

On March 21, 2013, Finance Minister James Flaherty released the Federal Budget of the majority Conservative government which he labelled the “Economic Action Plan 2013 – Jobs, Growth and Long-Term Prosperity”. The Budget again focuses on the government’s long-term strategy to strengthen the Canadian economy, reduce the deficit, create jobs and continues with the theme of enhancing the integrity of the tax system by: closing tax loopholes, strengthening compliance, and combating international tax evasion and aggressive tax avoidance, in addition to introducing several targeted tax measures.

Key personal tax changes proposed involve specifically targeted measures to curtail perceived abuses or tax “loopholes”, including proposed measures aimed at leveraged life insurance products, certain financial hedging arrangements (such as “forward sales”) and other financial products designed to convert fully taxable income into capital gains taxed at a lower rate. Notably, the Budget also proposed a higher effective tax rate on non-eligible dividends and announced the government’s intention to review the tax benefits associated with the graduated marginal tax rates available to testamentary trusts.

The most significant personal income tax measures 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

Adoption Expense Tax Credit

The Adoption Expense Tax Credit (AETC) is a 15% non-refundable tax credit that allows adoptive parents to claim eligible expenses relating to the adoption of a child under the age of 18 in the taxation year in which the adoption is finalized. Recognizing that significant expenses could be incurred prior to a match with a child, the Budget proposes to allow the adoption period for the AETC to be expanded in certain situations. This measure will apply to adoptions finalized after 2012.

First Time Donor’s Super Credit

The Charitable Donations Tax Credit (CDTC) provides an individual with a federal non-refundable tax credit of 15% for the first \$200 of annual charitable donations and a credit of 29% for the portion of donations that exceed \$200. To encourage charitable giving, the Budget proposes to introduce a temporary First-time Donor’s Super Credit (FDSC), on cash donations only, which will supplement the CDTC with an additional 25% federal tax credit for a “first-time” donor on up to \$1,000 of donations. This measure will be available in respect of donations made on or after the Budget Date and may be claimed only once in 2013 or a subsequent taxation year before 2018.

Lifetime Capital Gains Exemption

Currently, the income tax system provides an individual with a Lifetime Capital Gains Exemption (LCGE) on up to \$750,000 of capital gains realized on the disposition of qualified property, such as qualified small business corporation shares, and qualified farm and fishing property. Effective taxation year 2014, the Budget proposes to increase the LCGE to \$800,000, and will index the exemption for inflation in subsequent years. This measure will apply to all individuals, including those who have previously used the LCGE.

Deduction for Safety Deposit Boxes

In recognition of the declining importance of retaining paper copies of documents for income-earning purposes related to a taxpayer’s investment portfolio, the Budget proposes to make the cost of renting a safety deposit box from a financial institution non-deductible for income tax purposes. This measure will apply to taxation years that begin on or after the Budget Date.

Dividend Tax Credit

The dividend tax credit (DTC) and its gross-up mechanism are intended to compensate an individual for corporate income taxes to reflect that the corporation paying the dividend has already paid taxes on its profits. Under existing rates, the current DTC and gross-up factor applicable to non-eligible dividends overcompensates

individuals putting them in a better tax position than if they had earned the income directly. As a result, the Budget proposes to adjust the gross-up factor applicable to non-eligible dividends from 25% to 18% and the corresponding DTC from $\frac{2}{3}$ of the gross-up amount to $\frac{13}{18}$. This measure, which will effectively increase the tax cost of earning non-eligible dividends, is applicable to non-eligible dividends paid after 2013.

Labour-Sponsored Venture Capital Corporations Tax Credit

Labour-Sponsored Venture Capital Corporations (LSVCCs) are a type of mutual fund corporation, sponsored by labour unions or other labour organizations, that make venture capital investments in small-and-medium-sized businesses. The Budget proposes to phase out the current 15% federal tax credit provided for the acquisition of shares of LSVCCs on investments of up to \$5,000 each year. The federal LSVCC tax credit will remain at 15% when it is claimed for a taxation year that ends before 2015 and will be reduced to 10% for the 2015 taxation year, 5% for the 2016 taxation year, and then will be eliminated for the 2017 and subsequent taxation years.

