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2012 FEDERAL BUDGET ANALYSIS

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PERSONAL INCOME TAX MEASURES

Old Age Security and Guaranteed Income Supplement

The age of eligibility for OAS and GIS will be gradually increased from 65 to 67, starting in April 2023, with full implementation by January 2029. An 11-year notification period, followed by a 6-year phase-in period, is being provided to ensure that individuals have significant advance notification to plan their retirement and make adjustments.

This proposed legislative change to the age of OAS/GIS eligibility will not affect anyone who is 54 years of age or older as of March 31, 2012. Thus, individuals who were born on March 31, 1958 or earlier will not be affected. Those who were born on or after February 1, 1962 will have an age of eligibility of 67. Those who were born between April 1, 1958 and January 31, 1962 will have an age of eligibility between 65 and 67.

Medical Expense Tax Credit

The list of expenses eligible for the Medical Expense Tax Credit is regularly reviewed and updated in light of new technologies and other disability-specific or medically-related developments. Blood coagulation monitors for use by individuals who require anti-coagulation therapy, including associated disposable peripherals such as pricking devices, lancets and test strips will be eligible for the Medical Expense Tax Credit.

This measure will apply to expenses incurred after 2011.

Registered Disability Savings Plans

To ensure the ongoing effectiveness of Registered Disability Savings Plans (RDSPs), and in response to stakeholder comments received during the recent review of the RDSP, Budget 2012 proposes a number of changes to the rules governing these plans.

For further information concerning changes to RDSPs, please contact us.

Rollover of RESP Investment Income

To provide greater flexibility for parents who save in a Registered Education Savings Plan (RESP) for a child with a severe disability, Budget 2012 proposes to allow investment income earned in an RESP to be transferred on a tax-free (or "rollover") basis to an RDSP if the plans share a common beneficiary.

Mineral Exploration Tax Credit For Flow Through Share Investors

Budget 2012 proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2013. Under the existing "look-back" rule, funds raised in one calendar year with the benefit of the credit can be spent on eligible exploration up to the end of the following calendar year. Therefore, for example, funds raised with the credit during the first three months of 2013 can support eligible exploration until the end of 2014.

Eligible Dividends – Split-Dividend Designation and Late Designation

Corporate income is generally subject to two levels of tax – the corporate level and personal shareholder level when corporate profits are distributed as taxable dividends. In order to relieve against double taxation, the *Income Tax Act* integrates the corporate and personal income tax systems by crediting individuals through the Dividend Tax Credit (DTC) with their proportionate share of income tax assumed to have been payable at the corporate level on taxable dividends they receive.

Budget 2012 proposes to simplify the manner in which a corporation resident in Canada pays and designates eligible dividends by allowing the corporation to designate, at the time it pays a taxable dividend, any portion of the dividend to be an eligible dividend.

Budget 2012 also proposes to allow the Minister of National Revenue to accept a corporation's late designation of a taxable dividend to be an eligible dividend. Under the proposal, the Minister will be allowed to accept a late designation of an eligible dividend if the corporation makes the late designation within the three-year period following the day on which the designation was first required to be made.

Group Sickness or Accident Insurance Plans

To provide for more neutral and fair tax treatment of beneficiaries under a group sickness or accident insurance plan, Budget 2012 proposes to include the amount of an employer's contributions to a group sickness or accident insurance plan in an employee's income for the year in which the contributions are made to the extent that the contributions are not in respect of a wage-loss replacement benefit payable on a periodic basis.

This measure will apply in respect of employer contributions made on or after Budget Day to the extent that the contributions relate to coverage after 2012, except that such contributions made on or after Budget Day and before 2013 will be included in the employee's income for 2013.

Retirement Compensation Arrangements

Under the *Income Tax Act*, a retirement compensation arrangement (RCA) is a type of employer-sponsored, funded retirement savings arrangement. RCAs are normally used to fund the portion of a higher-income employee's pension benefit that exceeds the maximum pension benefit permitted under the Registered Pension Plan (RPP) contribution limits. The RCA rules were introduced in the 1980s to ensure consistent tax treatment across all employers for pension arrangements above the RPP limits.

