Canadian tax alert

2012-2013 federal budget highlights

March 29, 2012

The Minister of Finance, James M. Flaherty, presented his 2012-2013 Budget in the House of Commons this afternoon. He announced a projected deficit for the 2011-2012 fiscal year of $24.9 billion. The federal debt-to-GDP ratio is projected to be just under 34%. This ratio is projected to grow slightly in 2012-2013 and then decline to 28.5% by 2016-2017. Budgetary surpluses are predicted starting in 2015-2016. The projected total government net debt- to-GDP ratio of 33.3% in 2016 is about one-third of the G7 average and significantly less than the projected debt-to-GDP ratio of any of the other G7 countries. The deficit is projected to fall to $21.1 billion in 2012-2013 and continue to decline each year until 2015-2016, when a surplus is projected.

The budget reflects the fragile global economic recovery and anticipates modest economic growth in Canada in the near-term.

The Future of Tax

- Deloitte is Canada's largest tax practice and a global tax firm with a unique perspective on competitive tax policy and the key drivers of national prosperity.
- With the right tax policy, we believe that Canada can be more productive and globally competitive. The key lies in creating a tax ecosystem capable of fostering innovation and investment while supporting the objective of a balanced budget.
- **www.thefutureoftax.ca**
- **The Future of Productivity**

The Finance Minister predicts real growth in the economy of 2.1% in calendar year 2012 and 2.4% in 2013. Average annual growth over the next five years is projected to be just 2.4%. Growth in the U.S. economy is expected to be slightly stronger over the same term, with the average annual growth in real GDP over the next five years projected at 2.6%.

Unemployment is expected to continue to decline over the next five years from 7.5% in 2012 to 6.6% in 2016. Inflation is projected to remain around 2% over the next five years with 2012 projected to be at 2.1%. Similarly, the value of the Canadian dollar is projected to be just above par compared to the US dollar for the next five years. Short-term and long-term interest rates are projected to slowly increase over the next five years with the biggest increases being in 2014 and 2015.

Government program expenses will continue to grow slightly, although direct program expenses will decline over the next four years and then increase in 2015-2016 when the operating expense freeze ends. The budget announces the expected elimination of 12,000 government positions over a three year period and a reduction in federal employment of 19,200 over the same period.

There are no changes to tax rates in the budget, nor are there any changes to previously promised tax rate reductions. We continue to believe that the highest personal tax rate is too high and the level at which that rate becomes effective is too low and hurts Canada's global competitiveness for top talent. The government will extend the Employment Insurance hiring credit for small businesses and has announced measures to improve the immigration system.

As expected, changes are proposed for the Scientific Research and Experimental Development (SR&ED) tax credit system. Many companies performing research and development who are not entitled to refundability of the tax credits were hoping that the program would be expanded to give some relief in this area. Instead, the non-refundable credit is being reduced, the proxy percentage is being reduced and capital expenditures will no longer be eligible for SR&ED treatment. These changes will, in our view, do further harm to Canadian productivity growth. The budget proposes to provide $400 million to help increase private sector investment in early stage risk capital although the form of this support has not been determined. We had encouraged the creation of an angel investment tax credit but this was not proposed in the budget.

