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Tax Alert — Canada

Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your Ernst & Young advisor.

Federal budget 2013-14: continued focus on jobs and long-term growth

"We will remain focused on what matters to Canadians — jobs and economic growth, and ensuring Canada's economic advantage today will translate into the long-term prosperity of tomorrow."

Federal Finance Minister Jim Flaherty
2013 federal budget speech

The minister plans to do this through the following steps:

- Improving integrity and closing tax loopholes
- Strengthening compliance
- Combating international tax evasion and aggressive tax avoidance
- Consulting with Canadians

Tax policy and economic outlook

Since taking office in 2006, the Conservative government's Economic Action Plans have focused on jobs, growth and long-term prosperity. Today's budget continues with that theme.

In his budget speech, federal Finance Minister Jim Flaherty states, "Today, we outline a course of action in keeping with all our work so far. It builds on a legacy of success. It is an intentional, consistent plan that we have implemented with firm commitment, from coast to coast to coast."

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Deficit and federal debt outlook

Since the November 2012 *Update of Economic and Fiscal Projections*, the projected budgetary balance has improved slightly, reflecting both the economic outlook and the timing of government cost control.

As set out in Table A, the latest government projections call for a return to a budget surplus by fiscal 2015-16. Measured in relation to the size of the economy, the federal debt, while growing in the short to medium term, is expected to decline to 28.1% of gross domestic product (GDP) by 2017-18.

Table A

Projections of federal surplus (deficit) and debt

	Surplus (deficit) outlook	Federal debt	
	$billion	$billion	% of GDP
2012-13	(25.9)	608.7	33.5
2013-14	(18.7)	627.4	33.8
2014-15	(6.6)	634.0	32.6
2015-16	0.8	633.2	31.1
2016-17	3.9	629.3	29.6
2017-18	5.1	624.2	28.1

Totals may not add due to rounding

As a result, Canada is expected to achieve its June 2010 G-20 commitment to halve deficits by 2013 and stabilize or reduce total government debt-to-GDP ratios by 2016.

Canada continues to maintain a fiscal advantage over other G-7 economies. By 2017-18, both program expenses as a share of GDP and the net debt-to-GDP ratio will fall to pre-recession levels. Canada is expected to maintain the lowest net debt burden among G-7 countries.

The International Monetary Fund projects that Canada's total government net debt-to-GDP ratio (which includes federal, provincial and territorial debt, as well as the Canada Pension Plan and Québec Pension Plan), will remain the lowest among the G-7 countries.

Table B

Projections of federal budgetary surplus (deficit)
$billions

	Budget 2012	Nov. 2012 Update	March 2013 Update	Budget 2013
	F2012-13	F2012-13	F2012-13	F2013-14
Revenue outlook				
Income taxes				
Personal	125.4	125.5	126.2	131.5
Corporate	32.4	33.1	33.0	34.6
Non-resident	5.5	5.3	5.2	5.4
Excise taxes				
GST	30.9	29.4	28.9	29.9
Customs	4.1	4.1	4.0	4.0
Other taxes/duties	10.9	10.8	11.2	10.9
EI premiums	20.1	20.1	20.1	21.9
Other revenues	25.7	26.0	25.5	25.6
	255.0	**254.4**	**254.2**	**263.9**
Program expenses outlook				
Major transfers to persons				
Elderly benefits	(40.4)	(40.4)	(40.1)	(42.0)
EI benefits	(18.7)	(18.2)	(17.5)	(18.3)
Children's benefits	(13.2)	(12.9)	(12.9)	(13.1)
Major transfers to other levels of gov't	(58.4)	(58.6)	(58.5)	(60.3)
Direct program expenses	(114.7)	(120.8)	(122.1)	(119.2)
	(245.3)	**(250.9)**	**(251.0)**	**(252.9)**
Public debt charges	(30.8)	(29.6)	(29.0)	(29.7)
Surplus (deficit) outlook	**(21.1)**	**(26.0)**	**(25.9)**	**(18.7)**

Totals may not add due to rounding.