Budget 2012 proposes new prohibited investment and advantage rules to directly prevent RCAs from engaging in non-arm's length transactions. These rules will be based very closely on existing rules for Tax-Free Savings Accounts and Registered Retirement Savings Plans (RRSPs). As well, Budget 2012 proposes a new restriction on RCA tax refunds in circumstances where RCA property has lost value.

Employees Profit Sharing Plans

To ensure that EPSPs are used for their intended purposes, Budget 2012 proposes a targeted measure to discourage excessive employer contributions. This proposal introduces a special tax payable by a specified employee on an "excess EPSP amount". In general terms, an "excess EPSP amount" will be the portion of an employer's EPSP contribution, allocated by the trustee to a specified employee that exceeds 20 per cent of the specified employee's salary received in the year by the specified employee from the employer.

Life Insurance Policy Exemption Test

The exemption test that determines whether a life insurance policy is an exempt policy was implemented in the early 1980s and is intended to differentiate protection-oriented life insurance policies from investment-oriented life insurance policies. A life insurance policy is an exempt policy when the savings accumulating in the policy does not exceed the savings in a benchmark policy. The benchmark policy is generally defined as a policy where the death benefit is payable on the earlier of death and the age of 85 years (the endowment time) and premiums are payable 20 years after the issuance of the policy (the pay period). Depending on the type of coverage, the savings in the benchmark policy are calculated using prescribed mortality and interest rates, the rates used in determining the premiums, or the cash surrender value of the actual policy. The savings in an actual policy are measured using an amount that is equal to the greater of the cash surrender value of the policy and the modified net premium reserve in respect of the policy.

As the exemption test was implemented almost 30 years ago, the Government has reviewed the test to ensure that it continues to serve the intended purpose. The review indicates that technical improvements are required to update and simplify the test. Budget 2012 proposes to implement changes to the exemption test.

Amendments to the tax provisions arising from consultations with key stakeholders will apply to life insurance policies issued after 2013.

BUSINESS INCOME TAX MEASURES

Extending the Hiring Credit for Small Business

Small businesses are the engine of job creation in Canada, and are indispensable in their role as job creators. In recognition of the challenges faced by small businesses across the country, Budget 2011 announced a temporary Hiring Credit for Small Business of up to $1,000 per employer. This credit provided needed relief to small businesses by helping defray the costs of hiring new workers and allowing them to take advantage of emerging economic opportunities.

Economic Action Plan 2012 proposes to extend the temporary Hiring Credit for Small Business for one year. A credit of up to $1,000 against a small employer's increase in its 2012 EI premiums over those paid in 2011 would be provided. This temporary credit would be available to approximately 536,000 employers, whose total EI premiums were at or below $10,000 in 2011, reducing small business 2012 payroll costs by about $205 million.

Clean Energy Generation Equipment: Accelerated Capital Cost Allowance

Under the capital cost allowance (CCA) regime in the income tax system, Class 43.2 of Schedule II to the *Income Tax Regulations* provides an accelerated CCA rate (50 per cent per year on a declining balance basis) for investment in specified clean energy generation and conservation equipment.

Budget 2012 proposes to further expand Class 43.2 with respect to waste-fuelled thermal energy equipment, and equipment of a district energy system that uses thermal energy provided primarily by eligible waste-fuelled thermal energy equipment. Budget 2012 also proposes to expand Class 43.2 to include equipment that uses the residue of plants – generally produced by the agricultural sector – to generate electricity and heat

Scientific Research and Experimental Development Program

Budget 2012 proposes several changes to the SR&ED tax incentive program to make it simpler, and more cost effective and predictable.

SR&ED Investment Tax Credit Rate

Budget 2012 proposes to reduce the general 20-per-cent SR&ED investment tax credit rate applicable to SR&ED qualified expenditure pool balances at the end of a taxation year to 15 per cent. The 15-per-cent investment tax credit rate will apply in respect of taxation years that end after 2013, except that, for a taxation year that includes January 1, 2014, the 5-percentage-point reduction in the investment tax credit rate will be pro-rated based on the number of days in the taxation year that are after 2013. The enhanced 35-per-cent SR&ED investment tax credit rate applicable in respect of eligible CCPCs will remain unchanged on up to $3 million of qualified SR&ED expenditures annually.