Measures concerning businesses

- The budget proposes to reduce the 20% SR&ED investment tax credit rate to 15% for taxation years ending after 2013 with the rate being prorated for year-ends that straddle January 1, 2014. The enhanced 35% credit for eligible Canadian controlled private corporations remains unchanged.
- The budget proposes to exclude capital expenditures (including the right to use property that if acquired would be capital property) from SR&ED deductions and investment tax credits for property acquired after 2013. Capital expenditures acquired after this time for the purposes of SR&ED will be accorded the treatment otherwise applicable to such expenditures.
- The prescribed proxy amount for SR&ED purposes is proposed to be reduced from 65% to 60% for 2013 and to 55% for years after 2013.
- The budget proposes to limit the qualifying expenditures to arm's length contractors for SR&ED purposes to 80% of the contract payment for expenditures incurred after December 31, 2012
- The budget proposes to exclude from the payer's SR&ED qualifying expenditures, any amount that an arm's length contractor has paid in respect of a capital expenditure made to fulfill the contract for expenditures incurred after December 31, 2013.
- The budget proposes to introduce a pilot program to determine the feasibility of a formal pre-approval process for the SR&ED program.
- The debt-to-equity ratio for the thin capitalization rules which limit interest deductibility is proposed to be reduced from 2-to-1 to 1.5-to-1 for taxation years beginning after 2012
- The budget proposes to extend the thin capitalization rules to debts owed by partnerships where a Canadian resident corporation is a member for taxation years beginning on or after March 29, 2012
- Interest that is disallowed under the thin-capitalization rules is proposed to be re-characterized as a dividend subject to withholding taxes for taxation years ending on or after March 29, 2012
- The budget proposes to exclude interest expense of a Canadian resident corporation for the purpose of the thin capitalization rules where that interest is taxable as Foreign Accrual Property Income of a controlled foreign affiliate of the corporation for taxation years ending on or after March 29, 2012.
- The budget proposes to include waste-fuelled thermal energy equipment, equipment of a district energy system, and equipment that uses the residue of plants in Class 43.2 which is eligible for accelerated capital cost allowance for assets acquired on or after March 29, 2012.
- The budget proposes to phase out the corporate tax credit for pre-production mining expenditures. For exploration expenditures, the credit will be 10% for expenditures incurred in 2012, 5% for 2013 and will be completely eliminated by 2014. For pre-production development expenses, the credit will be 10% for expenditures incurred before 2014, 7% in 2014, 4% in 2015, and will be eliminated by 2016. In certain cases, pre-production development expenses incurred before 2016 will be eligible for the 10% credit.

- The budget proposes to phase out the 10% Atlantic Investment Tax Credit for oil and gas and mining activities. For assets acquired for use in oil and gas or mining activities, the credit will be 10% before 2014, 5% for 2014 and 2015, and will be eliminated after 2015. In certain cases, the 10% credit will be available for assets acquired before 2017.

- The budget proposes to extend the Atlantic Investment Tax Credit to certain electricity generation equipment and clean energy generation equipment used primarily in an eligible activity for assets acquired on or after March 29, 2012.
- For amalgamations or wind-ups that begin on or after March 29, 2012, a step up in the tax basis of a partnership interest where 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 will not be allowed.
- The budget proposes to make fully taxable the gain on income assets held by a partnership upon the sale of the 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 are used. This measure will apply to dispositions that occur on or after March 29, 2012.
- The budget proposes to allow a single designated partner of a partnership to waive the three year time limit for making a determination of any income, loss or deduction in respect of the partnership. This measure will apply on Royal Assent.
- The budget proposes to clarify, for transactions on or after March 29, 2012, that any transfer pricing adjustments that are considered secondary adjustments will be treated as a deemed dividend and subject to withholding taxes. The budget also clarifies where a Canadian corporation has been assessed a transfer pricing adjustment, a non-resident is entitled to repatriate an amount to avoid the application of the deemed dividend with the concurrence of the Minister.
- A measure is proposed to be introduced that will deem a dividend to have been paid by a Canadian subsidiary to its foreign parent to the extent of any non-share consideration given by the Canadian subsidiary for the acquisition of the shares of a foreign affiliate. The deemed dividend would be subject to withholding tax. The measure also proposes to disregard the paid up capital of any shares that are given as consideration, and is only applicable when the transaction does not meet a "business purpose" test. The proposed measure will apply to transactions on or after March 29, 2012.
- It is proposed that amendments will be made to the "base erosion" rules for banks in the Income Tax Act's foreign accrual property income regime after consultation with industry representatives.

