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THE TAX FACTOR

WHAT'S NEW FOR YOUR 2014 PERSONAL INCOME TAX RETURN

With 2015 well underway, it is that time again to put your mind to preparing for personal tax season. As you likely already know, your 2014 personal income tax return must be filed on or before April 30, 2015. If you or your spouse (or common-law partner) are self-employed, your filing due date will be extended to June 15, 2014; however, any balance of tax owing for the year is due by April 30. In either case, this means that if you haven't already begun getting your financial records and slips ready, you should start doing so now.

In this article, we are going to highlight a few of the more notable recent federal tax changes that may impact your personal tax return for 2014. When discussing non-refundable tax credits, we have made reference to the federal income tax rules only, as provincial and territorial tax credits vary from each other and from the federal credits.

The Family Tax Cut

The Family Tax Cut (FTC), a new federal non-refundable tax credit of up to $2,000 for couples with children under the age of 18, effective for the 2014 and subsequent taxation years, was introduced by the federal government in the fall of 2014. The proposed credit will allow the higher-income spouse to, in effect, transfer up to $50,000 of taxable income to a spouse in a lower income tax bracket for federal tax purposes, for up to a maximum tax saving benefit of $2,000. The tax saving is calculated on the basis of the difference in tax before and after the effective transfer of income.

To claim the credit, certain conditions must be met and you must complete new Schedule 1-A, *Family Tax Cut*, along with your personal income tax return. It is also important to remember that your net (and taxable) income and the net (and taxable) income of your eligible spouse (or common-law partner) will not change if you claim the FTC. As a result, benefits and tax credits that are calculated based on net income, such as the GST/HST credit, the Canada Child Tax Benefit, the age amount, and the spouse or common-law partner amount will not change.

For more information on the FTC credit, please see our Tax Alert titled *The Family Tax Cut and Other Federal Tax Changes Announced October 30, 2014*.

Search and Rescue Volunteer Tax Credit

The new Search and Rescue Volunteer Tax Credit (SRVTC) was announced in last year's federal budget and allows ground, air and marine search and rescue volunteers to claim a 15% non-refundable tax credit based on an amount of $3,000. You should note that in order to qualify for the SRVTC, a search and rescue volunteer must perform at least 200 hours of eligible services in the year, each of which is an hour of:

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- eligible search and rescue volunteer services for an eligible search and rescue organization, or
- eligible volunteer firefighting services for a fire department.

In this regard, an eligible search and rescue organization is an organization that is a member of the Search and Rescue Volunteer Association of Canada, the Civil Air Search and Rescue Association, or the Canadian Coast Guard Auxiliary, or whose status as a search and rescue organization is recognized by a provincial, municipal or public authority. Note that eligible volunteer services include both primary and secondary services. Further details on the breakdown of services and calculating eligible hours are available on the CRA's website.

An individual who performs both eligible volunteer firefighting services and eligible volunteer search and rescue services for a total of at least 200 hours in 2014 may claim either the SRVTC or the Volunteer Firefighters Tax Credit (VFTC), but not both credits. Also, keep in mind that an individual who claims either the SRVTC or the VFTC will be ineligible for the existing tax exemption of up to $1,000 for honoraria paid by a government, municipality or public authority to an emergency services volunteer.

Children's Fitness Tax Credit

The Children's Fitness Tax Credit (CFTC) is currently a non-refundable tax credit that entitles parents to claim up to a specified amount of eligible fitness expenses paid for each child who is under the age of 16 at the beginning of the year. Under proposed changes, the maximum amount of expenses that may be claimed under the CFTC is increasing to $1,000 (from $500) effective for 2014 and subsequent taxation years. A disabled child who is eligible for the Disability Tax Credit and who is under 18 years of age at the beginning of the year will continue to be entitled to claim an additional $500, as long as a minimum of $100 in eligible expenses is paid.

