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Tax Topics

THE TAX AND ESTATE PLANNING GROUP

2008 Federal Budget – One thing to talk about

Finance Minister Jim Flaherty delivered the Conservative government's third budget on February 26, 2008. Unlike in previous budgets where there was ostensibly something for everybody, this budget contained only a few measures of interest. The focus of this Tax Topic is on measures of interest to insurance and investment advisors.

There were no broadly based tax cuts. No truly big ticket items. Much of the heavy lifting (corporate and personal tax rate cuts and additional GST cut) had already been done in the fall Economic Statement in October 2007 (and which has already received Royal Assent).

The tax measures announced in the 2008 Federal budget, with few exceptions, could be characterized as tinkering with existing measures and programs. The following represents a summary of these measures with specific emphasis on the impact these would have on insurance and investment planning.

Tax-Free Savings Account (TFSA)
The budget introduces a tax-free savings account (TFSA), a new type of registered savings account. Starting in 2009 Canadian residents 18 years or older can contribute up to $5,000 annually to their TFSA.

Contributions to a TFSA will not be deductible. However, income, losses and gains in respect of investments held within a TFSA, as well as amounts withdrawn, will not be taxable and will not be taken into account in determining eligibility for federal income-tested benefits or tax credits such as the Canada Child Tax Benefit, the Goods and Services Tax Credit, the Age credit, Old Age Security benefits, the Guaranteed Income Supplement or Employment Insurance benefits.

The $5,000 annual contribution limit will be indexed to inflation annually, and rounded to the nearest $500, starting in year 2010. Unused contribution room will carry forward indefinitely. Any amounts withdrawn from an individual's TFSA in a year will be added to the individual's TFSA contribution room for the following year. This will allow individuals to re-contribute an equivalent of their withdrawn amount in future years. However, any excess contributions will be subject to a tax of one per cent per month.

A TFSA will generally be permitted to hold the same investments as Registered Retirement Savings Plan (RRSP), except for investments in non-arm's length entities. Financial institutions currently eligible to issue RRSPs, such as life insurance companies, Canadian trust companies, banks and credit unions will be permitted to issue TFSAs.

Because the investment income within and withdrawals from a TFSA will not be taxable, interest on money borrowed to invest in a TFSA will not be deductible. However, TFSA assets can be used as collateral for a loan.

Individuals will be able to contribute to a spousal or common-law partner's TFSA (subject to the contributing spouse's contribution room) and the income earned on these contributions within the TFSA will not be subject to the attribution rules.

Investment income earned within a TFSA after an individual's death will be taxable. However, TFSA assets can be transferred to the TFSA of a spouse or common-law partner regardless of

whether the survivor has available contribution room and without reducing their contribution room.

Individuals who become non-resident will be allowed to maintain their TFSA and continue to be exempt from tax on investment income and withdrawals. However, no contributions are permitted while the individual is a non-resident and no new contribution room will accrue.

TFSAs are a nice addition to the registered savings options. They will be particularly attractive for those individuals who:

- have existing non-registered investment accounts that they could transfer to a tax exempt TFSA,
- have already maximized their RRSP contributions who are looking to enhance their retirement savings or looking for other ways to shelter investment income,
- seniors over age 71 who can't contribute to RRSPs,
- individuals with low or modest income for whom the deduction provided by RRSP contributions is of limited value, and
- those for whom preserving income tested benefits is important.

Individuals will have to determine whether to save in a TFSA, an RRSP or both depending on their particular situation but anyone saving outside of an RRSP would contribute those funds to a TFSA first.

While these measures are good news, they do create some competition for exempt life insurance policies as tax-sheltered investment vehicles. The TFSA represents another tax-preferred investment vehicle with similar attributes to exempt policy investment growth – use of after-tax dollars with tax-sheltered growth. Where the TFSA differs is the ability to access the funds directly on a tax-free basis. Our preliminary conclusion is that clients would choose to do their TFSA investing first and then turn to exempt life insurance as a tax-preferred investment for non-registered funds in excess of TFSA limits.

By way of background, in the 2003 Federal Budget the government signaled its interest in determining whether the concept of a "tax pre-paid savings plan" could be an appropriate mechanism to provide Canadians with opportunities to save in a tax-efficient manner. TFSA's appear to be the result of 5 years of analysis.

Registered Education Savings Plans (RESP)

This budget proposes measures to provide additional flexibility to parents who save in RESPs and to students who later use these savings to help finance their post-secondary education.

