The 2014 Federal Budget - Our tax “free” comments

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Today, Finance Minister James Flaherty delivered his 10th Federal Budget (the “Budget”). Surprisingly, the Budget contained a lot more tax content than expected. Here are the highlights.

Executive summary

For those who do not have the energy to plow through the details or the Budget documents, here is a quick summary.

1. Graduated tax rates for trusts and estates are to be eliminated starting in 2016.
2. The tax exemption for Non-Profit Organizations and the reporting standards for such entities is under review.
3. The tax treatment for eligible capital expenditures is under review and proposed to be repealed and replaced.
4. Tax planning for multinational enterprises is under review.
5. A new rule dealing with treaty shopping is proposed.
6. The charitable tax rules dealing with gifts by will are being proposed to be streamlined and simplified.
7. The 60 month tax exemption for immigrants who hold their assets in a non-resident trust is being repealed.
8. A new $3,000 non-refundable personal tax credit for certain search and rescue volunteers is introduced.
9. The adoption credit is increased from $11,774 to $15,000.
10. The “kiddie tax” is being expanded to include income realized by trusts and partnerships who earn business income or rental income.
11. Payroll remittance thresholds for certain employers are being increased.
12. The section 273 joint venture GST / HST election is being proposed to be simplified and expanded.
13. Certain planning involving “captive insurance” affiliates and captive “offshore banks” is being curtailed.
14. The thin capitalization and withholding tax rules will be amended to apply to certain “back-to-back loan arrangements”.

Tax measures

1. Announced tax consultations

The Budget announced new consultations and updates on previously announced consultations.

a) Taxation of testamentary trusts and estates

As predicted in our [Budget prediction] blog, the Government announced that it is proceeding with the proposals to eliminate graduated tax rates for estates and testamentary trusts as generally outlined in its consultation paper. However, one deviation from the consultation paper is that graduated tax rates will continue to apply to beneficiaries of testamentary trusts who have disabled beneficiaries who qualify for the disability tax credit. The Government announced that more details surrounding the implementation of these new measures will be released in the coming months. The new rules will apply to the 2016 and subsequent taxation years and the government estimates that it will save approximately $70-$80M annually as a result of this change.

Overall, this is disappointing. It appears many submissions made by the public have effectively been ignored including the submission put forth by the Joint Committee. This will significantly impact estate planning and estate administration for Canadians on an ongoing basis. For accountants who file tax returns for estates who have a non-calendar year end, get ready for more work in the first three months of the year (yes, we know you could use more work during that time). Testamentary trusts that do not have a calendar taxation year will have a deemed taxation year-end on December 31, 2015. While such a year-end will not cause such trusts or estates to be subject to non-graduated tax rates for the 2015 year, it does reset the estate or trust's taxation year with the 2016 taxation year of the trust being subject to non-graduated tax rates for retained income.

Again, disappointing that the Department of Finance did not better respond to the many concerns put forward during the consultation period.

b) Consultation on Non-Profit Organizations ("NPOs")

An NPO is a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure, recreation or for any other purpose other than for profit. NPOs, under current law, are exempt from Canadian income tax. The government has heard concerns that certain NPOs may be earning profits that are not incidental to carrying out the organization's non-profit objectives, making income available for the personal benefit of members or maintaining disproportionately large reserves. In addition, reporting requirements for NPOs are limited and therefore members of the public cannot adequately assess the NPO's activities.

Given the above, the Government announced its intention to review whether the NPO income tax exemption remains properly targeted and whether NPOs reporting requirements are sufficient. Such a review will not include registered charities. A new consultation paper will soon be released by the government for comment by the public.

We generally believe this is a positive move by the government. Certainly there are some NPOs that use the available tax exemption to the benefit of their membership and earn business profits that are not incidental to their non-profit objectives. This can result in an unfair competitive advantage when compared to entities in the commercial mainstream. However, this review sounds very ambitious and the NPO sector should get ready for possible significant tax and reporting changes.

c) Consultation on the taxation treatment of eligible capital property ("ECE")

ECE is generally a capital expenditure incurred to acquire rights or benefits of an intangible nature for the purpose of earning income from a business other than an expenditure that is deductible as a current expense or that is incurred to acquire an intangible property that is otherwise treated as a depreciated property for purposes of the capital cost allowance ("CCA") rules. ECE also includes the cost of goodwill, customer lists, licenses and franchise rights and farm quotas that have an indefinite life.

