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## Tax News: 2011 Federal Budget Highlights

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## BUDGET OVERVIEW

Federal Finance Minister Jim Flaherty tabled his Budget in the House of Commons on Tuesday, March 22, 2011. All three of the opposition parties stated they will not support the Budget as presented. Failing some compromise, Prime Minister Stephen Harper will likely be obliged to call a federal election, in which case the Budget's proposals will not be enacted into law.

The Budget does not propose any new taxes for individuals, and it reflects the government's continuing commitment to previously announced corporate tax reductions. Nor does it propose any major new programs of spending initiatives — in fact it proposes a comprehensive review of government program spending aimed at increasing efficiency and effectiveness.

Some of the more significant tax-related and other proposals are discussed below.

### I. BUSINESSES

#### CORPORATE PARTNERSHIPS

Under current law, where one partner of a partnership is an individual, other than a testamentary trust, the partnership's fiscal year-end must be December 31. This 1995 measure prevents individuals from deferring income earned by the partnership to the subsequent calendar year. A partner corporation that is a professional corporation is also required to have a December 31 year-end. However, a corporate partnership still had deferral opportunities.

The Budget proposes rules to limit the deferral opportunities for corporations with partnership interests which, together with all affiliated (as defined) and related (as defined) persons, entitled the corporation to more than 10% of the partnership's income (or assets in the case of a wind-up) at the end of the last partnership year-end that ended in the corporation's fiscal period. The new rules will apply to corporate fiscal periods that end after March 22, 2011.

Where a partnership of corporations is established, it is common to set the year-end of the partnership on a date that is after the year-ends of the corporate partners. For example, if the corporate partners have March 31 year-ends, the partnership would generally be given an April 30 year-end in order to defer 11 months of income. This deferral opportunity will no longer be available. Each corporate partner will be required to include stub period income in its current fiscal period rather than in the subsequent period.

The following example provides a broad overview of the new rules for the aforementioned corporate partners (other than professional corporations) even if other members of the partnership are individuals or professional corporations.

Before the Budget, each corporate partner would have included in its March 31, 2011 income, only its share of the partnership's April 30, 2010 income. Subject to the transitional rules described below, the Budget will require an

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additional income inclusion equal to 11/12ths of that April 30, 2010 income. This approach is referred to as the formulaic approach. This stub period inclusion is then deducted in arriving at the partner's March 31, 2012 income, and a new income inclusion equal to 11/12ths of the April 30, 2011 income is added to the March 31, 2012 income.

A corporate partner can elect to include a lesser amount of stub period income if it estimates that the pro-rated portion of the actual April 30, 2011 income will be lower. There does not appear to be a rule that requires a corporation to use the formulaic or estimated approach consistently from year to year. In all circumstances, the corporation deducts the income inclusion in the following year.

If it is subsequently determined that the formulaic inclusion is greater than the estimated inclusion, the corporation must include an additional income inclusion in its March 31, 2012 fiscal period, which additional inclusion will include an interest component. If the shortfall is greater than 25% of the lesser of the estimated inclusion or the formulaic inclusion, the additional inclusion will include a penalty equal to 50% of the amount that exceeds such 25%.

The requirement to suddenly include 23 months of income in March 31, 2011 can be burdensome. Therefore, a transitional reserve is available to allow the stub period income to be brought into income over five years. The maximum reserve in the first fiscal period is 100%. The maximum reserves available in subsequent fiscal periods are 85%, 65%, 45%, 25% and 0%.

Partnerships all of the members of which are corporations other than professional corporations will be allowed a one-time election to change the partnership year-end if it desired to align the year-end of the partnership with that of one or more of its partners. The transitional relief described above will apply if this election is made.

There are numerous other technical rules to review. These will include provisions that deal with, for example, partnerships that have other partnerships as members, situations involving a first year corporate partner where no partnership year-end falls within the partner's fiscal period, partnerships with resource expenses, and where more than one partnership year-end falls within one corporate fiscal period.

#### **ACCELERATED CAPITAL COST ALLOWANCE (CCA)** — MANUFACTURING AND PROCESSING (M&P) EQUIPMENT

M&P equipment acquired before 2012 included in Class 29, is eligible for a 50% straight-line CCA rate, subject to the half year rule. The Budget has extended Class 29 treatment to eligible M&P equipment acquired before 2014. Eligible M&P equipment acquired after 2013 will be included in Class 43, which is subject to a 30% declining balance CCA rate.