Budgetary scorecard

As new economic data become available, the government continues to refine and update its forecasts for the return to a balanced budget. These forecasts provide insightful information on the growth in revenue, increases and decreases in transfer payments and program expenditures, and interest on the national debt.

In Table B above, we summarize the deficit projections of fiscal 2013 and fiscal 2014, including two updates to fiscal 2013 (the final fiscal 2013 accounts will be released in the fall 2013 Economic Update).

The deficit for fiscal 2013 is now projected to be $25.9 billion, down from the earlier estimate of $26.0 billion in November 2012, but up from the $21.1 billion in March 2012, primarily due to transfer payments to the provinces.

The deficit for fiscal 2014 is projected to be $18.7 billion, up from the $16.5-billion projection in November 2012 and the $10.2-billion projection in March 2012.

Budget 2013 measures

The government's projections of the impact of the measures introduced in today's budget are relatively modest (Table C). The measures are projected to increase the deficit in fiscal 2014 by $400 million, and to have modest decreases in the deficit in subsequent years.

To a large degree, this will be accomplished by improving tax fairness and closing tax loopholes, a reduction in departmental spending, strengthened Canada Revenue Agency (CRA) compliance programs and the introduction of select tariff changes.

Table C

Budget 2013 measures
$millions

	2013-14	2014-15	2015-16	2016-17	2017-18
Improving tax fairness and closing tax loopholes	300	800	900	1,100	1,200
CRA compliance programs	100	600	600	600	600
General preferential tariff	0	100	300	300	300
Reduction in departmental spending	100	100	100	100	100
Increase support jobs	(900)	(900)	(1,200)	(2,000)	(1,700)
Total budget measures	**(400)**	**600**	**800**	**100**	**500**

Totals may not add due to rounding

Notwithstanding the emphasis on closing "tax loopholes" and characterizing the measures introduced over the three previous budgets as having closed tax loopholes, by and large the majority of the monetary impact falls under the tax fairness or integrity banner. These include incentives in certain sectors, such as manufacturing, and the imposition of additional personal taxes on certain dividends from private corporations.

Following is a brief summary of the key tax measures.

Business income tax measures

Corporate tax rates

No changes are proposed to the corporate income tax rates or to the $500,000 small-business income limit of a Canadian-controlled private corporation (CCPC). The enacted Canadian federal corporate income tax rates are summarized in Table D.

Table D – Federal corporate income tax rates

	2012	2013
General corporate rate	15.0%	15.0%
Small-business rate	11.0%	11.0%

Loss trading transactions

Budget 2013 includes measures to tighten up the acquisition of control (AOC) measures related to corporations and to extend the AOC rules to trusts.

Corporations

Under existing rules, a corporation's tax attributes, referred to in the budget documents as its "loss pools," are subject to a number of constraints where *de jure* control of the corporation has been acquired by a person or group of persons.

The government notes that notwithstanding existing provisions in the *Income Tax Act* (the Act) which are intended to curtail inappropriate trading of loss pools, transactions intended to circumvent these rules continue to be undertaken. The example given to illustrate this is the transfer of property by a profitable corporation to a corporation with loss pools (the loss corporation) in exchange for shares of the loss corporation that result in the profitable corporation owning more than 75% of the value of the loss corporation but that do not give the profitable corporation voting control of the loss corporation. The income generated on the transferred property in the loss corporation is then distributed to the profitable corporation by way of dividends on the shares issued by the loss corporation to the profitable corporation.

The government has indicated that it perceives loss trading transactions as "aggressive tax avoidance" and it continues to challenge such transactions under existing rules in the Act. In order to ensure that the appropriate tax consequences apply, the budget introduces a new anti-avoidance rule deeming there to be an AOC where a person or group of persons acquires shares of a corporation that have more than 75% of the fair market value of all the shares of the corporation without otherwise acquiring control of the corporation if it is reasonable to conclude that one of the main reasons for not acquiring control is to avoid any of the restrictions that would have been imposed on the corporation's tax attributes.

