



FEDERAL BUDGET 2011

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WATERSTREET
FAMILY OFFICE

BREAD CRUMBS AND LOOPHOLES

By Tim Cestnick and Leigh Vyn

As we contemplate the 2011 Federal Budget, it's not difficult to summarize what this budget was all about: Providing a few (that is, very few) crumbs for taxpayers to enjoy, and closing a number of long-standing loopholes that we've known about for years. We've often wondered about the longevity of some of these loopholes. Some seemed too good to be true. Turns out the Department of Finance felt the same way.

We find it rather amusing that the government has chosen to title its budget documents "A Low-Tax Plan For Jobs and Growth," because there doesn't seem to be much related to lower taxes in this budget.

It seems to us that, regardless of what this budget might have said, the opposition parties are likely to seek to defeat the budget and we can anticipate a federal election in the near term. The real question, then, becomes: What issues will be raised by the various parties in an election campaign that will impact the personal wealth of Canadians? This may be the more important question than "what's in this budget for me?"

On a positive note, private sector economists expect Canada's real gross domestic product (GDP) to grow by 2.9 percent in 2011, which is up from the 2.5 percent projected in the fall of 2010. Further, employment growth and incomes in Canada have grown faster than in any other G-7 country from 2006 to 2010.

The government expects a balanced budget once again by 2015-16 (we do recall that last year the government expected the balanced budget to resurface in 2014-15). Canada's federal debt at the end of 2009-10 was \$519.1 billion, and is expected

to come in at \$556.4 for 2010-11. The debt is expected to continue to grow until 2014-15 at which time it is forecast to be \$615.2 billion. The small budgetary surplus of \$4.2 billion in 2015-16 is expected to result in a reduction in the federal debt to \$611 billion at that time.

Closing Loopholes

Let's talk more about the big theme in this year's budget: Closing existing loopholes. There are several areas where loopholes have been closed:

- Corporations that have owned interests in partnerships have been able to defer tax on partnership income by carefully selecting the right year-end. These deferral opportunities are being eliminated going forward.
- Certain stop-loss rules in our tax law will be extended to dividends deemed to be received on the redemption of shares held by corporations.
- The kiddie tax rules introduced a decade ago are being revised to include capital gains as a type of income that will be subject to the highest rates of tax in the hands of minor children upon the sale of private company shares.

- New rules will prevent the use of “RRSP-Stripping” schemes that some have used to extract cash from RRSPs without paying tax.
- A package of “integrity measures” for charities is being introduced to prevent certain abuses of the charitable donation incentives in the Income Tax Act.
- New rules will limit the benefits available on the donation of flow-through shares to charity.
- Rules around Individual Pension Plans will be revised to limit the benefit of these plans to be similar to those available through RRSPs.

PERSONAL TAX MEASURES

In the weeks leading up to the 2011 federal budget there was very little talk to be found anywhere about the type of tax measures that were likely to be proposed. The silence was deafening. Now, the score is in: There were more measures proposed in the 2011 Federal Budget to benefit the government by closing loopholes than measures designed to put more money in your pocket as a Canadian taxpayer. The following are personal tax changes introduced in the 2011 Federal Budget:



CHILDREN'S ART TAX CREDIT

Piggybacking on the introduction of the Children's Fitness Tax Credit in 2006, the 2011 Federal Budget proposes to recognize the costs associated with children's artistic, cultural, recreational and developmental activities. This 15 percent non-refundable credit, applies to eligible expenses of up to \$500 per child under the age of 16. Eligible expenses include fees paid for a wide variety of activities that are designed to promote the artistic, cultural, recreational or development of a child. Expenses paid are not limited to those areas considered to be “the arts” but seem to include just about any activity or lesson that your child may attend (music, art, dance, tutoring, language lessons, remedial lessons, etc.).

To be eligible for the credit, the program must run weekly for a minimum of eight weeks or if a camp, run a minimum of five consecutive days. This credit will apply to expenses paid during 2011 and subsequent years.

Strategy: This new tax credit seems to open the

door to gain tax relief for a very wide range of activities. We're hard pressed to think of activities that won't qualify here. So, be sure to keep all receipts for any and all activities that your children participate in. Chances are good that the expense will qualify.