#### **STOP LOSS RULES**

There are stop-loss rules which reduce the capital loss on the redemption of shares by the amount of dividends received. There are circumstances where a corporation can receive a tax-free intercorporate dividend and realize a capital loss on a redemption of shares even though there is no economic loss on the redemption. The Budget limits the situations in which this may apply. The new rules will not apply to private corporations that receive redemption proceeds on other private corporation shares.



### **CLEAN ENERGY GENERATION EQUIPMENT**

Eligible clean energy generation and conservation equipment, included in Class 43.2, is subject to a 50% declining balance CCA rate. The Budget expands Class 43.2 to include equipment that generates or conserves energy by using a renewable energy source (such as wind or solar), using fuels from waste, or making efficient use of fossil fuels.

### **QUALIFYING ENVIRONMENTAL TRUSTS (QETs)**

Regulators may require an operator of a mine, quarry or waste disposal site to pre-fund, by means of a trust, the costs of reclaiming or restoring a site. This is done by way of a QET. Future reclamation costs relating to pipeline abandonment will now be eligible for QETs.

The Budget will expand the eligible investments for QETs for 2012 and subsequent taxation years for trusts created after 2011. The Budget will also change the tax rate applicable to QETs from the top personal rate to the corporate rate generally applicable to the 2012 and subsequent taxation years.

## **II. INDIVIDUALS**

### **“KIDDIE TAX” ON CAPITAL GAINS**

The tax on split income (the “kiddie tax”) applies to certain income received by a minor child with a parent resident in Canada. Split income currently includes taxable dividends received in respect of unlisted shares of Canadian and foreign corporations and partnership or trust income derived from providing property or services to a business carried on by a person related to the minor child. However, split income does not currently apply to capital gains realized by the minor child.

The Budget has proposed a measure to extend the kiddie tax to capital gains realized as a result of income-splitting techniques which have been developed to avoid such tax.

As a result of the kiddie tax not currently applying to capital gains, the minor child is subject to tax on the capital gain at his or her marginal tax rate rather than the maximum personal rate. The Budget proposes to extend the kiddie tax to capital gains realized by 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. Such capital gains will be treated as dividends, included in the minor’s split income and subject to the kiddie tax. In addition, because the gains are treated as dividends, they will not qualify for the capital gains exemption.

This proposal will apply to capital gains realized after March 22, 2011.

### **CHILDREN’S ARTS TAX CREDIT**

For 2011 and subsequent taxation years, a Children’s Arts Tax Credit was introduced to provide a 15% non-refundable credit, based on an amount of up to \$500 of eligible expenses per child paid in a year. An eligible expense includes artistic, cultural, recreational, or development activities. If an expense is eligible for purposes of the Child Care Expense Deduction, the Children’s Fitness Tax Credit or the Medical Expense Tax Credit, it will not be eligible for this tax credit.



The credit will be available for the enrolment of a child, who is under 16 years of age at the beginning of the year, in an eligible program. A credit will also be available for a child who is eligible for the Disability Tax Credit and who is under 18 years of age at the beginning of the year. The credit may be claimed on an additional \$500 disability supplement amount when a minimum of \$100 is paid in eligible expenses.

An eligible program will be either a weekly program lasting a minimum of eight consecutive weeks or in the case of children's camps, a program lasting a minimum of five consecutive days. The full cost of the child's membership in an organization will be eligible for the credit if more than 50% of the activities offered by the organization include a significant amount of eligible activities. In addition, where the participant in the program can select from various activities, the full cost will be eligible for the credit if either more than 50% of the activities offered include a significant amount of eligible activities or more than 50% of the available program time is devoted to eligible activities.

The credit can be claimed by either parent, or can be shared between the parents.

### **FAMILY CAREGIVER TAX CREDIT**

For 2012 and subsequent taxation years, a Family Caregiver Tax Credit was introduced to provide a 15% non-refundable credit, based on a flat amount of \$2,000. This credit will assist caregivers of dependants with a mental or physical infirmity, including spouses, common-law partners, and minor children. Caregivers will be able to claim an enhanced amount for an infirm dependant under one of the existing dependency-related credits. Consequently, this enhancement would apply to one of the following credits: Spousal or Common-Law Partner Credit, Child Tax Credit, Eligible Dependant Credit, Caregiver Credit or Infirm Dependant Credit.

