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HIGHLIGHTS FROM THE 2015 FEDERAL BUDGET PROPOSALS

Tax-Free Savings Account

A tax-free savings account ("TFSA") allows individuals to earn investment income, including interest, dividends, and capital gains, on a tax-free basis. Although contributions to a TFSA are not tax-deductible, the income earned in a TFSA is not subject to Part I tax while in the account or when such income is distributed to the account holder. However, there are certain circumstances in which a TFSA may be subject to Part I tax, such as if the TFSA holds a "non-qualified investment" or carries on one or more businesses (see subsection 146.2(6)).

In 2009 the annual contribution limit for a TFSA ("TFSA dollar limit") was $5,000. For the 2013 and 2014 taxation years, the TFSA dollar limit was increased to $5,500 with proposed $500 annual increases indexed for inflation. Unused TFSA room can be carried forward indefinitely. Furthermore, distributions from the account add to the TFSA contribution room in the year after the distribution.

The 2015 budget proposes to increase the TFSA dollar limit from $5,500 to $10,000, effective as of January 1, 2015. In addition, the TFSA dollar limit will no longer be indexed for inflation.

Home Accessibility Tax Credit

Budget 2015 introduces a new federal "Home Accessibility Tax Credit" with respect to certain home renovation expenditures for "qualifying individuals" or "eligible individuals". The tax credit equals 15% of "qualifying expenditures" incurred in a taxation year in respect of an "eligible dwelling" up to a maximum expenditure of $10,000 and is effective for 2016 and subsequent taxation years.

In general, "qualifying individuals" include seniors who are 65 years or older, and persons with disabilities who are eligible for the Disability Tax Credit at any time in a taxation year.

The credit may also be claimed by an "eligible individual", which includes an individual that has claimed the spouse or common-law partner amount, the eligible dependent amount, the caregiver amount or the infirm dependent amount for the qualifying individual in the taxation year, or an individual who could have claimed such amounts if:

- in the case of the spouse or common-law partner amount or, if the eligible individual was not married or in a common-law partnership in the case of the eligible dependent amount, the qualifying individual had no income in the taxation year; and

- in the case of the infirm dependent and caregiver amounts, the qualifying individual was over the age of 18 and had no income in the taxation year.

An "eligible dwelling" is the principal residence owned by the qualifying individual. In order to qualify, the dwelling must be ordinarily inhabited by the qualifying individual or, alternatively, the individual must be reasonably expected to ordinarily inhabit the dwelling in the year. The dwelling may be owned by the individual solely, or jointly with a spouse or common-law partner. Similar to the principal residence rules, a qualifying individual may only have one "eligible dwelling" at any time.

An "eligible dwelling" will also include a dwelling owned by an "eligible individual" if the dwelling is the principal residence of the "eligible individual" and the qualifying individual ordinarily inhabits the dwelling with the eligible individual.

The Budget clarifies that if part of the dwelling is used to earn business or rental income, the qualifying or eligible individual may only claim the credit for the full amount of eligible expenditures made with respect to any personal areas in the dwelling.

If the qualifying individual's principal residence is a condominium or a co-operative housing corporation, the credit is available for eligible expenditures to renovate the unit and the qualifying individual's share of the cost of eligible expenditures with respect to common areas.

For the purposes of this tax credit, a qualified expenditure is an outlay or expense made in the year directly attributable to a "qualifying renovation" of the dwelling which includes any renovation that (a) is of an enduring nature and integral to the dwelling; **and** (b) is undertaken either to (i) enable accessibility, mobility or functionality for a qualifying individual within the eligible dwelling, or (ii) reduce the risk of harm in the dwelling or in obtaining access to the dwelling.

The Budget clarifies that the following expenditures would not qualify for the credit:

- expenditures made with the primary intent of improving or maintaining the value of a dwelling;
- the cost of routine repairs and maintenance normally performed on an annual or more frequent basis;
- expenditures for household appliances and devices (e.g., audio-visual electronics);
- payments for services (e.g., outdoor maintenance and gardening, housekeeping or security); and
- the costs of financing a renovation (e.g., mortgage interest costs).

Expenditures are not eligible for the credit if they are for goods or services provided by a person related to the qualifying or eligible individual unless that related person is registered for Goods and Services Tax/Harmonized Sales Tax.

If the credit can be claimed by both a qualifying individual and an eligible individual, the maximum eligible amount must be claimed by one of the individuals or shared among the individuals.