As a reminder, eligible expenses include those paid for ongoing programs that require significant physical activity. Strenuous games such as hockey or soccer, and activities such as golf lessons, horseback riding, sailing and bowling, as well as others that require a similar level of physical activity will qualify for this credit. Fees charged for extracurricular programs that take place in school may also be eligible.

You should note that to increase the benefits to low-income families, the federal government has also proposed to make this credit refundable, beginning in 2015.

Adoption Expenses Tax Credit

The Adoption Expenses Tax Credit, which has been claimable since 2005, is a non-refundable tax credit in respect of eligible adoption expenses incurred for the adoption of a child under the age of 18 years. Effective for the 2014 taxation year, the maximum amount of expenses that may be claimed has increased from $11,774 to $15,000. Therefore, the tax credit

is computed by multiplying 15% by the lesser of the $15,000 limit and the eligible adoption expenses in respect of the child.

The credit may be split between two adoptive parents, although the combined expenses claimed for an adopted child cannot exceed the $15,000 limit. Keep in mind that eligible adoption expenses are amounts paid for expenses incurred during the adoption period in respect of the adoption of a child and the credit must be claimed in the tax year in which the adoption period ends. Eligible expenses specifically include the following:

- fees paid to an adoption agency licensed by a provincial or territorial government,
- court, legal and administrative expenses related to an adoption order in respect of the child,
- reasonable and necessary travel and living expenses for the child and the adoptive parents,
- document translation fees,
- mandatory fees paid to a foreign institution,
- mandatory expenses paid in respect of the immigration of the child, and
- any other reasonable expenses required by a provincial or territorial government or an adoption agency licensed by a provincial or territorial government.

Lifetime Capital Gains Exemption

The lifetime capital gains exemption applies to capital gains realized on the disposition of qualified small business corporation shares, qualified farm property and qualified fishing property. Effective for dispositions in 2014, the exemption limit increased from $750,000 to $800,000. Note that the exemption limit will be indexed to inflation beginning in 2015.

Summary

Each year brings with it new changes to the federal tax rules, and 2014 was no exception. Being aware of the recent changes that may impact the preparation and filing of your 2014 personal income tax return can go a long way in ensuring that you optimize your personal tax planning strategy.

As we move closer to the 2014 filing deadline, make sure that you speak to your BDO advisor to determine whether any of these new changes will impact your 2014 personal income tax return.

NEW LEGISLATION PASSED THAT WILL IMPACT THE TAXATION OF TRUSTS

Due to the numerous tax advantages arising from their use, trusts are frequently employed in tax and estate planning. As a result of these advantages, the tax-motivated use of personal trusts has caught the attention of the federal government. Recently, on December 16, 2014, new legislation (included in Bill C-43) was enacted containing new rules that will fundamentally change the way that certain personal trusts will be taxed in Canada. Unfortunately, these changes affecting trust taxation could have a negative impact on existing tax and estate plans. In this article, we will take a look at two of the key changes to the rules governing the taxation of trusts, and how these changes may affect those who currently use, or who are planning to use, certain types of personal trusts as part of their overall tax planning strategy.

A brief review of trusts

In order to understand the implications of the recent legislative changes affecting trusts, it is beneficial to first briefly explain what a trust is and how it might be used in current tax planning. A trust is a legal relationship between three parties: the settlor, the trustee(s) and the beneficiary (or beneficiaries). A trust is formed when a settlor contributes property to the trust for the person(s) they intend to benefit (i.e. the beneficiaries). The trustee(s) of the trust is appointed by the settlor to manage and control the trust's assets, according to the instructions set out by the settlor in the trust agreement.