Beginning in 2008, the budget proposes to enhance the flexibility of RESPs by extending the contribution period from 21 years to 31 years and by raising the maximum time limit that an RESP may remain open from 25 to 35 years. Corresponding changes are proposed to individual RESPs for beneficiaries who are eligible for the Disability Tax Credit.

The budget also proposes more flexibility for a beneficiary to access RESP savings. Beneficiaries who cease to be enrolled in a qualifying post-secondary program after 2007 will be eligible to receive Education Assistance Payments (EAP) for up to six months after ceasing to be enrolled in that program.

Registered Disability Savings Plan (RDSP)

The 2007 Federal budget introduced the Registered Disability Savings Plan (RDSP) to help save for the long term financial security of severely disabled individuals. The 2008 budget states that the government is working with financial institutions to put the necessary administrative mechanisms in place so that RDSPs are available in 2008. To provide greater certainty for those planning on establishing an RDSP for a disabled individual, the budget also proposes to amend the rules so that plan beneficiaries cannot force a premature collapse of the plan.

Federal Locked-in Pension Plans

Of interest to individuals who have transferred funds from a federally regulated registered pension plan into a Life Income Fund (LIF) are proposals to increase the flexibility to withdraw

funds from these LIFs. This budget proposes to provide taxpayers with a LIF with three new options:

- individuals who are 55 or older will be entitled to a one-time conversion of up to 50 per cent of LIF holdings into a tax-deferred savings vehicle with no maximum annual withdrawal limits (e.g. a Registered Retirement Income Fund or RRSP),
- individuals who are 55 or older with holdings up to $22,450 will also be able to convert to a tax-deferred savings vehicle, and
- individuals facing financial hardship (e.g. low income, high disability or medical-related costs) will be entitled to unlock up to $22,450.

However, the budget did not indicate when these proposals would be effective.

Donation of Exchangeable Securities

The budget proposes to extend the existing capital gains tax exemption for donations of publicly-listed securities to capital gains realized on the exchange of certain unlisted securities where:

- the unlisted securities, at the time they were issued, included a condition allowing the holder to exchange them for publicly-listed securities;
- the publicly-listed securities are the only consideration received on the exchange; and
- the publicly-listed securities are donated to a registered charity or other qualified donee within 30 days of the exchange.

This measure will apply to donations made on or after February 26, 2008. Taxpayers may consider purchasing insurance or other investments with the tax savings derived from gifting exchangeable securities to charities.

Taxation of Eligible Dividends

Included in the 2008 budget are changes to the tax rates on eligible dividends. The personal dividend tax credit system is intended to give “credit” to individuals for the corporate tax paid inside the corporation before dividends are distributed. It does so by first requiring a “gross-up” of dividends (as a proxy for the actual corporate income earned) to be included in the individual’s taxable income, and then providing a personal dividend tax credit (as a proxy for the corporate income taxes paid).

In the 2007 Economic Statement the government announced reductions to general corporate income tax rates to 15% by 2012. It also stated that consideration would be given to adjusting the dividend tax credit for eligible dividends to align the dividend tax credit system with the corporate rates. The budget includes adjustments to the dividend gross-up factor and dividend tax credit rate for eligible dividends to better reflect the corporate income tax reductions. Below is a table which shows the effect of these changes on the rate of personal income tax on eligible dividends:

	2008 & 2009	**2010**	**2011**	**2012**
Dividend	$100	$100	$100	$100
Gross-up	$45	$44	$41	$38
Taxable Dividend	$145	$144	$141	$138
Tax on Dividend (@29%)	$42.05	$41.76	$40.89	$40.02
Dividend Tax Credit	$45 x 11/18 = $27.50	$45 x 10/17 = $25.88	$45 x 13/23 = $23.17	$45 x 6/11 = $20.73
Net Federal Tax on Dividends	**$14.55**	**$15.88**	**$17.72**	**$19.29**

These changes bring into line the federal dividend tax credit for eligible dividends to more

closely resemble the corporate tax rates announced in the 2007 Economic Statement:

	2008 & 2009	2010	2011	2012
Federal Dividend Tax Credit (as a % of the grossed up dividend)	19%	18%	16%	15%
Federal General Corporate Tax Rates	19.5%/19%	18%	16.5%	15%

Conclusion
The government has generally implemented most of their economic and tax measures with the 2007 Economic Statement and this budget did not bring about any major broad based initiatives. TFSA's are the one significant measure to talk about in the realm of financial planning arising from this budget.

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