Interestingly, where a qualifying expenditure is eligible for both the new home accessibility tax credit and the medical expense tax credit, the individual is permitted to claim both credits.

Minimum Withdrawal Factors for Registered Retirement Income Funds

A Registered Retirement Savings Plan ("RRSP") must be converted to a Registered Retirement Income Fund ("RRIF") or be used to purchase a qualifying annuity in the year that the taxpayer turns 71 years of age. Following conversion, contributions are no longer permitted and minimum amounts must be withdrawn from the plan commencing in the year after conversion. The minimum withdrawal amount is determined by applying a percentage factor as set out in subsection 7308(3) of the *Income Tax Regulations* and is based on the account holder's age.

Budget 2015 proposes to reduce this required minimum withdrawal amount to better reflect long-term historical real rates of return and expected inflation. Withdrawal amounts will be based on a 5% nominal rate of return and 2% rate of inflation indexing.

New Section 60.022 will be added to reflect the change in rules effective for the 2015 tax year. The prescribed factors will be amended as detailed in the following table which will replace the table in subsection 7308(3) of the *Income Tax Regulations:*

Existing and New RRIF Factors

Age (at start of year)	**Existing Factor** %	**New Factor** %
71	7.38	5.28
72	7.48	5.40
73	7.59	5.53
74	7.71	5.67
75	7.85	5.82
76	7.99	5.98
77	8.15	6.17
78	8.33	6.36
79	8.53	6.58
80	8.75	6.82
81	8.99	7.08
82	9.27	7.38
83	9.58	7.71
84	9.93	8.08
85	10.33	8.51
86	10.79	8.99
87	11.33	9.55
88	11.96	10.21
89	12.71	10.99
90	13.62	11.92
91	14.73	13.06
92	16.12	14.49
93	17.92	16.34
94	20.00	18.79
95 & over	20.00	20.00

Factors will remain unchanged for conversion of a RRIF of an annuitant prior to age 71 and older than 95.

Since the new factors come into effect effective for 2015, a RRIF holder who may have withdrawn more than the new minimum amount in 2015 will have until February 29, 2016, to re-contribute any excess withdrawn.

These new factors will also be used to determine what must be withdrawn annually, from a Registered Pension Plan as well as a Pooled Registered Pension Plan, starting at age 71.

Lifetime Capital Gains Exemption for Qualified Farm or Fishing Property

Since 1985, section 110.6 of the *Income Tax Act* has provided individuals with an exemption from tax payable in respect of certain capital gains realized on the disposition of qualified small business corporation shares and qualified farm or fishing property. The amount of the Lifetime Capital Gains Deduction ("LCGD") is $813,600 in 2015, and is indexed to inflation thereafter.

Budget 2015 proposes to increase the LCGD on the dispositions of qualified farm or fishing property that occur after April 20, 2015 to the greater of $1 million; and the indexed LCGD applicable to capital gains realized on the disposition of qualified small business corporation shares. In essence, the additional LCGD applicable to qualified farm or fishing property will be eliminated over time unless further revisions are made in future.

Budget 2015 also proposes to add new subsections 104(21.21) and 104(21.22) to the *Income Tax Act* providing a formula prorating gains arising on or after April 21, 2015 where a trust designates a capital gain in respect of qualified farm or fishing property in a designation year ending on or after April 21, 2015.

Registered Disability Savings Plan — Legal Representation

Registered Disability Savings Plans ("RDSP") have existed since 2008 and are trust arrangements that permit parents and others to contribute and save for the long-term financial security of a person qualifying for the disability tax credit. An RDSP can invest and earn income tax-free for the purpose of making future payments to the beneficiary. Budget 2012 introduced a temporary measure to allow a qualifying family member (i.e., a beneficiary's parent, spouse or common-law partner) to become the plan holder of an RDSP where the adult beneficiary may lack the capacity to enter into a contract.

This temporary measure was intended to apply until the end of 2016. However not all provinces and territories have had sufficient opportunity to introduce streamlined processes that permit a trusted person legally to manage the resources on behalf of the RDSP beneficiary. Budget 2015 proposes to extend the measure until the end of 2018 to give the provinces and territories the opportunity to address the RDSP legal representation issue described above.

Transfer of Education Credits — Effect on the Family Tax Cut

The Family Tax Cut ("FTC") was first introduced in October 2014 and is applicable to couples with children under the age of 18. The FTC allows the higher-income spouse or common-law partner to transfer notionally up to $50,000 of taxable income to a spouse or partner in a lower income tax bracket up to a maximum non-refundable federal tax credit of $2,000. The purpose of the FTC is to reduce or eliminate the federal tax differential between one-income families in relation to two-income families.