FAMILY CAREGIVER TAX CREDIT

If you are caring for an infirm family member, the 2011 Budget provides you some assistance with the introduction of the new Family Caregiver Tax Credit. This non-refundable tax credit equal to \$300 (15 percent credit on an amount of \$2,000), will be available to you if you care for an infirm dependent relative, which will now also include a spouse, common-law partner or minor child. The purpose of this credit is to enhance the support caregivers may already be receiving under the existing tax credits including the Spousal or Common-Law Partner Credit, the Child Tax Credit, the Eligible Dependant Credit, the Caregiver Credit, and the Infirm Dependant Credit. Eligibility for this credit won't begin, however, until the 2012 taxation year.

Strategy: There are a number of tax credits that are now available to those who are providing support to related dependents. The number of credits has increased over recent years. Make sure you speak to your WaterStreet advisor if you have any question about whether or not you are entitled to claim tax relief for this support. In addition, asking your infirm mother-in-law to come live with you could provide some tax relief (so, give it some thought).



MEDICAL EXPENSE TAX CREDIT

The medical expense tax credit is designed to provide some relief to those who incur larger medical and disability expenses. The credit can be claimed on expenses that exceed the lesser of 3 percent of net income and \$2,052 (in 2011). There is no ceiling on the amount of expenses that can be claimed by you, your spouse or dependent children under the age of 18. Similarly, a credit is also available to caregivers who incur medical expenses for a dependent relative (including a child over age 18,

grandchild, parent, grandparent, sibling, aunt, uncle, niece or nephew). In this case, the maximum in expenses that can be claimed in respect of these other dependent relatives is \$10,000. The 2011 budget proposes to eliminate this \$10,000 cap on eligible expenses for these other dependents. This measure will apply to the 2011 and subsequent taxation years.

Strategy: If you are providing any support to a relative to help cover the cost of medical expenses, consider whether you should be making those payments directly to the provider of the medical services to entitle you to claim a medical expense tax credit. Consider also whether this relative is dependent in a manner that will entitle you to this credit. Speak to your WaterStreet advisor for more.



CHILD TAX CREDIT

Under the current rules, only one person per household may claim the child tax credit. This rule unfairly treats situations where two or more families live in the same household. The 2011 Budget proposes to repeal the rule that limits the number of claimants to one per household. Speak to your WaterStreet advisor for more.



TUITION TAX CREDIT

The Budget proposes that, starting in 2011, expenses eligible for the tuition tax credit will include fees paid to associations or institutions to take an exam required in order to obtain a professional certificate or license. Ancillary fees such as the cost of exam or study materials will also be eligible for this credit. Expenses paid for travel, parking or special equipment will not be eligible.

Strategy: Claiming tax relief for the costs of education can be accomplished in multiple ways. In addition to the tuition, education and textbook tax credits, it's possible to use pre-tax dollars to pay for schooling through the use of family trusts that hold portfolio investments. In addition, loans from a corporation owned by a parent can result in cash flow to the student to pay for school, and a deduction to the student when he or she starts working full time and can use the tax relief. Your

WaterStreet advisor can share more information on these strategies.



EDUCATION TAX MEASURES – STUDYING ABROAD

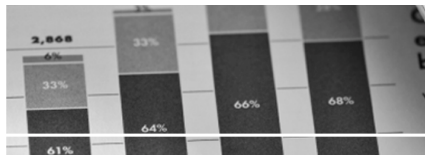
Under the current rules, students studying outside of Canada are eligible to claim the tuition, education and textbook tax credits provided that the tuition fees are paid for a course that runs for at least 13 weeks. This raises a problem however, as many programs at foreign universities are based on semesters that are shorter than 13 weeks, so Canadian students studying abroad are often ineligible for these credits. In response to this, the 2011 Budget proposes to reduce the course duration requirement from 13 weeks to 3 consecutive weeks. This change will also allow students abroad to claim Educational Assistance Payments (EAPs) from RESPs while studying outside Canada.

Strategy: Whenever a student studies outside of Canada, be sure to have the foreign educational institution sign Form TL11A as evidence of tuition paid. Also, be aware that the CRA changed its interpretation of the phrase, "full-time attendance at a university outside Canada" for purposes of the tuition tax credit for taxation years beginning after 2006 to include courses taken via the internet at a university outside Canada. Be sure to claim credits for these programs where possible.