Presently, the ECE rules are complex. Generally, 75% of ECE is added to a tax pool and the business can claim a deduction up to 7% per year on a declining balance basis. Of ECE receipts (received on a sale), 75% reduce the tax pool which first results in a recapture of previously claimed amounts. Any excess amounts are then 1/2 taxable as business income.

Given the complexity, the government announced that it is studying the possibility of repealing the present ECE system and essentially transferring such amounts to a new depreciable CCA class. The new CCA class would have a 5% declining balance depreciation rate and would be subject to all "normal" CCA rules (1/2 year rule on acquisition, recapture rules, etc). Special rules would apply to goodwill and certain transitional rules would apply to transfer the ECE tax pools to the new CCA pools. Detailed legislative proposals will be released by the Department of Finance for public consultation soon.

Overall, we were not anticipating this proposed change, and expect that it will have a profound effect on the agriculture industry (ie. dairy and poultry quota). We agree that the ECE regime is unnecessarily complex and generally support any initiative to simplify the taxation issues surrounding ECE. However, the devil is in the details and we look forward to studying the draft legislation when it is released.

We will be studying the draft legislation to determine how capital gains on the disposition of ECE by a Canadian controlled private corporation ("CCPC") are proposed to be dealt with. Currently, the disposition of ECE by a CCPC in excess of the tax pool balances is 1/2 taxable, with the resulting amount treated as business income. The proposed change appears to treat the excess as a capital gain and thus would be subject to the refundable dividend tax on hand account ("RDTOH") system which would effectively require the CCPC to pay out taxable dividends to recover the RDTOH whereas tax deferral is currently available due to the lower business income rates. Ultimately, a capital gain result by a CCPC is not as tax efficient as the current system given today's tax rates. Stay tuned.

d) Consultation on tax planning by multinational enterprises ("MNEs")

MNEs, like Apple, Amazon, Google, Starbucks and others have been peeled, searched, roasted (well, you get the idea) over the last year or so regarding their tax practices. The Organisation for Economic Co-operation and Development ("OECD") has also been very concerned and has launched a project aimed at addressing "base erosion and profit shifting" ("BEPS"). The OECD BEPS project is a very ambitious project and Canada is actively involved. Given such, the Budget announced that it is seeking input from the public on a series of targeted questions involving MNEs' tax activities / planning.

It also announced that it is seeking input on what actions the government should take to ensure the effective collection of sales tax on e-commerce sales to residents of Canada by foreign based vendors.

Stay tuned… this area is about to become even more interesting.

e) Treaty shopping

The 2013 Federal Budget announced that it was studying abuses relating to treaty shopping – a term commonly used to refer to arrangements under which an entity not entitled to the benefits of a particular tax treaty with Canada uses an entity that is resident of a state with which Canada has concluded a tax treaty so as to obtain Canadian tax benefits. This 2013 announcement attracted the attention of the CBA/CICA/CPA Joint Committee on Taxation which provided comments on the questions raised in the Consultation paper. In addition, the Canadian Tax Foundation held two high profile conferences in Calgary and Toronto last week where a distinguished set of speakers addressed the complex issues surrounding treaty shopping.

The 2014 Federal Budget has responded to the Consultation process by proposing a new rule that would address treaty shopping. The new rule would use a general approach focused on avoidance transactions and contain specific provisions setting out how it would apply. The Budget documents contain more information regarding how the new rule would apply and lay out a series of five examples to illustrate it. Interested parties will have 60 days to provide comments to the Department of Finance.

This is a fascinating area of study for tax geeks like us. However, it is enormously complex and challenging. Suffice it to say that this is a fast moving area of tax law and expect changes soon.