A dependant who is a minor will be considered to be infirm only if he or she is likely to be dependant on others for significantly more assistance when compared generally to persons of the same age for a long and continuous period of indefinite duration. This test will apply to dependants who are under age 18 at the end of the year and who are claimed for purposes of the Child Tax Credit or the Eligible Dependant Credit.

The threshold at which the Infirm Dependant Credit begins to be phased out will be increased so that the enhanced amount is fully phased out at the same income level as the 2012 enhanced Spousal or Common-Law Partner Credit. The \$2,000 Family Caregiver Tax Credit amount will be indexed for 2013 and subsequent taxation years to account for inflation.

### **MEDICAL EXPENSE TAX CREDIT**

— FOR OTHER DEPENDANTS

Individuals may generally claim a Medical Expense Tax Credit in respect of eligible expenses paid for themselves, their spouse or common-law partner or their children under age 18. Caregivers may also claim this credit for a dependant relative if the caregiver pays their medical or disability-related expenses. A dependant for this purpose includes a child under age 18 or older, a grandchild, parent, grandparent, brother, sister, uncle, aunt, niece or nephew who is dependant on the individual for support.

Currently, the maximum claim by a caregiver for such a dependant is limited to \$10,000 for a year. The Budget proposes to remove this \$10,000 maximum for 2011 and subsequent taxation years.



### **CHILD TAX CREDIT ELIGIBILITY**

The annual claim for the Child Tax Credit is currently limited to one individual in respect of the same domestic establishment. Consequently, where two or more families share a home, only one individual is entitled to claim the Child Tax Credit. The Budget proposes to eliminate this restriction for 2011 and subsequent taxation years. Consequently, the sharing of a home would no longer restrict otherwise eligible parents from claiming this credit.

### **VOLUNTEER FIREFIGHTERS TAX CREDIT**

For 2011 and subsequent taxation years, a Volunteer Firefighters Tax Credit was introduced to provide a 15% non-refundable credit based on a flat amount of \$3,000. A volunteer firefighter will qualify for this credit if they perform at least 200 hours of volunteer firefighting services in a taxation year for one or more fire departments. Eligible volunteer firefighting services consist primarily of responding to and being on call for firefighting, attending meetings held by the fire department and participating in required training. However, such eligible services do not include firefighting services provided to the fire department otherwise than as a volunteer.

In order to claim this credit, written certification must be obtained from the chief or delegated official of the fire department in order to confirm the number of eligible volunteer firefighting hours. This written certification must be provided to CRA when requested.

A volunteer firefighter who claims this credit will not be eligible for the existing tax exemption of up to \$1,000 for honoraria paid by a government, municipality or public authority in respect of firefighting duties. In addition, such payments must be reported to the CRA as part of the annual reporting of remuneration paid.

### **TUITION TAX CREDIT**

#### **— EXAMINATION FEES**

For 2011 and subsequent taxation years, amounts eligible for the Tuition Tax Credit will include fees paid to an educational institution, professional association or provincial ministry to take an examination that is required to obtain a professional status or to be licensed or certified in order to practice a profession or trade in Canada.

Ancillary fees and charges, such as examination material used during the examination and certain prerequisite study materials, will also be eligible for the credit. However, eligible ancillary fees and charges will not include the cost for travel, parking or equipment. Also, fees in respect of examinations taken in order to begin study in a profession or field, such as a medical college admission test, will not qualify.

The total of tuition and examination fees paid to the institution or association must exceed \$100 to be eligible.

### **EDUCATION TAX MEASURES**

#### **— STUDY ABROAD**

A Tuition Tax Credit is currently available to a Canadian student in full-time attendance at a university outside Canada to the extent that the tuition fees are paid in respect of a course of at least 13 consecutive weeks. The Education Tax Credit and the Textbook Tax Credit are also subject to this rule. In addition, a Canadian student can currently receive educational assistance payments ("EAPs") from an RESP for enrolment in such a program.



The Budget proposes to reduce the minimum course duration requirement to three consecutive weeks, from 13 consecutive weeks, for purposes of claiming the Tuition, Education and Textbook credits. In addition, for EAP purposes, the minimum course duration is proposed to be reduced to three consecutive weeks when the student is enrolled at a university in a full-time course.