SR&ED Capital Expenditures

Allowable current and capital expenditures in respect of SR&ED are fully deductible, and qualifying SR&ED expenditures are eligible for an investment tax credit. Budget 2012 proposes to exclude expenditures of a capital nature (including payments in respect of the use or the right to use property that would, if it were acquired by the taxpayer, be capital property of the taxpayer) from eligibility for SR&ED deductions and investment tax credits. This measure will apply to property acquired on or after January 1, 2014, and to amounts paid or payable in respect of the use of, or the right to use, property during any period that is after 2013.

This measure will also apply to exclude otherwise eligible contract payments made by a taxpayer from benefiting from SR&ED tax incentives to the extent that the payment is in respect of a capital expenditure made in fulfillment of the contract.

SR&ED Overhead Expenditures

Budget 2012 proposes to reduce the rate at which the prescribed proxy amount is calculated to 60 per cent (from 65 per cent) for 2013 and to 55 per cent after 2013. The proxy rate that will apply for taxation years that include days in 2012, 2013 or 2014 will be pro-rated based on the number of days in the taxation year that are in each of those calendar years.

SR&ED Contract Payments

Where a taxpayer (the payer) contracts to have SR&ED performed by a non-arm's length person (the performer), the total qualified expenditures on which either the performer or the payer can claim SR&ED investment tax credits are currently restricted to the amount of the qualified SR&ED expenditures incurred by the performer in fulfillment of the contract. These rules ensure that investment tax credits are not earned on the profit element of non-arm's length SR&ED contracts.

In the case of arm's length SR&ED contract payments, however, the payer is currently entitled to SR&ED investment tax credits in respect of the entire amount of the contract payment, while the amount of the contract payment is netted against the qualifying SR&ED expenditures of the performer.

Budget 2012 proposes to disallow from the expenditure base for investment tax credits the profit element of arm's length SR&ED contracts. For simplicity, it is proposed that this be achieved by way of a proxy, under which only 80 per cent of the cost to a payer of arm's length SR&ED contracts will be eligible for SR&ED investment tax credits.

This measure will apply to expenditures incurred on or after January 1, 2013.

Tax Avoidance Through the Use of Partnerships

Section 88 of the *Income Tax Act* contains rules that enable a taxable Canadian corporation (the Parent) that has acquired control of another taxable Canadian corporation (the Subsidiary) to increase the cost of certain capital assets acquired by the Parent on a vertical amalgamation with, or winding-up of, the Subsidiary (the section 88 bump).

Capital assets, such as land, shares of a corporation or an interest in a partnership, may be eligible for the section 88 bump. Assets producing income (as distinguished from producing only capital gains) are not eligible for the section 88 bump. These income assets include eligible capital property, depreciable property, inventory and resource property.

In recent years, corporate partnership structures have been used with increasing frequency to attempt to circumvent the denial of the section 88 bump in respect of a Subsidiary's income assets. Instead of the Subsidiary holding income assets directly, the income assets are held indirectly through a partnership. Upon the acquisition of control of the Subsidiary, the Parent amalgamates with, or winds up, the Subsidiary and then claims an increase (or "bump") to the cost of the partnership interest, even in circumstances where all of the fair market value of the partnership interest is derived from income assets.

A second concern arises in respect of section 100 of the *Income Tax Act*, which is meant to ensure that income assets held by a partnership are fully taxable on the sale of the partnership by a taxpayer to a tax-exempt person (since the tax-exempt person could wind up the partnership without paying any income tax). This rule does not currently apply to a sale of a partnership to a non-resident even though the income from a disposition of an income asset owned by the partnership may be exempt from Canadian income tax under either domestic law or one of Canada's tax treaties. As well, some taxpayers have sought to take advantage of the fact that section 100 does not expressly refer to indirect sales of partnership interests to a tax-exempt person.