Restricted Farm Losses

The Restricted Farm Loss (RFL) rules apply to taxpayers who have incurred a loss from farming and have not met the chief purpose income test which is intended to ensure that taxpayers for whom farming is not the principal occupation are limited in their ability to deduct farm losses from their non-farm income. As a result of this interpretation of the RFL rules being challenged in a recent Supreme Court case, the Budget proposes to amend the RFL rules and codify the chief source of income test in order to restore the intended policy of these rules. In addition, the Budget also proposes to increase the RFL limit from \$8,750 to \$17,500 of deductible farm losses annually. These measures will apply to taxation years that end on or after the Budget Date.

Closing Tax Loopholes

In keeping with the theme of recent Budgets, the government has again introduced specific and targeted measures to curtail perceived abuses and improve the integrity and fairness of the Canadian tax system. The most significant of these measures applicable to specific transactions involving individuals are outlined below.

“Synthetic Dispositions”

Some financial arrangements, which the government has termed “synthetic disposition transactions”, seek to defer tax or obtain other tax benefits by allowing the taxpayer to monetize or economically dispose of a property with an accrued but unrealized gain without triggering immediate tax consequences. Generally, the hallmark of these transactions is the elimination of the future risk of loss and opportunity for gain or profit, in exchange for another property (or right) of similar value, such as certain “forward sale” or “put-call collar” arrangements. The Budget proposes to treat these “synthetic disposition transactions”, which have the effect of eliminating all or substantially all of the taxpayer’s risk of loss and opportunity for gain, as dispositions at fair market value for tax purposes at the time of entering into the arrangement. This measure will apply to agreements and arrangements entered into on or after the Budget Date, as well as existing agreements if the term is extended on or after the Budget Date. However, some arrangements such as ordinary hedging transactions which typically involve managing the risk of loss, will be excluded from these measures.

“Character Conversion Transactions”

The government is also concerned with certain other financial products or arrangements involving the use of derivative contracts (which they refer to as “character conversion transactions”) which seek to reduce tax by converting investment returns having the character of ordinary income into capital gains which are only 50% taxable. These transactions typically link a derivative investment (which would otherwise produce ordinary taxable income) with the purchase or sale of an otherwise unrelated capital property (which produces a capital gain). However, the Budget proposes to treat the return from the underlying derivative arrangement, that has a duration of more than 180 days, as being distinct from the capital property disposition in order to prevent the perceived abuses of these investment products which would otherwise convert fully taxable income into capital gains taxed at lower rates. Any return that is not determined by reference to the performance of the capital property being purchased or sold will be treated as being on income account.

“Leveraged Life Insurance Arrangements”

The government has also acted to eliminate the perceived tax benefits associated with the use of leveraged life insurance arrangements, namely “leveraged insured annuities” and “ 10% arrangements” which have been the subject of recent challenges by the CRA.

A “leveraged insured annuity” typically involves the use of borrowed funds in connection with the purchase of a lifetime annuity and life insurance policy, both of which are issued in respect of the life of a particular individual.

A “ 10% arrangement” typically involves the purchase of a life insurance policy, followed by a loan to replace the capital and use of these loan proceeds to acquire income-producing assets to achieve interest deductibility. The interest income earned by the exempt insurance policy (which grows tax-free) is set at a rate (typically 8%) which is slightly lower than the interest rate on the loan (typically 10%) but because the interest expense is intended to be tax-deductible, an overall after-tax benefit is achieved.

The government is concerned with the “multiple and unintended” tax benefits created by the combination of the various investment products involved in these arrangements, especially in light of the beneficial tax treatment accorded to life insurance. As a result, the Budget proposes to reduce the tax efficiency of these products by eliminating the attractive tax benefits of these arrangements, such as the potential ability to deduct a portion of the life insurance premiums for tax purposes (and interest costs, in the case of the “ 10% arrangement”), and denying the addition to the capital dividend account of the death benefit for policies owned by private corporations which are associated with these arrangements.