#### **RESP's — ASSET SHARING AMONG SIBLINGS**

For 2011 and subsequent taxation years, the Budget proposes to allow for transfers between individual RESP's for siblings, without tax penalties and without triggering the repayment of Canada Education Savings Grants, provided the beneficiary of the plan receiving the transfer of assets had not attained age 21 when the plan was opened. This Budget proposal will provide subscribers of separate individual plans with the same flexibility to allocate assets among siblings as currently exists for subscribers of family plans.

#### **REGISTERED DISABILITY SAVINGS PLANS (RDSPs) — SHORTENED LIFE EXPECTANCY**

The current RDSP tax rules require the repayment of all Canada Disability Savings Grants and Canada Disability Savings Bonds received in the 10 years prior to a withdrawal or termination of the plan. However, subject to specified limits and certain conditions, the Budget proposes to allow RDSP beneficiaries with a life expectancy of five years or less to withdraw more of their RDSP savings by permitting annual withdrawals without triggering the 10 year repayment rule.

In order to utilize this proposal, the holder of the RDSP must elect in prescribed form and submit the election with the medical certification completed by the medical doctor to the RDSP issuer. A plan holder will also be permitted to reverse this election in the future.

This proposal will apply after 2010 to withdrawals made after the enacting legislation receives Royal Assent.

#### **RRSP's — ANTI-AVOIDANCE RULES**

The Budget proposes to enhance the current RRSP anti-avoidance rules to address concerns regarding the use of RRSP's in tax planning schemes, including "RRSP strips", by introducing rules similar to the anti-avoidance rules which currently apply to Tax-Free Savings Accounts (TFSA's). This proposal deals with the advantage rules, the prohibited investment rules and the non-qualified investment rules.

The current RRSP advantage rules will be expanded to apply a tax on the annuitant equal to the fair market value of the advantage, or in the case of a debt, the amount of the debt. The proposed RRSP advantage rules will include benefits derived from transactions which would not have occurred in a regular open market between arm's length parties. In addition, these advantage rules will apply to payments made to an RRSP on account of or in lieu of payments for services.

A special tax of 50% of the fair market value of a "prohibited investment" will apply to an RRSP annuitant. A prohibited investment, based closely on the TFSA rules, will generally include debt of the RRSP holder and investments in entities in which the RRSP holder, or non-arm's length person, has a significant interest, which is generally considered to be 10% or more. In addition, income, including capital gains, earned from such prohibited investments will be treated as an advantage and be subjected to a 100% tax of the advantage.



A special tax on the annuitant of 50% of the fair market value of a non-qualified investment will replace the current income inclusion and 1% per month penalty tax. This special tax will apply at the time that a non-qualified investment is acquired by the RRSP or at the time the investment becomes non-qualified. This tax will be refundable to the annuitant if the RRSP disposes of the investment by the end of year following the year in which the tax applied.

The Minister of National Revenue will have the authority to waive or cancel all or part of the tax with respect to all of the above proposed anti-avoidance rules if the Minister considers it just and equitable to do so in the circumstances. These new anti-avoidance rules will generally apply to transactions occurring, and investments acquired, after March 22, 2011. Investment income generated after March 22, 2011 on previously acquired investments will be considered to be a transaction occurring after March 22, 2011.

### **INDIVIDUAL PENSION PLANS (IPPs)**

The Budget has proposed two new measures with respect to IPPs. The first proposal will require annual minimum withdrawal amounts, similar to the current rules for RRIFs, once a plan member reaches age 72. In addition, contributions to an IPP which relate to past years of employment will have to be funded first out of a plan member's existing RRSP assets or by reducing the individual's accumulated RRSP contribution room before new deductible contributions for past service may be made.

These new measures will apply to a defined benefit Registered Pension Plan with three or fewer members if at least once member is related to an employer which participates under the pension plan. In addition, these new measures may apply to a designated plan, where at least 50% of the total pension adjustments of plan members in a year belong to individuals who are "connected" to the employer or who are highly compensated employees. A designated plan will be subject to these measures if it is reasonable to conclude that the rights of one or more members under the plan exist primarily to avoid this new definition.

The minimum withdrawal rules will apply to the 2012 and subsequent taxation years. For those IPP members who reached age 72 in 2011 or earlier, the required withdrawals will commence in 2012. For those IPP members who reach age 72 after 2011, the required withdrawals will commence in the year they reach age 72.

The Budget proposal with respect to past service contributions will apply to such contributions made after March 22, 2011, unless the past service was credited to an IPP member before March 22, 2011 under the terms of an IPP submitted for registration on or before March 22, 2011.