Budget 2012 proposes two measures to ensure that partnerships cannot be used to circumvent the intended application of sections 88 and 100. The first measure will generally deny a section 88 bump in respect of a partnership interest to the extent that the accrued gain in respect of the partnership interest is reasonably attributable to the amount by which the fair market value of income assets exceed their cost amount. This measure will apply where the income assets are held directly by the partnership or indirectly through another partnership. This measure will apply to amalgamations that occur, and windings-up that begin, on or after Budget Day.

Budget 2012 also proposes to extend the application of section 100 of the *Income Tax Act* to the sale of a partnership interest to a non-resident person, unless the partnership is carrying on business in Canada through a permanent establishment in which all of the assets of the partnership are used.

Partnership Waivers

The *Income Tax Act* provides that the Canada Revenue Agency (CRA) may, for a fiscal period of a partnership, make a determination (which includes a redetermination) under section 152(1.4) of the *Income Tax Act* of any income, loss, deduction or other amount in respect of the partnership. Where the CRA obtains a waiver from each partner, however, the time period for making a determination is extended. If one or more of the partners does not provide a waiver, and, as a result, the period cannot be extended, a determination will need to be made by the CRA using only the information that is available to it at that time.

Under current rules, the members of a partnership may designate a partner who is authorized to file an objection on behalf of all its partners, to a determination under the *Income Tax Act*. Budget 2012 proposes that a single designated partner of a partnership may also be empowered to waive, on behalf of all its partners, the three-year time limit for making a determination.

This measure will apply on Royal Assent to the enacting legislation.

INTERNATIONAL TAXATION MEASURES

Transfer Pricing

Where the terms or conditions of a transaction with a non-resident do not reflect arm's length terms and conditions, the Canada Revenue Agency (CRA) may adjust for tax purposes amounts related to the transaction to reflect arm's length terms and conditions. Such adjustments to transfer prices generally result in an increase to taxable income and to taxation under different sections under the Income Tax Act, referred to as "secondary adjustments".

A number of provisions in the *Income Tax Act* can apply to treat a benefit conferred on a non-resident as a dividend subject to withholding tax under Part XIII of the Act and it is the policy of the CRA to assess these secondary adjustments. There is, however, no specific provision in the transfer pricing rules regarding secondary adjustments.

Budget 2012 proposes to amend section 247 of the *Income Tax Act* to confirm that secondary adjustments will be treated as dividends for Part XIII tax purposes.

Budget 2012 also proposes, consistent with CRA administrative practice, to clarify that a non-resident is allowed to repatriate to a Canadian corporation that has been subject to a primary adjustment an amount equal to the portion of the primary adjustment that relates to the non-resident.

These measures will apply to transactions that occur on or after Budget Day.

Thin Capitalization Rules

Budget 2012 proposes to improve the integrity and fairness of the thin capitalization rules by:

- reducing the debt-to-equity ratio from 2-to-1 to 1.5-to-1;
- extending the scope of the thin capitalization rules to debts of partnerships of which a Canadian-resident corporation is a member;
- treating disallowed interest expense under the thin capitalization rules as dividends for Part XIII withholding tax purposes; and
- preventing double taxation in certain circumstances where a Canadian-resident corporation borrows money from its controlled foreign affiliate.

Overseas Employment Tax Credit

Generally, the Overseas Employment Tax Credit is available where:

- the employee is employed outside Canada for a period of more than six consecutive months by a person resident in Canada (or a foreign affiliate of such a person); and
- the employee's foreign employment income is derived from employment in connection with the exploration for or exploitation of certain natural resources, activities performed under a contract with the United Nations, or construction, installation, engineering or agricultural activities.

Budget 2012 proposes to phase out the OETC over four taxation years, beginning with the 2013 taxation year. During the phase-out period, the factor (currently 80 per cent) applied to an employee's qualifying foreign employment income in determining the employee's OETC will be reduced to 60 per cent for the 2013 taxation year, 40 per cent for the 2014 taxation year and 20 per cent for the 2015 taxation year. The OETC will be eliminated for the 2016 and subsequent taxation years.