While a trust can be used for both commercial and personal purposes, the focus of this article will be on personal trusts. A personal trust is one where beneficiaries do not pay for their interest in the trust, but rather receive their interest in the trust's assets as a gift. There are two types of personal trusts. The first is a testamentary trust, which is created on the death of an individual. A trustee of a testamentary trust will control and manage the assets of the deceased's estate in accordance with the deceased's wishes as set out under the will. Estates that do not give rise to an ongoing testamentary trust are also currently taxed as a testamentary trust from the time of death until the estate is administered. The second type of personal trust is called an "inter-vivos" trust, and these trusts are set up during the settlor's lifetime. Inter-vivos trusts are often used in accomplishing family tax and financial objectives. Both testamentary trusts and inter-vivos trusts can be further distinguished by the types of powers given to the trustee(s) to distribute income and/or assets. Trusts are said to be "discretionary" if the trustees decide who will receive distributions from the trust. In a "non-discretionary" trust, the trustees must make distributions in accordance with the terms of the trust agreement. It is possible for a trust to be both discretionary and non-discretionary. For example, the distribution of trust income could be left to the discretion of the trustees, but any distributions of capital to beneficiaries are fixed by the trust agreement. Discretionary inter-vivos trusts with family members as beneficiaries are often referred to as family trusts.

As a general comment, the most recent tax changes will have the greatest impact on non-discretionary trusts.

Designating income to be taxed in the trust

While there are numerous situations where the establishment of a trust may be beneficial, one common way trusts are used is to minimize tax. Generally, the *Income Tax Act* (ITA) requires income of a trust that is paid or payable to a beneficiary to be deducted in computing trust income and to be taxed in the hands of the beneficiary. However, specific rules in the ITA allow a trust to designate income that has been paid or is payable to beneficiaries as not having been paid or made payable to the beneficiaries. Income so designated would not be allocated to the beneficiaries of the trust as taxable income, thereby remaining to be taxed within the trust. The beneficiaries, however, do not lose their right to the income even though it is taxed in the trust.

Retaining income to be taxed in the trust can be advantageous in several situations. One such example is when an inter-vivos trust (such as an alter-ego, spousal or joint-partner trust) employs a strategy involving inter-provincial tax planning, whereby the trust resides in a jurisdiction with a lower income tax rate than the one in which the beneficiary resides. Income

can be designated by the trust to be retained and taxed within the trust so as to take advantage of a lower provincial tax rate. Keep in mind that determining the residency of a trust can be complicated. For a more detailed discussion of the common-law principles used to establish the residency of a trust, read our article in the 2012-03 issue of the *Tax Factor* titled "New test for trust residency confirmed".

If you consider the use of a testamentary trust, a strategy of retaining income to be taxed within the trust can be even more powerful. This is because, under the current rules, testamentary trusts have access to graduated tax rates that are normally only applicable to individuals. By retaining income to be taxed within the trust, the trust's beneficiaries are able to take advantage of an additional set of graduated rates and thus potentially lower their overall tax burden. This tax minimization strategy can be further enhanced if the testamentary trust is also a resident of a province or territory with a lower income tax rate than that of the beneficiaries.

The new rules will see constraints put in place to invalidate such designations in tax years in which the trust has taxable income in any amount greater than zero. This will essentially limit the income that can be retained in the trust to amounts sufficient to apply tax losses of the trust from other taxation years (if any) in amounts that would reduce taxable income of the trust to zero. As a result, effective January 1, 2016 (when these new rules are set to take effect), much of the tax advantage from the tax planning described above will cease. This will have an impact on the use of trusts resident in Alberta (which has the lowest personal tax rates in Canada), as it will not be possible to retain income and gains otherwise payable to beneficiaries. It is the ability to retain taxable income that allows these trusts to take advantage of Alberta tax rates.

Further to the above, the new rules also eliminate access to graduated rates for testamentary trusts after December 31, 2015, affecting both graduated rate planning and other post-mortem tax planning strategies. In particular, access to graduated rates will be limited to the first 36 months of an estate, following the death of the individual. For a more detailed discussion of the tax implications of these new rules on the taxation of testamentary trusts, read the article in our 2013-07 *Tax Factor* titled "Federal government releases proposed measures affecting the taxation of testamentary trusts".