REGISTERED EDUCATION SAVINGS PLAN

Parents or grandparents often save for education via an RESP "family plan." The benefits of a family plan allow the subscriber flexibility in that the plan assets can be shared among related children as beneficiaries of the plan. Other relatives that are not connected to the children by blood or adoption can only save for these RESP beneficiaries via individual plans – which are less flexible in the ability to allocate payments among siblings without triggering penalties and repayment of the Canada Education Savings Grants (CESG). The 2011 Budget proposes to allow transfers between individual RESPs for siblings without penalties, or repayment of the CESG provided that the beneficiary of the plan



receiving the assets had not attained the age of 21 when the plan was opened. This measure will apply to transfers that take place after 2010.

Strategy: There are optimal ways to use RESPs to set aside capital for a child’s education, and this can result in free money from the government in the form of Canada Education Savings Grants. If you want to establish RESPs for children, there are fewer concerns now as to whether a family plan or individual plan should be utilized. Speak to your WaterStreet advisor about optimal strategies to pay for a child’s education.



REGISTERED DISABILITY SAVINGS PLAN

Registered Disability Savings Plans are designed to help parents and others save for the long-term financial security of a child with severe disabilities. Contributions of up to \$200,000 can be made to this plan, with additional funding from the government via the Canada Disability Savings Grants (CDSGs) and the Canada Disability Savings Bonds (CDSB). Since the plan is designed to promote long-term savings, when a withdrawal is made from the plan, all grants received in the preceding ten years must be repaid to the government. In situations where a beneficiary has a shortened life expectancy, this repayment will deplete the resources available when they are needed most. The 2011 Budget proposes to allow a withdrawal of up to \$10,000 in taxable plan savings per year, without repayment of grants when the beneficiary has a life expectancy of five years or less.

Strategy: If you have a child or grandchild with a disability and haven’t yet established an RDSP, speak to your WaterStreet advisor about whether this makes good sense. The CDSGs and CDSBs represent free money from the government and it may make sense to use an RDSP in addition to, for example, a Henson Trust.



RRSP – ANTI AVOIDANCE RULES

The 2011 Budget proposes to close the loopholes around tax “schemes” involving RRSPs. Commonly referred to as “RRSP Strips” these schemes enabled taxpayers to access their RRSP funds without paying tax on those withdrawals.

Rather than continuing to challenge these under the existing provisions of the Income Tax Act, the government proposes to enhance the RRSP anti-avoidance rules, by introducing legislation similar to that which applies to Tax-Free Savings Accounts (TFSA). Although these new rules won’t impact those who hold their RRSP for long term retirement savings, it used to be the case that you could potentially hold a sizeable investment in private company shares in an RRSP. The rules have been tightened to limit that investment to less than 10 percent of a private company (this is a complex area of the tax law – so speak to your WaterStreet advisor for more information).

Strategy: We have never been proponents of the various “RRSP Strip” strategies that sought to extract capital from an RRSP or RRIF tax-free in a very aggressive manner. There are still opportunities to minimize tax on very large withdrawals from RRSP or RRIFs with proper planning. Further, there are still opportunities to use RRSPs to hold private company shares in limited circumstances. Speak to your WaterStreet advisor for more information.



INDIVIDUAL PENSION PLANS

If you have an Individual Pension Plan (IPP) there are two changes announced in the Budget that may impact you. First, commencing in 2012, once you reach age 72, there will be a minimum amount that will be required to be withdrawn from your IPP, similar to those withdrawal requirements you would have faced had you held the assets in a RRIF. Second, contributions to an IPP that represent past service will have to be funded first out of your existing RRSP or by reducing accumulated RRSP contribution room.

Strategy: IPPs can be an effective tool to reduce high corporate taxable income and to protect from creditors certain assets that have been paid out of the corporation for your benefit. IPPs can also provide greater estate planning benefits than other registered plans. IPPs do, however, come with some drawbacks which should be understood first. Speak to your WaterStreet advisor about IPPs.



TAX ON SPLIT INCOME

Although tax on split income (or “kiddie tax”) has been around since it was announced in the 1999 Federal Budget, it only applied to dividends received by a minor in respect of private company shares, and business income carried on by a person related to that minor child. The government has now proposed that the kiddie tax also apply to capital gains, if that gain is derived from the disposition of private company shares to a person who does not deal at arm’s length with the minor. The result is the gain will be treated at the top tax rate and will not benefit from the capital gains inclusion rate or capital gains exemption. Yet another loophole closed.