2. Personal tax measures

a) Charitable tax credits on death

The current system dealing with testamentary gifts is administratively complex. The current law, set out in subsection 118.1(5) of the *Income Tax Act* (the "Act"), is that a gift made by will is deemed to be made by the deceased immediately prior to death. In many cases, the tax result of such a rule is good since the deceased often, as a result of the deemed income inclusions arising upon death, can use the resulting charitable donation credits to reduce the tax liability. However, in some cases, as a result of unclear will drafting, there may be debate as to whether or not there was actually a gift made by will. For example, if the executor of the deceased has complete discretion as to whether or not to make a charitable gift or to which charity to make it, then any future gift made by the deceased's estate would likely not be viewed to occur immediately prior to death. Such charitable credit would be "trapped" in the estate only to be used against the estate's income arising after death.

Another problem that has often arisen with gifts by will is how to value such gifts. These gifts are deemed to occur at the value of the donated property immediately before death. However, the actual transfer of property to the charity can often take place months or years after death depending on how complex the estate administration is. When dealing with donated property that can be easily valued (such as publicly traded stocks), such valuation complexities can be minimized. However, what about assets where there is no readily available valuation (like private company shares, land, etc.)?

The Budget attempts to deal with the above issues head on. For deaths that occur after 2015, donations made by will and designation donations (such as amounts designated from RRSPs, RRIFs, TFSAs or life insurance policies) will be deemed to have been made by the estate and not the deceased at the time the property is transferred to the charity. People who administer estates will have the flexibility to allocate the available donation among any of: a) the taxation year of the estate in which the donation is made; b) an earlier taxation year of the estate; c) or the last two taxation years of the deceased. A qualifying donation will be a donation effected by a transfer within 36 months after the individual's death.

Wow… we really like these new proposals as they will reduce the income tax uncertainty that currently exists in this area.

b) Non-resident immigration trusts

For years, a limited Canadian tax exemption applied for certain immigrants (who have not previously been residents in Canada) with respect to their foreign sourced assets that were held by a non-resident trust. Overly simplified, if a person (who was never a resident of Canada) was considering becoming a resident of Canada, such person could transfer their existing foreign sourced assets to a non-resident trust before becoming a resident. The resulting income realized by the non-resident trust would be tax-free for a period of 60 months following the individual becoming a resident. This kind of planning compares very favorably had the immigrant not transferred his foreign sourced assets to a non-resident trust since the income realized on the immigrant's foreign sourced assets would otherwise have been subject to Canadian tax.

The Budget proposes to eliminate the 60 month exemption in respect of non-resident trusts for taxation years: a) that end after 2014 if i) at any time that is after 2013 and before February 11, 2014 the 60 month exemption applies in respect of the non-resident trust, and ii) no contributions are made to the trust on or after February 11, 2014 and before 2015; or b) that end on or after February 11, 2014 in any other case.

Well, it was good while it lasted. Overall, the elimination of this tax exemption is not that surprising, but unexpected in this Budget. However, this may have a correlation to the recent changes to the *Citizenship Act.* It will certainly make immigration to Canada a more painful tax exercise for very wealthy immigrants.

c) Adoption tax credit

The maximum amount of eligible expenses for purposes of claiming the 15% federal tax credit will be increased from $11,774 to $15,000 per adoptive child for 2014 and indexed to inflation for years thereafter.

d) Search and rescue volunteers tax credit

Welcome to another new personal tax credit. Eligible individuals who perform at least 200 hours of volunteer search and rescue services in a taxation year (for one or more ground, air or marine search and rescue organizations, that consist primarily of responding to and being on call for search and rescue related emergencies, attending meetings held by the organization and participating in required training) will be eligible for a new 15% non-refundable tax credit based on an amount of $3,000. Certain exceptions will apply.

While admirable, the introduction of this new credit continues a long list of tax credits that are administratively complex. One questions whether or not the tax system is the right method to reward these well deserving volunteers.

3. Business measures

a) "Kiddie Tax" adjustments

In 2000, the kiddie tax was introduced to shut down income splitting with minors that had become prolific. If the kiddie tax applies, the child who receives the income will be subject to the highest marginal rate applicable to that source of income. The parents of the child subject to the kiddie tax are also jointly and severally liable for its payment. The kiddie tax applies to taxable dividends (and shareholder benefits) received directly or indirectly through a partnership or trust in respect of unlisted shares of Canadian or foreign corporations. It also applies to income from a partnership or trust that is derived from providing property or services, to or in support of, a business carried on by a person related to the minor in which the related person participates. In recent years, the kiddie tax was also expanded to certain types of capital gains realized from dispositions of unlisted shares to persons who do not deal at arm's length with the minor.

