limited to the first three years of an estate.

Budget 2014 did, however, respond to concerns of various stakeholders that the existing graduated rate tax system for testamentary trusts set up for the benefit of a disabled person was an important tool in preserving access by these individuals to income-tested benefits, such as provincial social assistance benefits. As a result, graduated rates will continue to be available indefinitely for testamentary trusts whose beneficiaries are individuals who are eligible for the federal disability tax credit.

Along with changes to graduated rate taxation, there are a few other measures from the 2013 consultation paper that have found their way into the Budget 2014 proposals, specifically.

- Testamentary trusts will be required to make quarterly tax instalment payments. Currently, payment of tax can be deferred until 90 days after the trust's year end.
- The $40,000 basic exemption from alternative minimum tax (AMT) that is currently available for all testamentary trusts and estates would be restricted to estates that are not subject to flat top-rate taxation.
- The use of a calendar taxation year would be mandated for all testamentary trusts and estates that are subject to flat top-rate taxation, preventing the tax deferral that is currently available through use of an off-calendar year.

Non-tax Benefits

Although the Budget 2014 proposals will severely curtail the tax benefits available for testamentary trusts in the future, there are numerous other non-tax reasons why a testamentary trust may still make sense in your estate plan, including:

- Administration and management of inheritances for minor beneficiaries until they reach the age of majority.
- Control over the timing and amount of distributions to your beneficiaries. For example, you can specify that 50% of an inheritance would be distributed when the beneficiary reaches age 25 and the remainder at age 30.
- Flexibility in structuring payments to your beneficiaries. The trustee can be given discretion as to the amount and timing of distributions to your beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves.
- Preservation of a family inheritance. For example, your will may specify that income from the assets in your estate will be available to provide for the needs of your spouse during his or her lifetime but that the estate assets will ultimately go to your children upon your spouse's death, preserving the assets for the next generation.
- Professional investment management may be stipulated in the trust agreement, allowing funds to be handled by an experienced investment manager, rather than by beneficiaries who may be novice investors or prone to making poor investment decisions.
- Motivation of behaviour for a beneficiary. An "incentive trust" is generally designed to make distributions if a beneficiary engages in desired behaviours, such as paying for post-secondary education or engaging in employment or self-employment.

As with all planning strategies, you should seek the advice of a qualified tax advisor.