Strategy: There are multiple ways to split income with family members. Avoiding the kiddie tax is always a concern when moving income to the hands of minor children. Still, there are effective ways to split income with family – including minors – through the use of trusts. This is particularly effective when it comes to splitting income from a portfolio.



VOLUNTEER FIREFIGHTERS TAX CREDIT

The 2011 Budget proposes a non-refundable tax credit of \$450 (a 15-percent credit on \$3,000), for volunteer firefighters who perform a least 200 hours of volunteer firefighting services in a taxation year. If you claim this exemption, you will be ineligible for the existing tax exemption on honoraria of up to \$1,000 paid to volunteer firefighters. This tax credit will apply to the 2011 and subsequent taxation years.

Strategy: If you are a paid firefighter, don’t donate your time to the fire hall at which you regularly work. Your time there won’t qualify you for this tax credit.



GUARANTEED INCOME SUPPLEMENT

Starting July 1, 2011, seniors with little income other than the Guaranteed Income Supplement and Old Age Security Benefits will receive additional benefits of up to \$600 for single seniors and \$840 for couples. The amount of the

top-up will be phased out according to income, and will be completely eliminated when income (other than GIS and OAS) is above \$4,400 for single seniors and \$7,360 for couples.



EMPLOYEE PROFIT SHARING PLANS

The government has Employee Profit Sharing Plans (EPSPs) on the radar. The real issues seems to be that EPSP are being used by some business owners to avoid making CPP and EI contributions on employee compensation, to split income with family members, and defer tax for up to one year. To ensure that they are being used for their intended purposes, the government will be reviewing the existing rules to determine if any changes are needed. No changes have been announced yet, but these are likely to follow soon.

BUSINESS TAX MEASURES

The following measures will impact those who are business owners.



ACCELERATED CAPITAL COST ALLOWANCE

The budget proposes to provide assistance to the manufacturing and processing sector by extending the accelerated capital cost allowance (CCA) rate in machinery and equipment for two additional years. The CCA rate of 50 percent on a straight line basis will apply to eligible purchases made before 2014.



STOP LOSS RULES

The stop loss rules are a complex set of rules found in the Act that are designed to reduce the amount of the loss a corporation may claim on the disposition of shares, in situations where tax-free dividends were received on those shares prior to the disposition. In some cases, corporations were taking advantage of these rules in certain tax avoidance arrangements, particularly where private company shares owned by another corporation were redeemed by the owner-corporation and the resulting deemed dividends were reported as tax-free inter-corporate dividends. The Budget extends the stop-loss rules to close this loophole.

Strategy: There are still opportunities to move after-tax proceeds from one corporation to another (a parent company), on a tax-free basis. This can be useful for protecting those earnings from creditors of a business, or to fund other investment opportunities in a tax-effective manner. Your WaterStreet advisor is familiar with strategies to deal with the stop-loss rules and to accomplish many tax objectives using your current structure.



PARTNERSHIPS – DEFERRAL OF CORPORATE TAX

Corporations who have owned significant interests in a partnership have had the opportunity to defer a portion of income in situations where the fiscal year end of the partnership ended after the fiscal year end of the corporation. For example, a corporation with a December 31st year end is a partner where the year end of the partnership is January 31st. In the first year of operations, the corporation would not have to report any partnership earnings, since the year end of the partnership falls after the corporate year-end which allowed for a deferral of income. The 2011 Budget proposes to limit this deferral of tax where a corporation has a significant interest in a partnership, by requiring the corporation to accrue income from the partnership that falls within the corporation's fiscal year ('stub period'). This proposal will apply to corporate taxation years that end after March 22, 2011. In order to avoid a significant income inclusion in the first year, the proposed measures will bring this "stub period" income into the corporation's income over five years.

Strategy: Since the corporation will now be reporting more taxable income than it has in the past, there is an opportunity to explore other means to reduce corporate taxable income, including the use of IPPs, RCAs, accruing other compensation, and effectively transferring losses from one corporation to a more profitable corporation via amalgamation or other means, among other ideas.

