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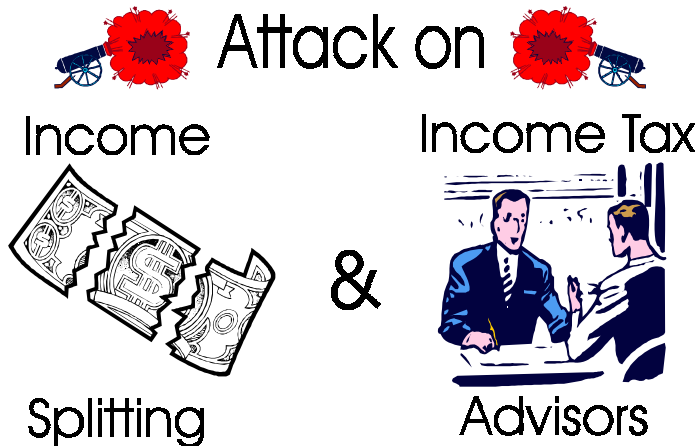
Manager

Federal Budget Issue - 1999

Published by Rich Rotstein Chartered Accountants

February 1999

Federal Budget 1999



On February 16, 1999 the Minister of Finance, Paul Martin, presented his 6th federal budget. While Mr. Martin continued with a balance budget theme established last year, individual taxpayers received only a very modest tax cut. However, without warning, he eliminated one of the last bastions of prudent tax planning in this country: **income splitting with minor children**. Income splitting is still breathing, but sharply reduced.

Commencing in the year 2000, the following incomes received by children under the age of 18 will be taxed at the top marginal rates with no deductions or personal credits allowed to reduce the taxes calculated on these incomes:

- **taxable dividends earned by a minor child**, whether directly or through a trust for the child's benefit. This change will apply to dividends paid on unlisted shares of Canadian and foreign companies (ie. shares of a family owned business owned by a minor child or a trust for the child's benefit);
- **income earned by a minor child through a partnership or trust** and derived by the provision of goods and services to a business carried on by:
 - a person related to the child;
 - a professional corporation of which the related person is a shareholder; or
 - any other corporation of which the related person is a specified shareholder.

This change will apply to corporations or partnerships that provide management and administrative services to a professional's practice or other business if the income from providing those services accrues to a related minor child.

The tax department is delaying implementation of these new anti-

income splitting provisions, probably to allow affected taxpayers to make representations. These proposals are targeted towards (1) professionals with management structures and (2) smaller incorporated businesses using multiple classes of shares to "sprinkle" income amongst family members. Using the top marginal rate of approximately 50%, a taxpayer employing one of these tax structures could save \$6,000 of income taxes per minor child per year. Typically, the dividends or partnership income allocated to the minor child was used for the benefit of the child (ie. private school tuition fees, toys, etc.). The elimination of this type of income splitting is consistent with the Liberal Government's maintenance of high income taxes and its continual support of anti small business initiatives. It will be interesting to see what kind of lobby small business mounts against this tax.

There was no across the board clampdown on income splitting. Investments can still be owned by minor children to income split capital gains earned on the investments. A minor child can still earn a reasonable salary for services rendered to the parent's business. It also appears that a minor child can loan monies to private corporation and income split the interest income earned on said loan.

The **3% general surtax** has been eliminated for all taxpayers for the 2000 and subsequent taxation years. For 1999, this general surtax has been reduced by 50%. The effect on income taxes of these surtax reductions will reduce the 1999 marginal tax rate by 0.435% and the 2000 rate by 0.87%.

The basic personal credit, the spousal credit and the equivalent to spouse credits will increase by token amounts, along with the threshold at which the spousal credit begins to be reduced by a dependant's income. The table below highlights the changes.

		1998	1999	2000
Basic personal credit		\$6,456	\$6,794	\$7,131
Spousal & equivalent-to-spouse	Credits or amounts	\$5,380	\$5,718	\$6,055
	Threshold	\$538	\$572	\$606

On death the **value of the deceased's RRSP or RRIF may be transferred tax free** to a surviving or spouse or if there is no spouse, other qualifying dependants. Effective for deaths after 1998, tax free transfers of RRSP's and RRIF's will be allowed to other qualifying dependants even if there is a surviving spouse.

A **retroactive lump sum payment**, such as an arbitration award, is currently taxable to the recipient in the year the payment is received. This can result in more income taxes being payable over the situation where the lump sum payment had been taxed in the year it was earned. After 1994, individuals receiving qualifying lump sum payments of \$3,000 or more will be allowed to use a special mechanism to compute the income

tax as if the payment had been received in the year to which it relates.

