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Federal Budget 2010: Personal and Small Business Tax Announcements

Federal Budget 2010 introduced several specific tax measures targeting individuals and corporations. The focus of this report is to focus on a few key elements of the 2010 Budget that affect personal and corporate taxation.

Employee Stock Options

After years of painstaking lobbying, relief has finally arrived to many employees who exercised employee stock options, deferring their tax obligations until the date of sale of the underlying shares, which in many cases, have since plummeted in value.

The relief contained in the Federal Budget is available to all affected employees, unlike the November 2007 remission order, forgiving both income taxes and arrears interest of thirty-five ex-employees of SDL Optics, Inc. (since acquired by JDS Uniphase) that arose from participation in their employer's stock purchase plan.

Under Canadian tax law, if you purchase shares through either an employee stock purchase plan or by exercising an employee stock option, your taxable employment benefit (and thus your tax liability) is based on the difference between the price you paid for the shares and the fair market value of shares on the date you receive them.

A stock option benefit deduction equal to 50 per cent is available to tax the stock option at capital gains-type rates, even though it's still classified as taxable employment income.

While the value of the taxable benefit is fixed when the shares are acquired, taxation of the benefit can generally be deferred until the year you sell the shares, at which time the shares may have substantially dropped in value. The allowable capital loss arising at the time of disposition cannot be used to offset the taxable employment benefit.

It is this mismatch of capital loss against employment income that has sparked intense lobbying by various employee groups, especially in the high-tech sector who face massive tax bills on money they never "received."

The 2010 Federal Budget proposed a number of measures directed at this issue.

First, to deal specifically with individuals who elected to defer paying tax on their stock option benefits until sale, the government introduced a new special elective tax treatment to ensure that the tax liability on a deferred stock option benefit won't exceed the fair market value of the shares being sold.

For example, let's say Jay's employer has a stock option plan and he was granted the option to purchase 1,000 shares of his employer at $20 per share.

Jay exercised that option when the market price of the shares was $220. Rather than sell the shares, he decided to hang on to them. By filing an election in the year of exercise, Jay was able to defer paying tax on this option benefit until he chose to sell the shares.

The stock option benefit deferred was $200,000, equal to the difference between what he paid ($20,000) and what the stock was worth when he exercised his option ($220,000).

This benefit, while not a capital gain, is taxed at the same rate as a capital gain – i.e. at 50% of your marginal tax rate – but is considered to be employment income.

The problem arises when Jay decides to sell his shares, which, given recent market conditions, have been pummeled and are now worth a mere $10 each.

As a result, Jay will receive proceeds on the sale of $10,000 and realize a loss of $210,000 ($10,000 – $220,000). This loss is considered to be a capital loss and thus can only be used to offset other capital gains. Nor can it be applied against the deferred employment benefit of $200,000, on which tax becomes due in the year of sale, even though this benefit was taxed at the same rate as a capital gain.

Under the new rules, if Jay elects to have them apply, instead of paying tax at capital gains rates of about 25% on his employment benefit of $200,000 or $50,000, he could pay the special tax equal to his proceeds of disposition of $10,000.

This relief is also available to any employee who sold shares acquired upon exercising options before 2010, provided the election is filed before the 2010 tax filing deadline (generally April 30, 2011). It will also apply to individuals who have not yet disposed of their optioned shares, as long as they dispose of them before 2015 and elect by the filing deadline for the year of disposition.

Secondly, the government has eliminated the tax deferral election effective immediately, such that an employee can no longer defer paying tax on the stock option benefit until the year of sale.

Finally, to ensure it collects its taxes when such options are exercised, the government will now insist on collecting the required income tax withholding when the options are exercised. Employers will be required to withhold tax at source for the period in which the employee exercised the option.

In a somewhat related budget announcement, the government is also cracking down on employee stock option plans that permit employees to dispose of their stock option rights for a cash payment from their employer.

Currently, the employer can deduct the cost of such cash payments while employees are still entitled to the 50 per cent stock option benefit deduction.

Under new proposals, for employees to be able to get this 50 per cent deduction, they must either exercise their options for shares, or their employer will have to file an election promising to forgo its deduction for the cash payment. If they don't, employees will be fully taxable on the value of such cash payments.

Registered Disability Savings Plan (RDSPs)

Registered Disability Savings Plans (RDSPs) were introduced in the 2007 Federal Budget to help parents and others save for the long-term financial security of a child with a severe disability. The RDSP is a tax-assisted savings vehicle which allows investment income to accumulate tax-deferred while attracting generous government benefits, such as the Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs).

Federal Budget 2010 has proposed two positive changes surrounding planning for a disabled beneficiary using RDSPs: the ability to roll over Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF) proceeds upon death to an RDSP and the carryforward of unused CDSGs and CDSBs.

Rollover of RRSP of RRIF Proceeds to an RDSP

The general rule is that when the annuitant of an RRSP or RRIF dies, the fair market value of the RRSP or RRIF as of the date of death is fully taxable to the deceased, unless a qualifying rollover applies.

For example, if the RRSP or RRIF is left to a surviving spouse or common-law partner, or to children or grandchildren who were financially dependent on the deceased RRSP or RRIF annuitant the proceeds can be taxed in the survivor’s hands instead of the deceased’s return.

Furthermore, if RRSP or RRIF proceeds upon death are left to a surviving spouse or partner or a child or grandchild who was dependant on the deceased because of a physical or mental disability, the fair market value of the RRSP or RRIF could be rolled over tax-deferred into the RRSP of the surviving spouse, partner or dependant child or grandchild. A rollover is also available for a child or grandchild who is financially dependent but without any disability, but only to an annuity to age 18.