Measures concerning individuals

- The age of eligibility for old age security (OAS) and the guaranteed income supplement (GIS) will be gradually increased from 65 to 67, starting in April 2023, with full implementation by January 2029. This proposed change will not affect anyone who is 54 years of age or older as of March 31, 2012. As well, starting on July 1, 2013, a taxpayer will be able to voluntarily defer receipt of the OAS, for up to five years, and receive a higher, actuarially adjusted, annual pension.
- The budget proposes to simplify the administration of the eligible Dividend Tax Credit (DTC) regime by allowing a corporation to designate, at the time it pays a taxable dividend, any portion thereof to be an eligible dividend qualifying for the enhanced DTC, with the remaining portion qualifying for the regular DTC. As well, the budget proposes to allow the Minister of National Revenue to accept a corporation's 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. As well, the Minister must be of the view that accepting the late designation would be just and equitable in the circumstances. These measures will apply to taxable dividends paid on or after March 29, 2012.
- The budget 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.
- The budget introduces new prohibited investment and advantage rules to prevent retirement compensation arrangements (RCAs) from engaging in non-arm's length transactions. These rules will be similar to the rules that were introduced for tax-free savings accounts and registered retirement savings plans and will generally be applicable as of March 29, 2012.

- Employee profit sharing plan (EPSP) rules are proposed to be amended to provide for a new special tax payable by a specified employee (generally defined to include an employee who does not deal at arm's length with the employer or who has at least a 10% interest in the employer) on an excess EPSP amount. The tax will be equivalent to the top marginal rate (federal and provincial for all provinces other than Quebec; federal only for residents of Quebec). The excess EPSP amount subject to the tax will be the portion of an employer's EPSP contribution allocated to a specified employee that exceeds 20 per cent of the specified employee's salary. This proposal is designed to ensure that EPSPs are being used for the purposes intended by the government by discouraging excess employer contributions and will apply in respect of EPSP contributions made by an employer on or after March 29, 2012 other than such payments made before 2013 pursuant to a legally binding written agreement entered into before March 29, 2012.
- Changes to the taxation of group sickness and accident insurance plans are proposed to provide for the income inclusion by employees of employer contributions to such plans 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 is not intended to affect the tax treatment of private health services plans or other plans described in paragraph 6(1)(a) of the Income Tax Act, and will apply in respect of employer contributions made on or after March 29, 2012 to the extent that the contributions relate to coverage after 2012, except that such contributions made on or after March 29, 2012 and before 2013 will be included in income for 2013.
- The budget proposes to expand the list of expenses eligible for the 15% medical expense tax credit, to include blood coagulation monitors for individuals who require anti-coagulation therapy, as well as associated pricking devices, lancets and test strips, when prescribed by a medical practitioner. This measure is applicable to expenses incurred after 2011.
- A number of measures are proposed concerning registered disability savings plans (RDSPs) arising from recent public consultations. Among others, the proposals include the following measures:
    - A temporary measure to permit a qualifying family member (a spouse, common-law partner or parent of the individual) to become an RDSP plan holder for an adult individual who may not be able to enter into a contract. This measure will apply from Royal Assent date until the end of 2016.
    - A proportional repayment rule with respect to Canada disability savings grants and Canada disability savings bonds in circumstances where repayment arises due to amounts being withdrawn from the RDSP. This measure will apply to RDSP withdrawals after 2013.
    - An increase in the maximum annual withdrawal amount in respect of primarily government-assisted plans (PGAPs), and to extend the minimum annual withdrawal requirement currently applicable to PGAPs when the beneficiary turns 60 years of age, to all RDSPs. This measure will apply after 2013.
    - A rollover of investment income earned in a registered education savings plan to an RDSP under certain circumstances, applicable after 2013.
    - Changes with respect to the rules applicable on the termination of an RDSP when a beneficiary becomes ineligible for the disability tax credit, providing for an election to extend the period during which an RDSP may remain open. This measure will apply to elections made after 2013.
- The budget proposes changes aimed at updating the test for determining whether a life insurance policy is an exempt policy and, as such, not subject to accrual taxation. As well, over the coming months, the government will engage in public consultations with respect to the necessary recalibration of the base for the investment income tax levied on life insurers. Amendments will apply to life insurance policies issued after 2013.
- The budget proposes to phase out the Overseas Employment Tax Credit over a four year period.