The previously announced FTC rules prevented the transfer of education-related credits from being taken into account in the calculation of the FTC, thereby potentially reducing the value of the transfer. Budget 2015 proposes to revise the calculation of the FTC to ensure that couples claiming the FTC and transferring education-related credits receive the appropriate value of the FTC.

The proposed FTC rules are intended to apply for 2014 and subsequent taxation years. Taxpayers that have already filed their individual income tax returns for 2014 will automatically be reassessed by the CRA once the provisions receive Royal Assent to receive any additional benefit that they are entitled to.

Small Business Tax Rate

Income earned by a corporation and paid to an individual as a dividend is required to be included in the individual's income and is subject to tax in the taxation year received. Under Canadian tax rules the amount of dividend is subject to a gross-up factor such that the amount of income reported by the individual is approximately equivalent to the pre-tax income of the corporation. A dividend tax credit ("DTC") is provided to the individual to compensate for the corporate taxes assumed to have been paid. In theory, the rules attempt to ensure that individuals will report the same income and be subject to the same tax as they would be if the income had been earned directly.

As a consequence of the proposed changes to the small business tax rate, the existing gross-up and DTC do not produce appropriate tax results. Accordingly, Budget 2015 proposes that the gross-up factor and the DTC (expressed as a percentage of the grossed-up dividend) will be revised approximately as follows:

Year	2015	2016	2017	2018	2019 onwards
Small business tax rate %	11	10.5	10	9.5	9
Gross-up %	18	17	17	16	15
DTC %	11	10.5	10	9.5	9

The reduced gross-up and reduced DTC are appropriate to dividends from income that is subject to the small business deduction. Since these provisions are to apply to all dividends other than eligible dividends, they will apply to dividends from investment income. It does not appear to be appropriate to have these reductions apply to dividends from investment income. The concept of integration of investment income earned by a Canadian-controlled private corporation seems to be eroded further.

Canadian-controlled private corporations currently enjoy a small business deduction ("SBD") that reduces federal income tax on up to $500,000 of active business income annually to a small business tax rate of 11%. The $500,000 threshold is shared among associated corporations and begins to be phased-out where taxable capital in Canada exceeds $10 million and is eliminated at $15 million or greater.

Budget 2015 proposes to increase the SBD so that the small business tax rate is reduced to 9% by 2019 as follows:

January 1, 2016 10.5%;

January 1, 2017 10.0%;

January 1, 2018 9.5%; and

January 1, 2019 9.0%.

Taxation years that straddle the calendar year will be pro-rated accordingly.

THE EFFECTIVE USE OF TRUSTS IN CONNECTION WITH INCOME SPLITTING (PART II OF IV)

— Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg".

Part I of this series of articles reviewed some of the basic tax requirements for using trusts to split income. In the second instalment of the series we will review some common income splitting opportunities that are accessible through the use of trusts. In particular, capital gains exemption ("CGE") multiplication planning, preferred beneficiary and age 40 trust planning, prescribed rate loan planning, and Ontario surtax planning will each be reviewed in turn.

CGE Multiplication Using Trusts

Although it is possible to multiply the CGE among family members by issuing shares directly to the family members, doing so can result in the current shareholder suffering a loss of both control over the shares and flexibility in arranging his or her future planning. For example, unborn persons at the time the planning is put in place would not be eligible to share in the CGE multiplication. Also, for various personal, creditor or other reasons, the benefit of hindsight might have lead the current shareholder to determine that it would have been better not to give shares to a particular person. Unfortunately, once property, such as shares, has been given away it is often very difficult to get it back.

Provided that one is dealing with a typical discretionary family trust deed, multiplication of the exemption should be possible by relying on the rules in subsections 104(21) and (21.2) of the *Income Tax Act* (Canada) (the "Act").[1] In addition, it should generally be possible to avoid many of the drawbacks associated with direct share ownership since, subject to the trustees complying with their fiduciary duties, they will generally be free to choose to allocate the exempt capital gains (i.e., CGEs) among some or all of the trust beneficiaries, including beneficiaries who were born following the creation of the trust.

Preferred Beneficiary Election and Age 40 Trusts

In addition to the general rules that permit income splitting, there are some special rules that permit income splitting and CGE multiplication without making amounts payable to beneficiaries.