SALES AND EXCISE TAX MEASURES

Pharmacists' Services

To ensure that no tax applies to prescription drugs, pharmacists' drug dispensing services and prescription drugs have both been zero-rated since the inception of the GST.

Budget 2012 proposes to exempt from the GST/HST services rendered by pharmacists within a pharmacist-patient relationship for the promotion of the patient's health or for the prevention or treatment of a disease, disorder or dysfunction of the patient. The proposal will result in an exemption for the non-dispensing health care services that pharmacists are authorized to provide in the course of their professional practice. Pharmacists' services of dispensing prescription drugs will continue to be zero-rated.

Under the current rules, a prescribed list of diagnostic health care services, such as blood tests, are exempt when ordered by certain health care professionals, such as physicians or registered nurses. Budget 2012 proposes to expand the exemption for these diagnostic services to include those ordered by pharmacists when the pharmacists are authorized to issue such orders under the laws of a province.

These measures will apply to supplies made after Budget Day.

Corrective Eyewear

Budget 2012 proposes to zero-rate corrective eyeglasses or contact lenses supplied under the authority of an assessment record produced by a person who is entitled under the laws of the province in which the person practices to produce the record authorizing dispensing of corrective eyewear.

This measure will apply to supplies made after Budget Day and to supplies made on or before that day if GST/HST was not charged, collected or remitted in respect of the supply.

Medical and Assistive Devices

The following medical and assistive devices will be added to the zero-rated medical device list after Budget day:

- Blood coagulation monitoring devices
- Medical and assistive devices supplied on written order

Doubling GST/HST Streamlined Accounting Thresholds

To further simplify GST/HST compliance for small businesses and PSBs, and in support of the objectives of the *Red Tape Reduction Commission's* report presented to the Government on January 18, 2012, Budget 2012 proposes to double the existing streamlined accounting thresholds. Specifically:

- the annual taxable sales threshold at or below which eligible businesses can elect to use the Quick Method will increase to $400,000 (from $200,000) of GST/HST-included taxable sales; and

- the annual taxable sales and taxable purchases thresholds at or below which eligible businesses or PSBs can elect to use the Streamlined Input Tax Credit Method and eligible PSBs can elect to use the Prescribed Method for Calculating Rebates will increase:

    - to $1,000,000 (from $500,000) of taxable sales, and
    - to $4,000,000 (from $2,000,000) of taxable purchases.

This measure will be effective in respect of a GST/HST reporting period of a person (or a claim period of a person, in the case of the Prescribed Method for Calculating Rebates) beginning after 2012.

OTHER MEASURES

Gifts to Foreign Charitable Organizations

Budget 2012 proposes to modify the rules for registering certain foreign charitable organizations as qualified donees. Foreign charitable organizations that receive a gift from the Government may apply for qualified donee status if they pursue activities:

- related to disaster relief or urgent humanitarian aid; or
- in the national interest of Canada.

Tax Shelter Administrative Changes

Budget 2012 proposes to encourage tax shelter registration and reporting by:

- modifying the calculation of the penalty applicable to a promoter when a person participates in an unregistered charitable donation tax shelter;
- introducing a new penalty for a promoter who fails to meet their reporting obligations with respect to annual information returns; and
- limiting the period for which a tax shelter identification number is valid to one calendar year.

Travellers' Exemptions

Budget 2012 proposes to increase the travellers' exemption to $200 from $50 for returning Canadian residents who are out of the country for 24 hours or more. Budget 2012 similarly proposes to increase exemption levels for travellers who are out of the country for 48 hours or more to $800. This new threshold will replace the current 48-hour exemption of $400 and the current 7-day exemption of $750.

There will continue to be no duty or tax exemptions for absences of less than 24 hours. Volume and quantity limits on alcohol and tobacco products also remain unchanged.

The new exemption levels, to be given effect by amendments to the *Customs Tariff*, will be effective in respect of travellers returning to Canada on or after June 1, 2012.