Sales and excise tax measures

- A number of goods and services tax/harmonized sales tax (GST/HST) measures in respect of health care services, drugs and medical devices are proposed, generally applicable to supplies made after March 29, 2012, including:
    - An exemption from GST/HST for non-dispensing health care services that a pharmacist is authorized to provide in the course of his/her professional practice. The dispensing of prescription drugs will continue to be zero-rated

- The expansion of the zero-rating of corrective eyewear in circumstances where the eyewear is supplied by an individual authorized under provincial law to conduct vision assessments and authorize the dispensing of corrective eyewear, such as an optician
  - The expansion of medical and assistive devices eligible for zero-rating and the extension of eligibility for zero-rating where otherwise qualifying devices are supplied on the written order of a registered nurse, occupational therapist or physiotherapist as part of their professional practice.
- The budget proposes to double the existing streamlined accounting thresholds available for small businesses and public service bodies electing to use the quick method or special quick method of accounting to determine the amount of GST/HST to remit. This measure will apply in respect of GST/HST reporting periods beginning after 2012.
- To ensure that changes recently announced by the Minister of Natural Resources regarding fuel consumption testing requirements do not affect the application of the Green Levy, the budget proposes that the Excise Tax Act be amended to ensure that the weighted average fuel consumption rating for the purposes of the Green Levy continues to be computed by reference to the current test method. This measure will apply on Royal Assent.
- Following a review of existing tax provisions, the budget proposes relieving changes to the tax treatment of rental vehicles temporarily imported by Canadian residents.

Other measures

- The budget proposes to modify the rules for registering certain foreign charitable organizations as qualified donees. This measure will apply as of the later of January 1, 2013 and Royal Assent.
- The budget proposes to provide additional enforcement tools to enhance compliance and increase disclosure by charities around political activities. It also provides the Canada Revenue Agency with the ability to suspend for one year the tax-receipting privileges of a charity that exceeds the limitation on political activities. These measures will apply as of Royal Assent.
- The budget proposes to impose more stringent penalties for not registering as a tax shelter or reporting tax shelter sales. These measures will apply as of Royal Assent.
- The budget proposes to eliminate the 5% Most Favoured Nation rate of duty on certain imported oils used as production inputs in gas and oil refining as well as electricity production. This measure will apply to goods imported on or after March 30, 2012.
  Travellers’ exemptions are proposed to be increased for returning Canadians who are out of the country for 24 hours or longer. These changes will apply to travellers returning to Canada as of June 1, 2012.

For further details, we refer you to the **Ministry of Finance website**.

Contacts

Canadian Managing Partner, Tax
Andrew W. Dunn
416-601-6227

St. John’s
Brian Brophy
709-758-5234

Quebec
Dominic Vendetti
450-978-3527

Denis de la Chevrotière
819-797-7419

Montreal
Judith Bellehumeur
514-393-6512

Ottawa
Jeff Black
613-751-5479

Toronto
Heather Evans
416-601-6472

National Tax Policy Leader
Albert Baker
416-643-8753

Southwestern Ontario
Len Lucier
905-315-6730

Prairie
Larry Bookman
306-343-4409

Calgary
Brian Pyra
403-503-1408

Rocky Mountain Region
John Bylhouwer
604-539-3624

Vancouver
Etienne Bruson
604-640-3175

30 Wellington Street West, P.O. Box 400
Stn Commerce Court
Toronto ON M5L 1B1 Canada