Trusts

Currently, there are no AOC rules in respect of a trust where there is a significant change in the beneficiaries of the trust, including commercial type trusts that have issued transferable units of the trust.

The budget includes measures applicable to trusts which are similar to the corporate AOC rules where there is a "loss restriction event." A trust will be subject to a loss restriction event where a person or partnership (or group of persons or partnerships) becomes a majority-interest beneficiary of the trust (or a majority-interest group of beneficiaries). Modified affiliated person rules will apply for the purpose of applying the majority-interest tests. Certain exceptions will apply in respect of transactions involving changes in the beneficiaries of personal trusts and the existing rules deeming (or not deeming) there to be an AOC in the context of corporations will apply in determining if there is a loss restriction event.

The proposed changes to the AOC rules apply to transactions occurring on or after the budget date. Limited grandfathering is provided for transactions undertaken by persons who are obligated to complete a transaction pursuant to an agreement in writing entered into before budget day.

Taxation of corporate groups

The government indicated that its examination of the taxation of corporate groups is now complete and that moving to a formal system of group taxation is not a priority at this time. This process was first introduced as part of budget 2010.

Noting the concerns raised by the provinces, a lack of consensus on how to proceed and the potential upfront costs, the current system will be maintained, subject to ongoing work with the provinces to deal with their concerns with the current approach to loss utilization within corporate groups.

Synthetic dispositions

The budget includes a proposal related to so-called "synthetic disposition transactions." The government indicated that depending on the specific facts, this type of transaction can be challenged under existing rules, but nevertheless legislative measures are being introduced to ensure that the appropriate tax consequences apply to these transactions.

These measures are intended to ensure that where a taxpayer enters into a financial arrangement with respect to a property that eliminates all or substantially all of the taxpayer's risk for loss or opportunity for gain, the taxpayer will be deemed to dispose of the property at the time of entering into the arrangement, regardless of the form of the arrangement. With certain exceptions, the synthetic disposition rules will include any arrangement entered into through one or more agreements directly by the taxpayer (or by a person who does not deal at arm's length with the taxpayer) with respect to a taxpayer's property.

Where a taxpayer has a synthetic disposition with respect to the property, the taxpayer will be deemed to have disposed of and to have reacquired the property except for purposes of meeting certain stop loss rules and foreign tax credit limitation rules in certain circumstances. For example, a financial institution that acquires a foreign stock over a dividend payment date must hold the stock for longer than one year in order to claim a foreign tax credit in respect of foreign withholding taxes imposed on the dividend. Hence, where an arrangement is entered into to legally hold the stock for this period but the holder has entered into a synthetic disposition transaction, the credit will not be available.

These measures will generally apply to agreements and arrangements entered into after the budget date.

Character conversion transactions

Budget 2013 also targets certain financial arrangements that are designed to "convert" income-like economic returns into capital gains, through the use of derivative contracts. These arrangements typically involve the use of a forward purchase or sale agreement that is priced by reference to the performance of a portfolio of investments that generally produce fully taxable ordinary income. Under the new measures, such derivative forward agreements that have a duration of more than 180 days will effectively be bifurcated into an income component and a capital component. For example, with a forward sale agreement, the derivative return will be treated as income that is distinct from any gain from the disposition of the subject capital property, the gain portion thus being limited to the value of the subject property at the time the agreement is entered into (and perhaps any portion of the return that is based on the performance of the subject capital property).

Support for business R&D

Budget 2013 includes measures to support advanced research, particularly for genomics research. It continues to respond to recommendations contained in the Expert Panel Report on Research and Development, *Innovation Canada: A Call to Action* (also known as the Jenkins Report), which was released on 17 October 2011, with relatively modest measures to support business innovation.

Today the minister also announced new initiatives to promote the broader venture capital system and entrepreneurship culture.

