Federal Budget June 2011: STEP Canada Summary

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As a result of winning a majority in the May 2011 election, the federal government has returned to the House with a Budget that is almost identical to the document it tabled back in March when election fever was in the air. The proposed amendments of interest to STEP Canada members and their clients are of significantly technical nature, driven by administrative concerns within the federal Department of Finance ("Finance"). Following are the principal highlights.

"Kiddie Tax" targets certain capital gains

The "tax on split income" rule, popularly known as "Kiddie Tax" in section 120.4 of *Income Tax Act* (the "Act"), limits income-splitting techniques that seek to shift certain types of income from a higher-income individual to a lower-income minor.

The highest marginal tax rate, currently 29%, applies to "split income" consisting of taxable dividends received from private corporations and income from a partnership or trust if that income is derived from providing property or services to, or in support of, a business carried on by a person related to the minor or in which the related person participates.

The Kiddie Tax does not currently apply to capital gains realized by minors. As a result, income-splitting techniques have been developed that utilize this tax loophole. These techniques involve capital gains being realized for the benefit of a minor on a disposition of shares of a corporation to a person who does not deal at arm's length with the minor. In 2005, the CRA indicated that the general anti-avoidance rule ("GAAR") was a concern with respect to using stock dividends to avoid the Kiddie Tax (see Income Tax Technical News N° 34).

In response, the 2011 Budget contains a proposal to extend the Kiddie Tax rule to capital gains realized by, or included in the income of, a minor from a disposition of shares of a corporation to a person who does not deal at arm's length with the minor, if taxable dividends on the shares would have been subject to the Kiddie Tax. Capital gains that are subject to this measure will be treated as ineligible dividends, and as a consequence, they will not be subject to the capital gains inclusion rates or qualify for the lifetime capital gains exemption. Further, the corporation will be considered not to have paid a dividend. Several commentators have observed that the wording of paragraph 23 of the Notice of Ways and Means Motion is quite broad and might be interpreted to deny capital gains treatment on the disposition of the common shares in typical estate freeze planning many years after the freeze. It is reasonably clear that the target of the proposed measure is narrower than this, but it remains to be seen how the statutory provision will be worded. This measure will apply to capital gains realized on or after March 22, 2011. In addition, Ottawa will continue to monitor the effectiveness of the Kiddie Tax, and take "appropriate action if new income-splitting techniques develop."

Donations of flow-through shares: Limit placed on capital gains exemption

Current tax measures provide an incentive to donate publicly listed securities to registered charities that have appreciated in value and carry unrealized capital gains by eliminating the capital gains tax on such donations.

A taxpayer can acquire and donate publicly listed flow-through shares at little after-tax cost since the donor benefits from:

- the deduction for the expenses flowed through from a corporation
- applicable federal and provincial mineral exploration flow-through share tax credits;
- the Charitable Donations Tax Credit or deduction in respect of the value of the shares; and,
- relief from capital gains tax, including tax on the portion of the gain attributable to the zero cost for the shares.

If not donated to a registered charity, the full amount of the proceeds received on a disposition would be recognized as a capital gain since the flow-through shares are treated as having a cost of zero for the purpose of calculating any gain or loss on their disposition.

Capital gains tax on the proceeds up to the amount of the original cost are viewed by the government as a partial recovery of the tax benefit provided by the deduction for the original cost of the share, not a gain resulting from an appreciation in the share's value. The current exemption from capital gains tax on donations of publicly listed securities allows taxpayers to avoid this feature of the flow-through share rules. The 2011 Budget contains a proposal to eliminate this tax benefit with complex new tax rules.

The exemption from capital gains tax on donations of publicly listed securities will be available in respect of a donation by the taxpayer of flow-through shares only to the extent that the capital gain on the donation exceeds the "exemption threshold" at the time of the donation. The "exemption threshold" of a taxpayer in respect of a particular class of flow-through shares will generally be equal to the amount by which the sum of the original cost, without regard to the deemed zero cost of flow-through shares, of all flow-through shares of the particular class issued to the taxpayer exceeds the amount of each capital gain realized by the taxpayer on a disposition of any shares of the particular class, not exceeding the amount of the "exemption threshold" immediately before the time of the disposition. In effect, a taxpayer will be required to recognize a capital gain to the extent that the capital gain realized on a subsequent disposition of the flow-through shares is equal to or less than the original cost of the shares.