The 2010 Federal Budget proposes that the RRSP rollover rules be extended to permit a tax-deferred rollover upon death of funds from a parent or grandparent’s RRSP to the RDSP of a “financially dependent” disabled child or grandchild.

Generally speaking, a disabled child or grandchild is considered to be “financially dependent” if the child’s income for the year preceding the year of death was less than $17,621 (for 2010). That being said, a disabled child who has a higher income level may still be considered financially dependent, but only if such dependency can be factually determined.

The total amount of RRSP or RRIF proceeds that can be rolled over cannot exceed the disabled beneficiary’s available RDSP contribution room, which is equal to the lifetime contribution limit of $200,000 less prior years’ RDSP contributions. The rolled over amount will not attract CDSGs.

In addition, since the amount of RRSP proceeds rolled over on a tax deferred basis to an RDSP will never have been taxed, the amount rolled over (excluding any future income and growth on this amount) will form part of the portion of a disability assistance payment that will ultimately be included in the beneficiary’s income when withdrawn from the RDSP.

To qualify for the rollover, the RDSP beneficiary (or his or her legal representative) must file an election with both the CRA and HRSDC at the time the RDSP contribution is made.

Special transitional rules have also been introduced for RRSP and RRIF annuitants who died since 2008 which would effectively allow an “eligible individual” to elect to contribute up to the amount of a deceased annuitant’s RRSP or RRIF proceeds to the RDSP of a disabled child or grandchild of the deceased who was financially dependent on the deceased annuitant (subject, as discussed above) to available RDSP contribution room.

An “eligible individual” is either a direct beneficiary of the deceased’s RRSP or RRIF or someone who received RRSP or RRIF proceeds through the deceased annuitant’s estate. Provided the contribution is made before 2012, an offsetting deduction will be available either on the deceased annuitant's terminal tax return for the year of death or on that of the eligible individual making the contribution, as appropriate.

Note that no contributions from the rollover can be made prior to July 2011. This is to give RDSP providers the time to implement the necessary system changes.

Carry Forward of CDSGs and CDSBs

Under the RDSP rules, annual contributions can attract CDSGs of up to $3,500, depending on the beneficiary's family income and the amount contributed, up to a lifetime maximum of $70,000. For 2010, the CDSGs are equal to 300% on the first $500 of annual contributions and up to 200% on the next $1,000. When family income is over $81,941, the CDSG is equal to 100% on the first $1,000 of annual contributions.

As well, CDSBs of up to $1,000 annually can also be paid into RDSPs for lower income families, based on the disabled beneficiary's family income, up to a lifetime maximum of $20,000. For 2010, CDSBs begin to phase out for incomes above $23,855 and are fully phased-out at $40,970.

Until the 2010 Budget, Beneficiaries were unable to carry forward unused CDSG and CDSB entitlements to future years. The Federal Budget introduces a new 10-year carry forward of CDSG and CDSB entitlements.

When an RDSP is established, CDSGs will be paid on unused entitlements for the preceding 10 years, but no earlier than 2008, the year the RDSP first became available, up to an annual maximum of $10,500. CDSB entitlements will also be determined and paid into the plan for each prior year. Both CDSGs and CDSBs will be based on the beneficiary's family income in those particular years.

Cosmetic Surgery

Under the Income Tax Act, individuals are permitted to claim a federal 15% Medical Expense Tax Credit (METC) for medical and disability-related expenses above the lesser of $2,024 and three per cent of net income.

Generally, a medical expense qualifies for the METC if is directly related to a disability or a medical condition. According to the government, "an expense is not generally intended to be eligible if it is ordinarily incurred by persons without a disability or a medical condition or has a substantial element of personal consumption and choice."

To this end, effective March 5, 2010, any expenses incurred for purely cosmetic procedures, including related travel expenses, will be not be eligible for the METC. This would include both surgical and non-surgical procedures aimed purely to enhance one's appearance. These would include liposuction, hair replacement procedures, Botox injections, and teeth whitening.

However, cosmetic procedures required for medical or reconstructive purposes, such as surgery performed in conjunction with a personal injury or disfiguring disease will still qualify.

Prior to this announcement, it was the CRA's longstanding administrative position that any amount paid to a medical practitioner for surgery of any kind, whether cosmetic or elective, would qualify for the METC since it was "presumed that such surgery is beneficial to the patient's health."

Corporate Taxpayers – Interest on Overpaid Taxes

Responding to criticism in the most recent Auditor General's report about corporations receiving interest on overpaid taxes at higher than market rates, Federal Budget 2010 has changed the rules for how interest is calculated on overpaid taxes by corporations.

Under the existing rule, the government pays interest on overpaid taxes at the prescribed rate plus two per cent. The prescribed rate is equal to the average yield of three-month Government of Canada Treasury Bills sold in the first month of the preceding quarter, rounded up to the nearest percentage.

The budget proposes that effective for the third quarter of 2010, the interest rate payable by the CRA on overpaid taxes to corporations will simply be the prescribed rate, currently set at 1%. This new rate for corporations will apply to income taxes, GST/HST, EI premiums, CPP contributions among other amounts.

This new lower rate, however, will **not** apply to individuals.

As with all planning strategies, you should seek the advice of a qualified financial or tax advisor to discuss how the changes in the federal budget could impact your financial plans.

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