### **MINERAL EXPLORATION TAX CREDIT**

Flow-through shares allow companies to renounce or "flow through" tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses. The Mineral Exploration Tax Credit provides an additional incentive to individuals who invest in flow-through shares. The credit is equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors. This credit was scheduled to expire at the end of 2011.

The Budget proposes to extend this credit to flow-through share agreements entered into on or before March 31, 2012. Under the existing "look-back" rule, funds raised with the credit in the first three months of 2012 can be spent on eligible exploration until the end of 2013.



### III. CHARITIES

#### DONATIONS

Over the past number of years, the government has significantly expanded the opportunity for Canadians to make tax-deductible charitable contributions. Along with this enhanced opportunity, there have been a number of issues which the government feels have impacted the “regulatory regime” and “fairness” of the current system. The Budget has proposed a number of changes to deal with these issues.

#### QUALIFIED DONEES

A qualified donee is a person eligible to issue a tax-deductible receipt and will include registered Canadian amateur athletic associations (the rules for these organizations have been expanded to generally conform with other charitable entities), municipalities and certain municipal public bodies in Canada, housing corporations which exclusively provide low-cost housing for the aged, universities outside Canada, the student bodies of which ordinarily includes students of Canada, and certain charitable organizations outside Canada. Each qualified donee is required to be included on a publicly available list maintained by the Canada Revenue Agency (CRA).

If a qualified donee does not comply with requirements such as, official receipts, books and records, and good governance, the CRA may suspend receipting privileges, revoke qualified donee status or assess monetary penalties.

#### RETURNED GIFTS

Where a qualified donee returns a gift with a value greater than \$50 to a donor, the donee will be required to issue a revised receipt and the donor’s original tax return will be reassessed accordingly. Specific provisions will determine other tax consequences depending on whether or not the original “gift” is considered to have been a gift.

#### GIFTS OF NON-QUALIFYING SECURITIES (NQS)

A taxpayer is not able to claim a charitable donation of a NQS (e.g., shares of or debt obligations issued by the taxpayer or a person that is not at arm’s length from the taxpayer) unless the donee disposes of the security within five years after the date of the gift. The amount of the donation is deemed to have been made in the year of the disposition, for an amount not exceeding the proceeds realized by the donee.

#### GRANTING OF OPTIONS TO QUALIFIED DONEES

Prior to the Budget, a qualified donee could issue a receipt equal to the value of an option to acquire property of the donor that the donor granted to the donee. The donee must now acquire the property in order to issue a receipt.

#### DONATIONS OF PUBLICLY LISTED FLOW-THROUGH SHARES

The current legislation provides that when a taxpayer makes a gift of publicly listed shares, the taxpayer will receive a donation receipt equal to the value of the shares and will not be required to include any resultant capital gain in the computation of income. In the case of a donation of publicly traded flow-through shares, the tax cost of the shares is often reduced to nil by virtue of the flow-through of deductions and credits.



Therefore, the resultant capital gain, which is equal to the value of the share, is not taxed under the existing rules. The combination of the flow-through deduction and the elimination of the capital gain significantly reduce the after-tax cost of the donation. The Budget proposes that only the capital gain in excess of the original cost of the flow-through share will be exempt from tax.

The rules will apply to flow through shares issued pursuant to an agreement entered into after March 22, 2011. An anti-avoidance rule will apply to the donation of property acquired on a rollover.

## IV. CUSTOMS TARIFF MEASURES

### **SIMPLIFICATION FOR BUSINESS**

In this Budget the government is continuing its efforts to facilitate trade by business through further simplification of the Customs Tariff, including classification of assets, transparency of tariff treatments applicable to imports, and removal of expired provisions.

### **LOW VALUE IMPORTS**

Imports of \$500 or less arriving by post or courier will now be subject to the generic Most-Favoured-Nation tariff rates currently used for goods imported by travellers. Tariff rates of 0%, 8% or 20% will apply depending on the description of the good being imported. This measure is expected to have a minimal impact on tariff revenues but will increase the Canada Border Service Agency's efficiency when dealing with such imports.

### **EXPANDING AND FACILITATING TRADE**

The government is continuing its ambitious free trade agenda to provide new and diverse opportunities to Canadian companies. At the present time Canada has in place free trade agreements with eight countries. Negotiations are currently underway involving trade opportunities with 50 other countries including India and the European Union.





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