

# TaxTalk

## 2011 FEDERAL BUDGET HIGHLIGHTS

On Tuesday, March 22, 2011, the Honourable Jim Flaherty, Minister of Finance, presented his Budget Statement to Parliament. Notwithstanding its defeat and the resulting dissolution of Parliament, the Budget serves as an important precursor of the possible tax changes to come.

Set out below are highlights of certain budget proposals that we believe to be of most interest to you.

Please note that our commentary is at the date of the Budget, notwithstanding that the Budget did not pass and its provisions will need to be reintroduced.

### ECONOMIC OVERVIEW

	2010/2011 Estimate (\$ billion)	2011/2012 Forecast (\$ billion)	Growth (%)
Revenue	235.6	249.1	5.7
Expenditure:			
- Public debt	30.8	33.0	7.1
- Other	245.2	245.7	0.2
Surplus (Deficit)	(40.5)	(29.6)	
Net Public Debt	556.4	586.0	

	2010 Actual (%)	2011 Estimate (%)	2012 Forecast (%)
Inflation	1.8	2.4	2.1
3 Month Treasury Bill Rate	0.6	1.3	2.5
Unemployment Rate	8.0	7.5	7.2
Real Growth in GDP	3.1	2.9	2.8

The Budget projects deficits of \$40.5 billion in 2011, and \$29.6 billion in 2012. This outlook continues the government's confidence in longer-term economic recovery as well as the intention to move away from stimulus spending to fiscal restraint.

The federal debt-to-GDP ratio is projected to be approximately 34 percent and will grow slightly in 2011-2012, before declining to 30 percent by 2015-2016, which is the level before the impact of the economic recession.

Government expenditures will continue to grow, with the focus of this Budget being building infrastructure to create jobs. Unemployment is expected to decline from 7.5 percent to 6.5 percent over the next five years, while inflation is projected to be 2.4 percent for 2011, and around 2 percent for the next five years.

Savings are expected from three primary sources: strategic reviews of government departments and agencies, continued restraint in government wage increases, and the closing of certain "tax loopholes".

There are no new changes in respect of personal or corporate tax rates, or to sales taxes, but corporate tax rates will decrease due to previous initiatives. Although there were no new changes in the corporate, personal, or sales tax rates, the budget did include several measures to tighten the tax base and close or limit certain tax planning strategies, including the ending of partnership tax deferrals for corporate partners, new rules to restrict the exemption from capital gains tax on the donation of flow-through shares and new rules for individual pension plans and RRSP anti-avoidance rules.

### PERSONAL TAX MEASURES

#### Personal Income Tax Rates

The 2011 Budget does not introduce any new personal tax rate changes. The top marginal rate for individuals remains at 46.41%. This rate starts to apply when taxable income exceeds \$128,800<sup>1</sup>.

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2011:

Taxable Income (See Note)	Federal Rate (%)	Ontario Rate (%)	Combined Rate (%)
\$ 10,527 to \$ 37,774	15.00	5.05	20.05
\$ 37,775 to \$ 41,544	15.00	9.15	24.15
\$ 41,545 to \$ 66,519	22.00	9.15	31.15
\$ 66,520 to \$ 75,550	22.00	10.98	32.98
\$ 75,551 to \$ 78,365	22.00	13.39	35.39
\$ 78,366 to \$ 83,088	22.00	17.41	39.41
\$ 83,089 to \$128,800	26.00	17.41	43.41
\$ 128,801 and over	29.00	17.41	46.41

Note: These are the federal and Ontario tax brackets.

<sup>1</sup> In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2011, the brackets have increased by 1.4%. As a result, the top tax rate will apply in 2011 when taxable income exceeds \$128,800 (2010 - \$127,022).

### ***Tax on Split Income***

The Income Tax Act contains a number of rules intended to reduce the ability of a higher-income individual to split taxable income inappropriately with lower-income individuals. One of these rules, the “*tax on split income*”, limits income-splitting techniques that seek to shift certain types of income from a higher-income individual to a lower-income minor.

This income includes taxable dividends from private company shares and income from a trust or partnership derived from providing property or services to a business carried on by a person related to the child.

The Budget proposes to extend the tax on split income to capital gains that are 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 tax on split income. This measure will apply to capital gains realized on or after March 22, 2011.

### ***Donation of Publicly-Listed Flow-through Shares***

Individuals generally receive an exemption from capital gains tax when they donate publicly listed securities to charity. In general terms, the budget disallows the exemption from capital gains tax on donations of shares of a class in which a taxpayer acquired shares issued pursuant to a flow-through share agreement entered into on or after March 22, 2011, except to the extent that cumulative capital gains from dispositions of shares of that class exceed the original cost of the flow-through shares.

Flow-through shares are treated as having a cost of zero for the purpose of calculating any gain or loss on their disposition. As a result, when an investor holding only flow-through shares sells them, the full amount of the proceeds received is recognized as a capital gain for tax purposes.

The Budget proposes that if a share, or a right to acquire a share of a particular class of the capital stock of a corporation (i.e., a flow-through share) is issued to a taxpayer under a flow-through share agreement entered into on or after March 22, 2011, the exemption from capital gains tax on donations of publicly listed securities will be available for a subsequent donation by the taxpayer of a share of that class only to the extent that the capital gain on the donation exceeds a threshold amount (the exemption threshold) at the time of the donation.