The Budget proposes to further expand the scope (for 2014 and subsequent taxation years) of the kiddie tax to income that is, directly or indirectly, paid or allocated to a minor from a trust or partnership if i) the income is derived from a source that is a business or a rental property; and ii) a person related to a minor is actively engaged on a regular and continuous basis in the activities of the trust or partnership to earn income from any business or rental property; or has, in the case of a partnership, an interest (directly or indirectly) in the partnership.

In order to plan around the kiddie tax, certain businesses (that provided services to the public) were carried on by the owner-manager through a trust or partnership of which a trust (for the benefit of the owner manager's family) would be a partner. It was arguable that any resulting profits could then be allocated and split with the family, and without the incidence of the kiddie tax. Now, such plans will be subject to the kiddie tax for any amounts allocated to the minor children of the owner-manager.

In addition, certain advisors have been recommending the use of trusts to carry on a person's consulting business in order to combat the risk that the "personal services business" rules would apply if such consulting business would be carried on through a corporation. These advisors would further recommend that the trust's income could be split with the consultant's minor children. Such plans will now result in the imposition of the kiddie tax for any amounts allocated to the person's minor children.

b) Payroll remittance thresholds

Currently, employers who had, two calendar years ago, a total average monthly withholding amount of at least $15,000 but less than $50,000 are required to remit payroll deductions to the CRA up to twice a month. (Threshold 1)

In addition, employers who had, two calendar years ago, a total average monthly withholding amount of at least $50,000 are currently required to remit deductions to the CRA up to four times per month. (Threshold 2)

The Budget proposes to increase the minimum average monthly withholdings for Threshold 1 from $15,000 to $25,000 and the minimum average monthly withholdings for Threshold 2 from $50,000 to $100,000.

This measure appears to be an elimination of "red tape" initiative and Canadian employers will certainly welcome it.

c) GST / HST for joint ventures

Interestingly, the Budget contains a measure that the CRA commented on last week (and that will be the subject of a Moodys Gartner blog scheduled to be released later this week) regarding GST / HST participants in certain joint ventures. As will be discussed in more detail in our blog, participants in certain joint ventures are able to make an election that simplifies the GST / HST accounting obligations by allowing the joint venture participants to elect one person to be responsible for accounting for the GST / HST in the course of the joint venture activities. However, such an election, under section 273 of the *Excise Tax Act*, is available only if the activities of the joint venture are prescribed by regulation.

The Budget intends to propose a new joint venture election (as well as complementary anti-avoidance measures) that will enable the participants in a joint venture to make the election as long as the activities of the joint venture are exclusively commercial and the participants are engaged exclusively in commercial activities. Draft legislation will be released by the Department of Finance later this year for public comment.

Overall, this is a very welcome initiative by the Department. As mentioned earlier, we are scheduled to release a blog on GST / HST matters involving joint ventures later this week and such blog will attempt to reconcile this new initiative with the CRA's earlier comments involving joint ventures.

d) Captive insurance and offshore banks

Canada's foreign accrual property income ("FAPI") rules (contained in section 95 of the Act along with its related regulations to the Act) are intended to prevent taxpayers from shifting certain Canadian sourced income (usually passive types of income) to lower tax rate jurisdictions. Under the FAPI regime, such income earned by a controlled foreign affiliate ("CFA") of a taxpayer resident in Canada is considered FAPI and is taxable in the hands of the Canadian resident taxpayer on an accrual basis.

Some taxpayers have entered into "clever" tax planning designed to circumvent the FAPI rules and involve insurance swaps. Such plans generally involve transferring Canadian "risks", originally insured in Canada, to a wholly owned foreign affiliate of the taxpayer. The Canadian risks are then exchanged with a third party for foreign risks that were originally insured outside of Canada, while at the same time ensuring that the affiliate's overall risk profile and economic returns are essentially the same as they would have been had the affiliate not entered into the exchange.