Spousal, alter-ego and joint-partner trusts

Another of the recently enacted rules will have a significant impact on the taxation of a specific type of personal trust, which we'll refer to as a "life-interest trust". These trusts, which include spousal, alter-ego and joint-partner trusts, provide a specified beneficiary with a right to receive income from the trust during their lifetime. In addition, if any capital distributions are made during the life-interest beneficiary's lifetime, they can only be made to that beneficiary. Under the current rules, when the life-interest beneficiary dies, a disposition of all of the capital property held in the trust is deemed to take place and the trustee(s) generally use the assets of the trust to pay the arising tax liability before distributing the remaining assets of the trust to the trust's capital (or "residual") beneficiaries.

The new rules contain a significant alteration in respect of what happens upon the death of the life-interest beneficiary. Beginning on January 1, 2016, when a beneficiary of a life-interest trust dies, there will be a deemed year end of the trust for tax purposes. All of the trust's income for that final year of the trust, including any capital gains arising from the deemed disposition of the trust's assets as a result of the death of the life-interest beneficiary, will then be included on the terminal tax return of the deceased beneficiary. On first blush, this may appear to be a beneficial result since the income associated with the deemed disposition will now be subject to the applicable marginal tax rates of the individual. And in some situations, there will be a benefit. However, on further scrutiny, it is apparent that this change could create negative implications for some taxpayers.

To illustrate how these rules may adversely impact some taxpayers, let's take a look at a specific situation involving Robert and Denise. Robert and Denise are married and each has children from their previous relationships. Robert sets up a spousal trust in his will in order to benefit Denise following Robert's death. Denise would be the income beneficiary of

the trust, but the residual (or capital) beneficiaries would be Robert's children from his previous marriage. The trust specifically would not be allowed to pay capital to Denise during her lifetime. On Denise's death, any gains and income for the trust's year to that point, including the deemed gain on the disposition of the trust's assets arising on her death, would be taxable to her estate as income payable. Consequently, it would be Denise's estate that would be responsible to pay the tax liability arising from the deemed disposition of the trust's assets. However, the beneficiaries of Denise's estate are her children, and as such they would not be the ones to receive the capital from the spousal trust. Put simply, Robert's children would inherit the tax-paid capital from the spousal trust, while Denise's children would suffer a reduction in their own inheritance as a result of having to bear the cost of the tax on the assets going to Robert's children. Obviously, in this example, this would be an unwelcome and totally unfair result.

Provisions were included in the legislation to require that the trust and the estate be held jointly and severally liable with respect to the taxes arising from the deemed disposition of the trust's assets on the death of the life-interest beneficiary. However, these provisions do not appear to be adequate to ensure that the Canada Revenue Agency won't pursue the estate for the taxes owing. And, further complications could arise given the trustees of the trust in our example would most likely have no ability to pay the deceased's tax under the terms of the trust.

It is important to note that the new disposition rules on the death of the life-interest beneficiary are not limited to testamentary trusts. These rules will impact all existing and new spousal, alter-ego and joint-partner trusts for taxation years beginning in 2016.

Planning in light of these changes

Trusts are commonly employed in tax and estate planning. These new rules will have a significant impact on the taxation of personal trusts going forward. Since there is less than one year remaining before these rules are set to take effect, it is important to meet with your BDO advisor as soon as possible to discuss how these changes will impact any trusts that you or your family have set up or that you may have provided for in your will, and to plan accordingly.

The federal government has indicated that they are willing to entertain discussion in respect of making changes to some of the rules in order to address the unintended negative consequences to some taxpayers. However, as of the time of this publication, there hasn't been any specific information released on what these subsequent changes may be or how they may impact the rules as they currently stand. Rest assured that if and when changes are announced, we will provide further updates.

As we alluded to in this article, there are other changes to the rules affecting the taxation of personal trusts which will become effective on January 1, 2016. One such change is the introduction of the "qualified disability trust". A discussion about qualified disability trusts will be a topic for a future *Tax Factor* article. In the meantime, if you do have any questions about the new legislation and its impact on the taxation of trusts, contact your BDO advisor.

The information in this publication is current as of February 1, 2015.

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