Federal Budget 2013 analysis

In the days leading up to the release of the 2013 Federal Budget, Finance Minister Jim Flaherty telegraphed the government's primary focus on job creation. Staying with that narrative, he introduced a number of initiatives to promote broad-based job creation, as well as some targeted measures designed to promote particular constituencies.

The secondary theme floated ahead of Budget Day was the closing of tax loopholes. As it turns out, these latter initiatives touch on more than just the obscure, with particularly serious implications for small business corporations and those who employ advanced life insurance strategies.

And of course, there are a few goodies in terms of tax relief. Charities will be pleased with an enhanced tax credit, and small business owners may be able to protect against some future capital gains.

As is our practice at Invesco Canada, this summary selectively focuses on specific Budget elements that may have the biggest impact on personal finances and investments. It was prepared from within the budget lock-up in Ottawa by Doug Carroll, Invesco's Vice President of tax and Estate Planning.

1. Job creation

Much of Mr. Flaherty's Budget Speech dealt with job creation, infrastructure funding and supporting manufacturing and innovation. This is to be achieved through a renewal of "Labour Market Agreements" between the federal government and its provincial counterparts.

A new program entitled the Canada Job Grant could provide $15,000 or more per person for skills development. Up to $5,000 will be provided by the federal government, and that amount may be matched by the applicable province or territory and the employer.

Key constituencies targeted in the Budget are apprentices, persons with disabilities, youth, Aboriginal peoples and immigrant workers. The approaches widely range from allocation of funds toward education and training, communication efforts toward individuals and potential employers, as well as targeted infrastructure and sector-specific programs.

2. Tax relief

a. Charitable giving - First-Time Donor's Super Credit (FDSC)

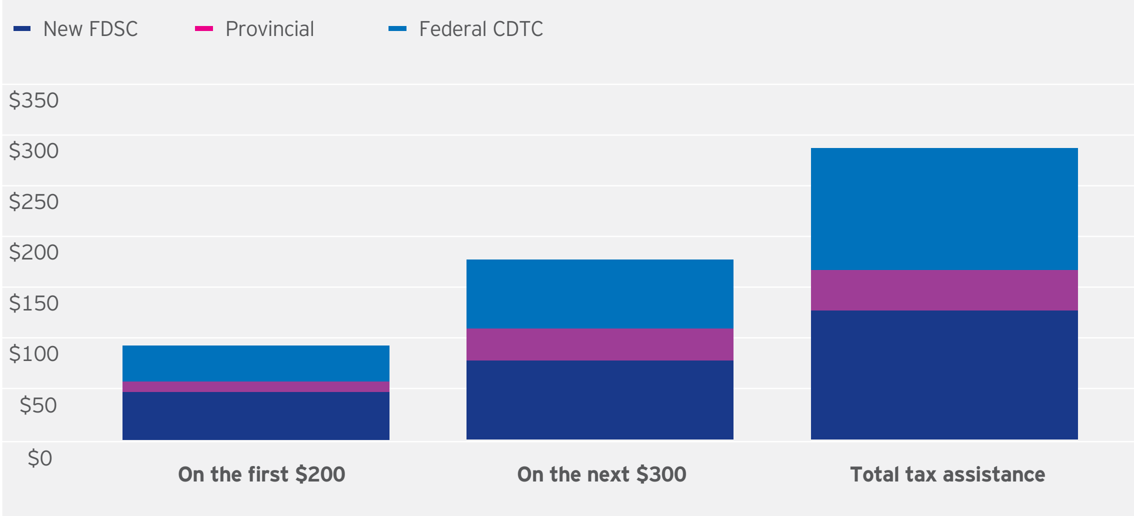
The Charitable Donations Tax Credit (CDTC) provides an individual with a non-refundable tax credit of 15% for the first $200 of annual charitable donations and a credit of 29% for the portion of donations that exceeds $200. Provincial credits generally operate on a similar two-tier basis.

A new temporary First-time Donor's Super Credit (FDSC) is proposed that will supplement the CDTC with an additional 25% tax credit for a first-time donor on up to $1,000 of donations. Accordingly, a first-time donor will be entitled to a 40% federal credit for donations of $200 or less, and a 54% federal credit for the portion of donations over $200, but not exceeding $1,000. Only donations of money will qualify for the FDSC.