For example, when a "preferred beneficiary election" can be in compliance with the tests set out in subsection 104(14) it will be possible to cause income of a trust to be taxable in a qualifying beneficiary's hands even though no amount is made payable to the beneficiary. However, since 1995 the ability to use the preferred beneficiary election has generally been limited to situations involving disabled beneficiaries. Prior to that time, the preferred beneficiary election was much more widely used.

Another special situation that can enable income splitting without making amounts payable is where the so-called "age 40 trust" rules in subsection 104(18) are complied with.[2]

In order to qualify as an age 40 trust, amounts that would otherwise have been income of a trust in a particular taxation year must meet a number of conditions. In particular, the amounts cannot have become payable in the year and they must be held in trust for an individual who has not turned 21 in the year. In addition, the individual beneficiary's rights must have vested and they must not be subject to the exercise or failure to exercise any discretionary power. Finally, the individual beneficiary's rights must not be subject to any conditions to receive the income other than that the individual survive to an age not exceeding 40 years. It is for this reason that these trusts are often referred to as age 40 trusts.

Prescribed Rate Loan Planning

The Loan for Value Exception

In general, low interest rate loans that are made directly or indirectly through a trust to spouses (including common-law partners), non-arm's length minors, and other non-arm's length persons that allow such persons to earn income from property will be caught by the personal attribution rules in the Act,[3] which will result in all of the income and losses (and for spouses all of the capital gains and capital losses) being attributable back to the lender. Fortunately these rules will not apply in any situation involving "loans for value".[4]

Planning that uses the loans for value exemption to the attribution rules is commonly referred to as prescribed rate loan planning. In order to qualify for the loan for value exception to the personal attribution rules, a loan will need to

[1] Unless otherwise noted all statutory references are to the Act. These rules were discussed in Part I of this series of articles under the heading "Character of Income".

[2] Rules in subsections 104(13.1) and (13.2) might also be used to designate amounts paid by a trust to a beneficiary as being taxable only in the trust, which can give rise to a number of income splitting benefits. For example, for testamentary trusts these rules would allow designated amounts paid out to beneficiaries to still enjoy the testamentary trust's graduated tax rates. Even where non-testamentary trusts are used, these rules may provide certain inter-provincial tax planning benefits. However, due to the December 16, 2014, enactment of Bill C-43, *Economic Action Plan 2014 Act, No. 2* (discussed further in Part III of this series of articles), effective for the 2016 and subsequent taxation years, the ability to utilize the designations provided under these provisions will be significantly restricted.

[3] See, in particular, subsection 56(4.1) (low interest loans made for the benefit of non-arm's length persons where certain reasonability tests are met), sections 74.1 (income or losses from the transfer or loan of property made for the benefit of spouses or minors), section 74.2 (capital gains or capital losses from the transfer or loan of property made for the benefit of spouses), and section 74.3 (extends the rules in sections 74.1 and 74.2 to loans made to certain trusts).

[4] The rules in section 120.4 (Kiddie Tax rules), while not attribution rules, must also be kept in mind when prescribed rate planning involves minors.

meet a number of conditions.[5]

First, the loan must bear interest at the lesser of the prescribed rate of interest in place at the time the loan is made and an arm's length interest rate at that time. In general, the prescribed rate will be the lower of these rates, and currently that rate is 1%. In addition to bearing interest at the appropriate rate, interest on the loan must actually be paid to the lender no later than 30 days after the end of the particular year. This latter condition is extremely important since a failure to pay interest by the time limit in any particular year will cause the prescribed rate exception to cease to apply to that loan forever.

Benefits of Prescribed Rate Loan Planning

Although loans for value could be and often are directly made to individuals, the flexibility and control provided by making these loans to trusts often makes trusts the ideal vehicle of choice for making such loans.

Almost continuously since the middle of 2009, it has been possible to lock in a prescribed rate loan at a 1% interest rate. The result of the rate being so low is that a borrower who has received such a loan does not need to generate very much net income from the loan in order to cover the debt payments and, assuming that the borrower is taxed at a lower rate than the lender, income splitting will have been achieved. Of course, if actual returns earned by the borrower are also low, the benefits of the income splitting may be quite limited, especially when costs and aggravation of the planning are factored in.[6] Also, since interest must actually be paid each year it will be desirable that the investments generate annual cash returns to facilitate payment.

Although equity markets have been generally performing extremely well as of late, interest sensitive markets have continued to lag, which might make prescribed rate loan planning less beneficial for some fixed income investors. However, over time it is anticipated that even the returns in these markets will return to historical norms and since, subject to future legislative changes, the current 1% prescribed rate can be locked in forever, putting this planning in place while rates are low may yield long-term family benefits.