These proposed amendments will generally apply for taxation years ending on or after the Budget Date. However, the Budget also proposes to alleviate the income tax consequences of a withdrawal on termination of existing “ 10% arrangements” if the withdrawal is made on or after the Budget Date and prior to 2014.

On a related note, the government also confirmed its intention to proceed with its review of the life insurance “exempt policy” test and the possible introduction of related legislative proposals, as originally introduced in the 2012 Federal Budget.

Administrative/Compliance Measures

Extended Reassessment Period

- **Foreign Income Verification Statement (Form T1135)**

A Canadian-resident individual, corporation, trust and certain partnerships that, at any time during a year, owns specified foreign property costing more in total than \$100,000 must file a Foreign Income Verification Statement (Form T1135) with the CRA. A delay in the filing of a Form T1135 effectively reduces the time available for CRA to obtain the information necessary for a proper examination of the foreign income reported on the taxpayer’s income tax return. As such, the Budget proposes to extend the normal reassessment period for a taxation year of a taxpayer by three years in certain circumstances such as when the taxpayer fails to identify or to report income from a specified foreign property, or when Form T1135 is not filed on time. Additionally, Form T1135 will be revised to require more detailed information, such as the foreign country, the name of the entity holding the foreign investments, and the foreign income generated. The revised form and the above measures will apply to the 2013 and subsequent taxation years.

- **Tax Shelters and Reportable Transactions**

As above the Budget proposes to extend the reassessment period for reportable tax avoidance transactions and tax shelters when the required information returns are not filed properly and on time.

Charitable Donation Tax Shelters

In order to discourage participation in questionable charitable donation tax shelters and to reduce the risk that unpaid amounts will ultimately become uncollectible, the Budget proposes to modify the prohibition on the CRA from taking collection action in cases where a taxpayer has objected to an assessment of tax, interest or penalties resulting from the disallowance of a deduction or a tax credit claimed in respect of a tax shelter involving a charitable donation. More specifically, the CRA will be permitted to collect 50% of the disputed tax, interest or penalties pending the ultimate determination of the taxpayer’s liability. This measure will apply in respect

of amounts assessed for the 2013 and subsequent taxation years.

International Tax Evasion and Aggressive Tax Avoidance

The Budget proposes a number of measures to strengthen the capacity of the CRA to combat international tax evasion and to address international aggressive tax avoidance as follows:

- **International Electronic Fund Transfers**

The Budget proposes that certain financial intermediaries report to the CRA international electronic funds transfers (EFTs) of \$10,000 or more. Reporting will be required beginning 2015.

- **Information Requirements Regarding Unnamed Persons**

The Budget also proposes changes to streamline the CRA process for obtaining information concerning unnamed persons from third parties.

- **Stop International Tax Evasion Program**

The Budget announced a new “Stop International Tax Evasion Program”, which will enable the CRA to pay individuals with knowledge of international tax non-compliance a percentage of tax collected as a result of the information provided. The CRA will announce further details on the program in the coming months.

Other Tax Measures

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 subject to the graduated tax rates available to individuals. In contrast, a trust created during one’s lifetime (an “inter-vivos” trust) pays federal tax at the flat (top) rate of 29% (except for certain “grandfathered” inter-vivos trusts created before June 18, 1971).

However, the government is concerned with the growth in the tax-motivated use of testamentary trusts and its impact on the tax base, including the use of multiple testamentary trusts allowing beneficiaries of those trusts to effectively access more than one set of graduated rates, delays in completing the administration of estates and the use of these trusts to avoid the Old Age Security (OAS) clawback. As such, although the Budget does not propose any specific tax measures to address these concerns, the Budget document announced that the government intends to consult on possible measures to eliminate the tax benefits from the graduated, marginal tax rates available to testamentary trusts, estates and grandfathered inter-vivos trusts and intends to engage in consultations with affected stakeholders regarding these possible measures.

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

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