### ***Individual Pension Plans (IPPs)***

Defined benefit Registered Pension Plans (RPPs) are sometimes established for one individual, generally an employee of a corporation that he or she controls. Sometimes a spouse or other family member is also a member of the individual pension plan (IPP).

The Budget proposes that annual minimum amounts will be required to be withdrawn from IPPs once a plan member reaches age 72. It also proposes that contributions made to an IPP that relate to *past years* of employment will be required 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 the past service may be made.

### ***Tax Changes to Savings Plans***

The Budget proposes the following measures in an effort to improve the functionality of various savings vehicles.

- To enhance the existing anti-avoidance rules for ***Registered Retirement Savings Plans (RRSPs)***, the Budget introduces a Prohibitive Investment rule (closely based on the rule for Tax-Free Savings Accounts).

It levies a special tax equal to 50% of the fair market value of the investment on acquisition of a prohibited investment by the RRSP, and generally allows a refund of the special tax if the investment is disposed from the RRSP by the end of the year following the year in which the tax applied, unless the RRSP holder knew or ought to have known that the investment was a prohibited investment when it was acquired.

- To allow ***Registered Disability Savings Plan (RDSP)*** beneficiaries who have shortened life expectancies to withdraw, under certain situations, more RDSP savings by permitting annual withdrawals without triggering the 10-year replacement rule.
- To provide flexibility to subscribers of *separate*<sup>2</sup> individual ***Registered Education Savings Plans (RESPs)***, the Budget proposes to allow, in certain circumstances, the transfer of plan assets between individual RESPs for siblings without triggering the repayment of Canada Education Savings Grants.

<sup>2</sup> As opposed to family plans which currently provide additional flexibility for the subscriber(s) by allowing the allocation of plan assets among the related children, subject to certain restrictions.

## BUSINESS TAX MEASURES

### *Corporate Income Tax Rate*

The 2011 Budget does not introduce any new corporate tax rate changes. However, corporate rates are scheduled to decrease pursuant to previously enacted or announced measures.

The following table summarizes federal and Ontario corporate tax rates, with respect to active business income earned by a Canadian-controlled private corporation in Ontario, and reflects federal and Ontario tax rate reductions for a December 31, 2011 year end.

Active Business Income	Federal Rate (%)	Ontario Rate (%)	Combined Rate (%)
up to \$500,000	11.00	4.50	15.50
> \$500,000	16.50	11.75	28.25
> \$1,500,000 with M&P *	16.50	10.00	26.50

Note: "M&P" refers to manufacturing and processing tax credit.

### *Tax Deferral via Partnerships*

Currently, there exists deferral opportunities for certain corporations with interests in partnerships that have a fiscal period different from the corporate taxation year.

The Budget proposes to limit such deferral opportunities by requiring the corporation to include not only the income of the partnership for the taxation year that ends in the corporation's taxation year, but also to accrue partnership income for a stub-period of the partnership's subsequent taxation year which begins in the taxation year and ends in the following one. As a relieving factor, the stub-period income is then reversed in the following year, while a new stub-period income is then included in income.

This measure could result in the inclusion of significant incremental partnership income for a corporation's first taxation year ending after March 22, 2011. To mitigate the potential cash-flow impact of accruing a partnership's stub-period income, transitional relief will be available to recognize the incremental amount gradually over the five taxation years that follow the corporation's first taxation year that ends after March 22, 2011.

### *Hiring Credit for Small Business*

The Budget proposes a one-time credit of up to \$1,000 against a small company's increase in its 2011 Employment Insurance premiums over those paid in 2010 to encourage hiring. This credit is available for employers whose total Employment Insurance premiums were at or below \$10,000 in 2010.

### *Stop-Loss Rules on Share Redemptions*

The Budget proposes to extend the application of the stop-loss rules to any dividend deemed to be received on the redemption of shares held by a corporation, other than dividends deemed to be received on the redemption of shares of the capital stock of a private corporation that are held by a private corporation whether directly or indirectly through a partnership or trust.

### *Employee Profit Sharing Plans (EPSPs)*

The Department of Finance has acknowledged the potential abuse in the use of EPSPs by business owners in reducing or deferring income taxes, and in avoiding the payment of Canada Pension Plan contributions and EI premiums. As a result, it will begin reviewing the existing EPSP rules to determine the need for technical amendments to ensure that EPSPs continue to be a useful vehicle for employers and are used for their intended purpose. Before proceeding with any proposals, Finance will undertake consultations to seek stakeholder views.

As indicated above, although the 2011 Federal Budget did not contain changes to personal or corporate tax rates, it did contain some proposals to close or restrict some tax planning opportunities. As Parliament was dissolved soon after the Budget was introduced, it will be necessary for the new government to introduce a new budget. The Conservative government has indicated that it will re-introduce its 2011 Budget if it is re-elected. In spite of the uncertainty that exists with regard to the pending election and the 2011 Budget proposals, the 2011 Budget is possibly an indicator of 'things to come' so taxpayers should plan accordingly.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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