Modifications to Higher Rate Pre-Existing Prescribed Rate Loans

Because prescribed rate loans are forever, some clients may still have older prescribed rate loans in place at rates in excess of the current 1% prescribed rate. If you run into one of these older loans and want to impress your client by helping them to refinance the loan to take advantage of the current 1% prescribed rate, you will want to make sure you do it correctly.

Simply amending the rate on the loan does not work. Neither does refinancing the loan with proceeds of a new loan.

In fact, it appears that the only way to refinance an existing prescribed rate loan with a lower prescribed rate loan is for the borrower to actually dispose of its income earning properties and to use the proceeds to repay the original loan.[7] In some cases this may result in the realization of taxable income on the disposition and, as a result, it may turn out that leaving the high rate loan in place will continue to be preferable to refinancing the loan.

Ontario Provincial Surtax Planning

In general, if the Kiddie Tax rules in section 120.4 are applicable to income earned by a child, the child will pay tax on that income at the child's top marginal tax rate. While this is generally true, in Ontario there may still be some advantage to income splitting with minor children provided that the child has little, if any, other income.

The reason for this benefit is that Ontario provincial surtaxes will not become payable until the child's income exceeds the Ontario provincial surtax thresholds. Savings from this type of planning are generally quite modest. For example, for each minor receiving $42,000 of ordinary investment income, split income savings in 2014 will be a bit less than $2,900. Actual savings will differ depending on the type of income earned and may be more or less than this amount. There will also be some additional compliance costs to this planning so actual savings will be somewhat lower than this amount, but for some, even with these costs and depending on the number of minor children a person has, this

[5] The loan for values in respect of subsection 56(4.1) are found in subsection 56(4.2) and nearly identical rules in respect of sections 74.1, 74.2, and 74.3 are found in subsection 74.5(2) (there are also exclusions for transfers made for fair market value consideration in subsection 74.5(1) but these are not relevant to this discussion).

[6] Consequently, unless the amount of a prescribed rate loan is substantial, it will generally not be worth implementing this strategy.

[7] See CRA Document No. 2002-0143985, dated October 18, 2002 and CRA Document No. 9336625, dated April 29, 1994.

planning will still be worth pursuing.

[Please note: At the time of publication, the 2015 Ontario Budget had not yet been presented.]

DESIGNATING THE PRINCIPAL RESIDENCE

— Ian V. MacInnis, Fogler, Rubinoff LLP (Lawyers)

The principal residence exemption is undoubtedly one of the most substantial tax "breaks" under the *Income Tax Act* (Canada) (the "Act"). Technically, in order for an individual to claim the principal residence exemption, the taxpayer must file a prescribed form to designate the property as a principal residence. Regulation 2301 to the Act specifies Form T2091 must be filed with the taxpayer's income tax return for the year in which the property is disposed of or the year in which the taxpayer grants an option to acquire the property, whichever comes first. If Form T2091 is not filed on a timely basis, the exemption is not available on a strict reading of the Act.

As an administrative policy, the Canada Revenue Agency (the "CRA") does not require the form to be filed unless the principal residence exemption does not completely eliminate the capital gain, or the 1994 election to use the $100,000 capital gains exemption was filed for the property. In addition, the instructions on Form T2091 state that the form is to be attached to the tax return "only if a capital gain has to be reported" (i.e., where the principal residence exemption does not completely eliminate the capital gain on the sale of the property).

It is important to note that this administrative concession is not binding on the CRA. Indeed, the CRA could reverse its position after the time for filing the form has expired. In at least three cases, the Minister of National Revenue raised the argument that the principal residence exemption was not available because timely elections were not filed. In at least three cases, the failure to file the required form was fatal to the taxpayer. This should serve as a warning to all taxpayers who rely on administrative concessions of the CRA. The CRA would have the authority under subsection 220(2.1) of the Act to waive the requirement to file Form T2091. Indeed, it could be argued that paragraph 2.15 of Income Tax Folio S1-F3-C2 constitutes such a waiver, but it would be prudent to file Form T2091 to remove any doubt. This would be particularly important in those situations where there is some sensitivity or doubt whether the principal residence exemption is available in whole or in part to the taxpayer (e.g., the sale of property in excess of one-half hectare or in situations where there might be doubt as to whether a taxpayer "ordinarily inhabited" the property in any given year in which the exemption is being claimed).

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