The list of **qualifying medical expenses** tax credit is being expanded for 1999 to include the following:

- therapy for persons with severe and prolonged disabilities;
- care and supervision of such persons living in a group home; and
- tutoring for persons with learning disabilities, or other mental impairments.

After 1999, corporations will be permitted to **offset refund interest on income tax overpayments and interest owing on unpaid taxes**. This measure is intended to eliminate the inequity that arose because refund interest is taxable yet arrears interest is non-deductible.

New rules are being introduced regarding **offshore trusts and foreign investment funds**. Previously monies transferred or loaned to offshore trusts avoided Canadian taxes on said monies if the trust had no Canadian resident beneficiaries. These trusts will now be treated as Canadian residents subject to Canadian taxes. The Canadian transferor of property to the offshore trust will be jointly liable with the trust for the tax liability.

Foreign investment funds will now be subject to rules similar to foreign accrual property income rules. Foreign investment funds will include any non-resident entity if more than 50% of the cost of its assets are investment properties. Taxpayers will be subject to income tax on either their pro-rata share of the fund's undistributed income or on changes in the fair market of their investment. Bona fide offshore investments will not be subject to these rules (trusts and funds situated in the United States).

These new proposed offshore rules may simply be scare tactics the Department wants to use against aggressive taxpayers. In addition, some of the requirements may be difficult to enforce. However, these rules could drive affluent taxpayers to hide assets offshore which undermines a self-assessment tax system. The new rules are delayed until after 1999 to give a bit of breathing room and also to listen to taxpayer comments over the next year.

A new penalty provision will now apply to third parties that make false statements or omissions in tax matters. These third parties include tax shelter promoters, tax advisors, tax preparers and valuers. Examples given in the budget materials include:

- 1) an art flip deal where the value of the art deviates by more than a prescribed amount from the value of the art determined by Revenue Canada; and
- 2) an accountant who includes the cost of a client's personal vacation as a business expense on the client's tax return.

Depending on the circumstances, the penalty to be applied will be the greater of:

- a) 100% of the gross income derived by the person in respect of the arrangement, or
- b) 50% of the amount of tax sought to be avoided by a taxpayer, or
- c) \$1000.

These penalties are designed to apply to both income tax and GST matters.

These new penalty provisions have the tax community concerned about what their responsibilities now are in the area of tax planning and tax compliance. How far does an accountant have to go to discharge his liability



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of making a false statement or omission? Consider the following:

- Is the accountant now supposed to audit his client's expenses, even in a compilation engagement, looking for personal expenses? Accountants will probably have to increase their documentation in their files at a minimum. The cost of preparing tax returns will soar.
- If personal expenses are discovered by a tax auditor of being included as business expenses, is the accountant automatically guilty? Will the penalties be automatically assessed against the accountant?
- Can clients no longer confide in or discuss with their accountants aggressive or contentious tax issues? If a client attempts to write off a loan loss as an allowable business investment loss or even a business loss and it turns out on an audit that the loan loss is to be treated as a capital loss, is the accountant penalized by the tax department for 50% of the taxes recovered? Can accountants still advise their clients to take aggressive tax positions if the accountant is to be held accountable?
- Do accountants now need written representations from clients any time an aggressive tax strategy is utilized? How would the representations read? Would the representation still absolve the accountant of any penalty liability?
- Will clients "shop around" for an accountant who is willing to take the risk in an aggressive tax situation?
- Will the tax department use the threat of this new penalty provision in getting tax advisors to agree to the tax department's assessing position?

Only time will tell whether these questions and similar ones can be answered. In the meantime, tax professionals are now assessing their positions in light of this new penalty provision. Fortunately, these particular provisions will apply after Royal Assent, so it will probably be a concern for the year 2000 tax season.

Other miscellaneous budget proposals include an enrichment of the **child tax benefit** for the years 1999 and 2000, and changes to the labour-sponsored venture capital corporations rules. However, many experts feel the budget should have done far more. In the near future we would like to see (1) substantial **reductions in our high marginal**

personal tax rates, (2) an **increase in the \$200,000 small business deduction** for Canadian owned private corporations (which has not been increased in 18 years), (3) an **increase in the 20% foreign investment content for pensions and RRSP's**, and (4) the **elimination of the 5% surtax** on incomes in excess of \$65,000. We can only wait and see.

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