An individual will be considered a first-time donor if neither the individual nor the individual's spouse or common-law partner has claimed the CDTC or FDSC in any taxation year after 2007.

As an example, using Ontario for illustration, a qualified donor who makes a $500 donation in 2013 would be entitled to a total of $286 in tax assistance.

First-time donor's super credit (FDSC)



b. Sports equipment and baby clothing

As an acknowledgement of the retail price gap that sometimes exists between Canada and the United States, certain tariffs will be eliminated. This will cover baby clothing generally and some sports equipment.

Example of tariff relief for Canadian consumers		
Product	**Current tarif***	**Tariff as of April 1, 2013**
Baby clothing	18%	Free
Ice skates	18%	Free
Hockey equipment	2.5% - 18%	Free
Skis and snowboards	6.5% - 20%	Free
Golf clubs	2.5% - 7%	Free
Exercise equipment	6.5%	Free

*Tariff rates are as per Canada's Customs Tariff. Tariffs apply on the F.O.B. landed value of imported goods.

c. Adoption expense tax credit

The Adoption Expense Tax Credit (AETC) is a 15% non-refundable tax credit that allows adoptive parents to claim eligible adoption expenses relating to the completed adoption of a child under the age of 18 (up to a maximum of $11,669 in expenses per child for 2013). Generally, expenses only become qualified after a child is matched with his or her adoptive family.

To better recognize that there may be significant costs that adoptive parents must incur prior to being matched, the adoption period will be extended back to when an application is made to the appropriate provincial ministry, licensed agency or Canadian court.

This measure will apply to adoptions finalized after 2012.

3. Small business

a. Lifetime capital gains exemption (LCGE)

The Budget proposes to increase the LCGE on capital gains realized on the disposition of qualified small business corporation shares and qualified farm and qualified fishing property.

The current amount of $750,000 will be increased to an $800,000 exemption of capital gains realized by an individual on qualified property, effective for the 2014 taxation year. After 2014, the LCGE will be indexed to inflation. The new LCGE limit will apply for all individuals, even those who have previously claimed the LCGE.

b. Changes to dividend tax credit (DTC)

To calculate tax on Canadian dividends, a taxpayer is required to gross-up the actual dividend received in order to emulate the income the corporation is presumed to have earned in order to pay the dividend. The DTC then compensates the individual for the amount of corporate-level tax presumed to have been paid on the grossed-up amount.

There are separate gross-up and DTC credit rates applicable to income that has been charged full corporate tax rates ("eligible" dividends) and those dividends generated after benefiting from the corporate small business deduction. The government has determined that the current DTC and gross-up factor applicable to non-eligible dividends over-compensate individuals for income taxes presumed to have been paid at the corporate level on active business income.

The Budget proposes to adjust the gross-up factor applicable to non-eligible dividends from 25% to 18% and the corresponding DTC from 2/3 of the gross-up amount to 13/18. Expressed as a percentage of the grossed-up amount of a non-eligible dividend, the effective rate of the DTC in respect of such a dividend will be 11%.

This measure will apply to non-eligible dividends paid after 2013.

4. Life insurance strategies

a. Leveraged insured annuities

A leveraged insured annuity (LIA) involves the use of borrowed funds in connection with a lifetime annuity and a life insurance policy, both of which are issued on the life of an individual. The strategy is designed to obtain deductibility of the interest on the borrowed funds while earning tax-free income within the exempt life insurance policy.

The Budget proposes to eliminate some of these unintended tax benefits by treating a life insurance policy as a "LIA policy" if:

- a person or partnership becomes obligated on or after Budget Day (March 21, 2013) to repay an amount to another person or partnership (the lender) at a time determined by reference to the death of the individual; and
- an annuity contract, the terms of which provide that payments are to continue for the life of the individual, and the policy are assigned to the lender

Income accruing in an LIA policy will be subject to annual accrual-based taxation, no deduction will be allowed for any portion of a premium paid on the policy, and the capital dividend account of a private corporation will not be increased by the death benefit received in respect of the policy.

This measure will apply to taxation years that end on or after Budget Day. This measure will not apply in respect of leveraged insured annuities for which all borrowings were entered into before Budget Day.

b. 10/8 arrangements

A 10/8 arrangement involves investing in a life insurance policy with a view to borrowing against that investment for the purpose of creating an annual interest-expense tax deduction for a long period of time (i.e., until the death of an individual whose life is insured under the policy). The interest rate earned by the taxpayer is typically the rate paid on the borrowing less a fixed percentage. In some cases, the insurance premiums may be deductible. Where funds of a closely-help private corporation are used for this purpose, the further effect is an eventual credit to the corporation's capital dividend account.