A taxpayer's exemption threshold in respect of a particular class of shares will be reset at nil at any time that the taxpayer no longer holds any shares of that class. As well, an anti-avoidance rule will apply to the donation of property acquired by a donor in a tax-deferred transaction -- a "rollover."

Ottawa cracking down on "schemes" involving RRSPs

Finance is proposing a series of rules that it says will prevent certain "schemes" undertaken by a small number of taxpayers involving Registered Retirement Savings Plans. Finance says it has successfully challenged a number of these schemes under existing tax rules. Nevertheless, the Budget states, these schemes continue to evolve, and be marketed.

First, Finance is proposing to adopt the "advantage" concept from the tax rules governing Tax-Free Savings Accounts (TFSA). For example, benefits derived from transactions that would not have occurred in a regular, open market between arm's length parties would be caught. So would payments to an RRSP made on account or in lieu of payments for services. This could include: 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 corporation; investment income where the income is tied to the existence of another investment, for example, the offering of two types of securities in tandem, where one is held inside an RRSP and one outside.

Benefits derived from asset purchase and sale transactions between RRSPs and other accounts controlled by the RRSP annuitant, known as "Swap Transactions" would be caught under the new rules.

Income from "non-qualified investments" would be targeted too. Examples of non-qualified investments include shares in private investment holding companies or foreign private companies, and real estate.

An RRSP annuitant will be subject to a special tax of 50% of the fair market value of a non-qualified investment. The tax liability will apply at the time that a non-qualified investment is acquired by the RRSP or at the time an investment becomes non-qualified. Unless the annuitant knew or ought to have known that the investment was non-qualified, this tax will be refundable to the annuitant if the investment is disposed of from the RRSP by the end of the year following the year in which the tax applied.

The "advantage" rule will also be applied to "prohibited investments." In the TFSA context, a "prohibited investment" generally includes debt of the TFSA holder and investments in entities in which the TFSA holder or a non-arm's length person has a "significant interest" (10% or more), or with which the TFSA holder does not deal at arm's length.

A special tax equal to 50% of the fair market value of the investment will apply to an RRSP annuitant on acquisition of a prohibited investment by his or her RRSP. The tax will generally be refunded, if the investment is disposed of from the RRSP by the end of the year following the year in which the tax applied, unless the annuitant knew or ought to have known that the investment was a prohibited investment when it was acquired.

Federal government to relieve RDSP restrictions on beneficiaries with shortened life expectancies

In recognition of the need for Registered Disability Savings Plan (RDSP) beneficiaries with shortened life expectancies to access their savings, the Ottawa is proposing to provide more flexibility to withdraw their RDSP assets without requiring the repayment of "Canada Disability Savings Grants" and "Canada Disability Savings Bonds." These new rules require a medical doctor to certify in writing that the beneficiary's state of health is such that, in the doctor's opinion, the beneficiary has a life expectancy of five years or less.

If a planholder decides to take advantage of this measure, the plan holder will be required to elect to do so in a prescribed form and submit the election with the medical certification to the RDSP issuer. To reverse an election, the planholder will be required to provide notice in a prescribed form to the RDSP issuer.

New rules proposed for Individual Pension Plan withdrawals and contributions

It is proposed that the tax rules governing individual pension plans" ("IPPs") include annual minimum withdrawal amounts similar to current requirements for Registered Retirement Income Funds (RRIFs), once a plan member attains the age of 72.

Finance is also proposing that contributions made to an IPP that relate to past years of employment be required to be funded first out of a plan-member's existing Registered Retirement Savings Plan (RRSP) assets, or by reducing the individual's accumulated RRSP contribution room before new deductible contributions in relation to the past service may be made.

It is proposed that an IPP be required to pay out to a member, each year after the year in which he or she attains 71 years of age, an amount equal to the greater of: the regular pension amount payable to the member in the year pursuant to the plan 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 of which the member was the annuitant.

Consultations proposed to ensure viability of Employee Profit Sharing Plans

Employee Profit Sharing Plans (EPSPs) are used by business owners to share profits with their employees. Finance states in the Budget, "In recent years, these plans have increasingly been used as a means for some business owners to direct profit participation to members of their families with the intent of reducing or deferring taxes on these profits. Some employers are also using EPSPs to avoid making Canada Pension Plan contributions and to avoid paying Employment Insurance premiums on employee compensation."

To ensure that EPSPs continue to be a vehicle for employers used for their "intended purpose", Finance will review the existing rules for EPSPs to determine whether technical improvements are required in this area.