CHARITY TAX MEASURES

For the second year in a row, the Department of Finance is tightening rules that impact the charitable sector.



CHANGES IN THE CHARITABLE SECTOR

The 2011 Budget announced a series of "integrity measures" to help combat fraud and abuse of charitable donation incentives, and further strengthen the charitable sector. Changes include:

- Qualified donees (which include, but are not limited to registered charities), must adhere to the same regulatory requirements as registered charities when it comes to issuing receipts, and maintaining books and records;
- An organization may lose its charitable registration if a director, trustee, officer or other individual who controls its operation has ever been found guilty of a criminal offence or within the last five years, has been found guilty of an offense relating to financial dishonesty, or was a promoter of a tax shelter under which a registered charity lost its registration status as a result of its participation.
- The CRA will now have the ability to reassess a taxpayer to disallow a donation credit, if the donated property is returned to the taxpayer;
- The donation credit cannot be claimed by a taxpayer for the donation of a non-qualifying security, until the donee has (within five years), disposed of the security for consideration that is not another non-qualifying security.

Strategy: For those who sit on charity boards it will become more important than ever to understand the backgrounds of the others on the board. A charity can lose its ability to issue donation receipts if the wrong people make their way to the board.



DONATIONS OF PUBLICLY LISTED FLOW-THROUGH SHARES

Prior to today's Budget announcement, you could purchase flow-through shares, get a tax deduction for virtually the entire amount invested, donate the shares to charity and receive a donation tax credit for the full value of the shares. In addition, you wouldn't have to pay tax on the resulting

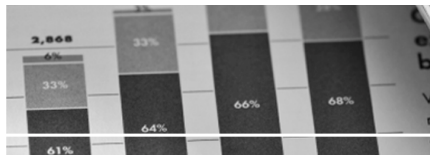
capital gain when the shares were “disposed of” by transferring them to the charity. The rules are now tightened so that the capital gain on the transfer of the shares to the charity will be taxable, unless the gain represents the value of the shares over and above what you paid for the shares (your cost amount). In effect, for every \$100 donation to charity, about five cents was coming out of the taxpayer’s pocket and 95 cents was coming out of the government’s coffers. This is what the government is changing with this proposal.

For illustrative purposes, the table below sets out a hypothetical flow-through share donation by an Ontario taxpayer in the top income tax bracket under the current rules. (Results can vary depending on factors, including the purchase price of the shares, their value at the time of donation, the province of residence of the donor, the donor’s marginal tax rate, and the availability of federal and provincial flow-through credits.). In this example, all of the benefit due to the capital gains exemption is assumed to accrue to the donor.

This example assumes that the donated flow-through share is eligible for the federal and provincial mineral exploration tax credits (15% and 5% respectively) and that it is issued at a 20% premium to the \$100 value at which ordinary shares of the class in which it is issued are trading. It also assumes that after the flow-through deductions have been claimed by the taxpayer, he or she donates the shares to charity at its fair market value of \$100 (the flow-through share premium generally drops out of the price once the flow-through deductions have been claimed).

Strategy: It still makes good sense to donate shares or other securities to charity. The advantage of using flow-through shares for this purpose, over other securities, has now been eliminated. A strategic philanthropic plan will include creative ways to maximize the tax savings and the value of your estate for future generations using philanthropy as a vehicle. Speak to your WaterStreet advisor about your own strategic philanthropy.

| | | |
|--|------------|-------------|
| Price paid for flow through share (20% Premium) | | \$ 120.00 |
| Less: | | |
| Value of flow-through share deductions (Federal / Provincial) | \$ (55.70) | |
| Net value of flow through share tax credits (Federal / Provincial) | \$ (12.90) | |
| Capital gains tax on disposition of shares (Federal / Provincial) | \$ - | |
| Value of charitable donation tax credit (Federal / Provincial) | \$ (46.40) | \$ (115.00) |
| Net after-tax cost | | \$ 5.00 |
| Donation amount | | \$ 100.00 |
| Government support as % of donation | | 95% |



About WaterStreet

WaterStreet Family Office is Canada's leading Multi Family Office™ advisory firm. We are a team of professionals from multiple disciplines offering independent, objective advice on all matters related to the wealth of our clients. We work with wealthy families as a centre of stability and influence in helping them to grow and preserve their financial assets and family heritage.

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