In respect of taxation years that end on or after Budget Day, if such a policy is pledged as security for borrowing, then the following income tax benefits will be denied:

- the deductibility of interest paid or payable on the borrowing that relates to a period after 2013;
- the deductibility of a premium that is paid or payable under the policy that relates to a period after 2013; and
- the increase in the capital dividend account by the amount of the death benefit that becomes payable after 2013 under the policy and that is associated with the borrowing

5. Communications with consumers of financial services

a. Comprehensive financial consumer code

The government has proposed the development of a comprehensive financial consumer code to better protect consumers of financial products and ensure they have the necessary tools to make responsible financial decisions. It is not clear what is to be included in this code, but the government will be conducting "extensive consultations… to seek the views of Canadians," before moving to streamline legislation and regulations.

b. Protecting vulnerable Canadians from predatory lending

Specific mention is made to the government's concerns about high-cost loans and payday lending. The federal government will continue to work with provincial authorities to assure that these products are effectively regulated. As well, the government will take steps to make the public aware that government cheques can be cashed at any bank in Canada, whether or not the payee is a bank customer.

c. Financial literacy for seniors

Mention is made of past steps taken by this government to protect seniors, including increased criminal penalties where fraudsters target seniors and amendments to privacy legislation enabling financial institutions to report suspected fraud upon seniors.

6. Targeting tax simplification and tax loopholes

a. Charitable donation tax shelters

The Canada Revenue Agency (CRA) is generally prohibited from taking collection action in respect of assessed income taxes and related interest and penalties where a taxpayer has objected to the assessment. As charitable donation tax shelters can be many years in litigation, there can be a significant delay in collections from affected taxpayers.

The Budget proposes to amend the limitation on CRA's collections efforts to allow CRA to collect 50% of disputed tax, interest or penalties, pending ultimate determination of the taxpayer's liability.

b. End of Labour-Sponsored Venture Capital Corporations (LSVCC) Tax Credit

The LSVCC was introduced in the 1980s when access to venture capital for small- and medium-sized businesses was limited. The economic environment and the structure of the venture capital market have changed significantly since then, and the effectiveness of the LSVCC has been questioned by many commentators.

The Budget proposes to phase out the federal LSVCC tax credit and to end new LSVCC registrations. The government will consult with stakeholders to assist in an orderly phase-out.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at invesco.ca.

c. Restricted farming losses

In the 2012 decision of the Supreme Court of Canada (SCC) in *R. v. Craig*, the taxpayer was able to deduct farming losses against other income even though farming was subordinate to his other source of income. This overruled the 1977 SCC decision in *Moldowan v. R*.

In response, the Budget proposes amendments to codify and restore the chief source of income test as interpreted in Moldowan. Essentially, other sources of income must be subordinate to farming income in order for the farming losses to be deductible against those other sources.

d. Foreign activities reporting

The government intends to step up its efforts to combat international tax evasion and aggressive tax avoidance. Among the initiatives:

- certain financial intermediaries must report electronic funds transfers of $10,000 or more;
- the CRA will launch the Stop International Tax Evasion Program to solicit informants on evasion transactions exceeding $100,000 of federal tax, with awards up 15% of federal tax avoided; and
- Form T1135 will be revised and more broadly promoted to make taxpayers more aware of their foreign reporting obligations, and how to comply with them

e. Certain financial arrangements and sophisticated trust issues

A few items of a technical nature are also affected by Budget proposals. Due to their technical nature, interested individuals are encouraged to consult the Budget document directly and discuss its implications with a tax professional. These items include synthetic dispositions, character conversion transactions, trust loss trading and attribution rules affecting non-resident trusts.

f. Consultation on graduated rate of taxation of trusts and estates

Testamentary trusts and inter vivos trusts grandfathered in 1971 are entitled to the use of graduated tax rates. This in turn allows the beneficiaries of such trusts to make multiple use of the graduated tax brackets.

The government is also concerned with potential growth in the tax-motivated use of testamentary trusts and the associated impact on the tax base. The government is considering the elimination of these tax benefits, and will issue a consultation paper to provide stakeholders with an opportunity to comment on those possible measures.

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