New flexibility under RESP rules

Registered Education Savings Plans (RESPs) are tax-assisted savings vehicles designed to help families accumulate savings for a child's post-secondary education. Parents and grandparents may open family plans for siblings. However, individuals such as aunts or uncles who are not considered under the Act to be connected to the children by blood or adoption and want to save for a number of children through RESPs have only been able to do so through separate individual plans.

To provide subscribers of separate individual plans with the same flexibility to allocate assets among siblings that exist under family plans, the 2011 Budget proposes to allow transfers between individual RESPs for siblings without penalty. These measures will apply to asset transfers that occur after 2010.

Tougher regulation proposed for charitable sector

Finance is proposing tougher regulatory measures for the charitable sector. The Act grants the privilege of issuing official donation receipts to certain types of organizations referred to as "qualified donees." Registered charities are the most common type of qualified donee.

In the 2011 Budget, Finance is proposing to extend certain regulatory requirements which govern registered charities to organizations such as: registered Canadian amateur athletic associations; universities outside of Canada that usually have Canadian students; municipalities; and, municipal and public bodies performing government functions and certain charitable organizations outside Canada such as the United Nations.

Like registered charities, these qualified donees will now be required to be listed on a publicly available list maintained by the Canada Revenue Agency ("CRA").

Finance also wants to ensure that its rules for donation receipts are met by enabling the CRA to suspend receipting privileges or revoke qualified donee status for organizations that do not conform to the Act and its regulations. Proper receipts must: be only for transfers that qualify as gifts; properly establish the fair market value of donated property; ensure that receipts contain accurate and complete information.

Notably, Finance also wants to clear the path for access to qualified donees' books and records by proposing that the CRA be allowed to verify donations through gaining access to the books and records upon request.

Tighter controls on charitable board membership

Finance is proposing stricter regulation of members of the board of directors, trustees, officers or individuals who otherwise control or manage the operation of a registered charity or an RCAAA. At present, the Act does not provide for consideration of the criminal history or other misconduct by such individuals as grounds for refusal to register the organization or to revoke its registration. It is proposed that the CRA be enabled to refuse or to revoke the registration of an organization, or suspend its authority to issue official donation receipts, if one of the aforementioned individuals:

- has been found guilty of a criminal offence in Canada or an offence outside of Canada that, if committed in Canada, would constitute a criminal offence under Canadian law, relating to financial dishonesty or any other criminal offence that is relevant to the operation of the organization;
- has been found guilty of an offence in Canada within the past five years;
- was a member of the board of directors, a trustee, officer or equivalent official, or an individual who otherwise controlled or managed the operation of a charity during a period in which the organization engaged in serious non-compliance for which its registration has been revoked within the past five years; or,
- was a promoter of a gifting arrangement or tax shelter in which a charity participated and the registration of the charity was revoked within the past five years for reasons related to its participation.

Reassessment for donors who receive returned donations

There are instances when a qualified donee returns donated property to a donor. To ensure that charitable donations tax credit or deduction previously claimed is not improperly retained, the CRA will be permitted to reassess a donor to disallow a donation tax credit or deduction, where property is returned to a donor. In these circumstances the qualified donee will be required to amend the receipt and send a copy of the revised receipt to the CRA when the amount of the receipt has changed by more than $50.

Tax benefits deferred for donations of non-qualifying securities

Generally, a charitable donations tax credit or deduction is not available to a donor until the use and benefit of the donor's property have been transferred to a registered charity or other qualified donee.
One of these provisions applies in the case of donations of non-qualifying securities (NQS) of the donor. An NQS is generally defined as a share, debt obligation or other security issued by the taxpayer or by a person not dealing at arm's length with the taxpayer.
Determination of eligibility for a charitable donations tax credit or deduction to the donor will be deferred -- within five years of the donation of the NQS -- when the donee has disposed of the NQS for consideration that is not, to any person, another NQS.
These measures will apply in respect of securities disposed of by donees on or after March 22, 2011.

Clarifying rules for donating options

It is proposed that the charitable donations tax credit or deduction will not be available to a taxpayer for granting an option to acquire property of the taxpayer to a charitable organization until the donee acquires property of the taxpayer that is the subject of the option. The taxpayer will be allowed a credit or deduction at that time based on the amount by which the fair market value of the property at that time exceeds the total amount, if any, paid by the donee for the option and the property. A charitable donations tax credit or deduction generally will not be available to the taxpayer if the total amount paid by the qualified donee for the property and the option exceeds 80% of the fair market value of the property at the time of acquisition by the donee.