While the government is challenging some of these arrangements through the general anti-avoidance rule (the "GAAR"), the Budget intends to amend the existing FAPI rules to effectively shut down these "captive insurance" arrangements. These new rules will apply for taxation years of taxpayers that begin on or after February 11, 2014.

For certain Canadian companies that have organized "captive insurance" affiliates, the Budget proposal will have a large impact on their insurance planning. Remedial planning will need to be immediately done.

One of the exceptions to Canada's FAPI regime (the "regulated foreign financial institution exception") is for a business carried on by an affiliate as a foreign bank, trust company, credit union, insurance corporation (and other limited exceptions) the activities of which are regulated under the laws of the country in which the business is carried on. As the Budget documents state, the purpose of the regulated foreign financial institution exception is to treat certain *bona fide* financial services businesses carried on by foreign affiliates as active businesses rather than as investment businesses. If considered an investment business, the FAPI regime would then apply to the foreign affiliate bank.

However, the government is concerned about certain taxpayers that are not financial institutions that purport to be eligible for the regulated foreign financial institution exception. Accordingly, the Budget proposes to introduce new rules that will tighten the regulated foreign financial institution exception. The Budget documents contain the detailed new proposals, but in effect "offshore banks" of Canadians (who are not a Canadian regulated financial institution) will now likely not be eligible for the FAPI exception. The government estimates that this new measure will increase Canadian tax revenues by approximately $250M /yr.

e) Amendments to Thin Capitalization Rules

The thin capitalization rules under subsection 18(4) of the Act (and its related provisions) limit the deductibility of interest expense of a corporation or a trust in circumstances where the debt owing to certain non-residents exceeds a 1.5:1 debt-to-equity ratio. For a corporation, these rules generally apply to debts owing to a "specified shareholder" (a person that, either alone or together with persons with which the person is not dealing at arm’s length, owns shares representing at least 25% of the votes or value of the corporation) that is not resident in Canada and to those debts owing to any other non-resident that does not deal at arm’s length with a specified shareholder. For a trust, similar rules apply to debts owing to a “specified beneficiary” that is not resident in Canada and to any other non-resident that does not deal at arm’s length with a specified beneficiary.

The government has observed that some persons have sought to avoid the thin capitalization rules (or the Part XIII withholding tax that applies to certain interest payments made to non-residents) through the use of so-called “back-to-back loan” arrangements. Such plans generally involve interposing a foreign bank between the two related persons in order to avoid the thin capitalization rules compared to the situation where the loan would have made directly between the two related parties.

The Budget proposes to introduce an anti-avoidance rule in the Part XIII withholding tax rules and the existing thin capitalization rules. Where such a back-to-back loan arrangement exists, appropriate amounts in respect of the obligation, and interest paid or payable thereon, will be deemed to be owing by the taxpayer to the non-resident person for purposes of the thin capitalization rules. The Part XIII withholding tax will also be deemed to apply to such amounts. The non-resident person and the taxpayer paying such amounts will be jointly and severally liable for the additional Part XIII withholding tax. A back-to-back loan arrangement will exist where, as a result of a transaction or series of transactions, the following conditions are met:

i) a taxpayer has an outstanding interest bearing obligation owing to a lender (the intermediary); and

ii) the intermediary, or any person that does not deal at arm’s length with the intermediary

a. is pledged a property by a non-resident person as a security in respect of the obligation,
b. is indebted to a non-resident person under a debt for which recourse is limited, or
c. receives a loan from a non-resident person on condition that a loan be made to the taxpayer.

Such measures will apply for taxation years that begin after 2014 for the thin capitalization rules and to amounts paid or credited after 2014 for the Part XIII withholding tax changes.

These are significant changes and Canadians will need to take these proposals into account when planning their international financing affairs. Overall, the tax measures in this Budget are very targeted and certainly will not have the “sex” appeal of Budgets past (if anything in tax can be said to be sexy!). Tax geeks like us will have plenty to ponder for a while though. We would be pleased to discuss any of the Budget measures with you.