From a legislative perspective, the consultations on scientific research and experimental development (SR&ED) contingency fees, announced in the 2012 budget, indicated that intervention to regulate contingency fees directly is not required. However, the budget responds to recommendations to take action to address aggressive positions being taken by some tax preparers and claimants.

New measures supported by modest new funding are also being announced to enhance the predictability of the SR&ED tax incentives program.

Measures to support advanced research

For the purpose of strengthening research partnerships between post-secondary institutions and industry, the government proposes to provide $37 million over the next two years to support research partnerships with industry through the granting councils.

It also proposes to provide $165 million in 2014–15 to support Genome Canada's multi-year strategic plan.

Fostering business innovation

As stated above, the 2013 budget continues to respond to recommendations contained in the Jenkins Report by proposing the following measures on business innovation:

- $121 million over two years to invest in the National Research Council's strategic focus to help the growth of innovative businesses in Canada.
- $20 million over three years for a new pilot program to be delivered through NRC-IRAP to help SMEs access research and business development services at universities, colleges and other non-profit research institutions
- $325 million over eight years to Sustainable Development Technology Canada in support of new, clean technologies.

Venture capital and entrepreneurship

Measures include:

- $60 million over five years to help innovation hubs
- $100 million through the BDC for strategic partnerships with business accelerators and co-investments in graduate firms
- The creation of new Entrepreneurship Awards built on the BDC's Young Entrepreneur of the Year award,
- $18 million over two years to the Canadian Youth Business Foundation (conditional on the raising of $15 million in matching non-federal funding)

SR&ED legislative measures — disclosure of third-party service providers and billing arrangements

Budget 2013 introduces measures to provide the CRA with new tools to address the minority of SR&ED program tax preparers and taxpayers who participate in claims where the risk of non-compliance or lack of eligibility of the work claimed is perceived to be high.

The SR&ED prescribed claim forms will require more detailed information to be provided about SR&ED program tax preparers and billing arrangements. In particular, the Business Number of each third party having assisted with the claim preparation will be required, as well as whether contingency fees were used and the amount of the fees payable. If no third party was involved, the claimant will be required to certify that this is the case. This is intended to provide the CRA, over time, with information to help identify SR&ED program claims that carry a higher risk.

Budget 2013 proposes that a new penalty of $1,000 be imposed in respect of each SR&ED claim where the required disclosure information is missing, incomplete or inaccurate. In the case where a third-party SR&ED program tax preparer has been engaged, the SR&ED program claimant and tax preparer will be jointly and severally, or solidarily, liable for the penalty. This measure will apply to SR&ED program claims filed on or after the later of 1 January 2014 and the day of Royal Assent to the enacting legislation.

Other corporate tax measures

Accelerated capital cost allowance

Continuing with the theme of prior budgets, the minister announced changes to capital cost allowance (CCA) rates:

- **Manufacturing and processing equipment (Class 29) –** The temporary increase to a 50% CCA rate that was set to expire on 31 December 2013 has been extended for eligible assets acquired in 2014 and 2015. The half-year rule will apply, such that a full write-off may be claimed over three taxation years.
- **Clean energy generation equipment (Class 43.2) –** For assets acquired on or after 21 March 2013, the budget proposes to expand Class 43.2 by making biogas production equipment that uses more types of organic waste eligible for inclusion. Specifically, it will include pulp and paper waste and wastewater, beverage industry waste and wastewater (e.g., winery and distillery wastes) and separated organics from municipal waste. In addition, it will broaden the range of cleaning and upgrading equipment used to treat eligible gases from waste that is eligible for inclusion.

Reserve for future services

The Act permits a taxpayer to claim a reserve for services expected to be rendered after the taxation year. Budget 2013 proposes amendments to ensure that this reserve cannot be used by taxpayers with respect to amounts received for the purpose of funding future reclamation obligations. Such taxpayers will have to look to the qualifying environmental trust rules for relief.

This change applies to amounts received on or after budget day, subject to some limited grandfathering.

Restricted farm losses

Budget 2013 proposes to amend the restricted farm loss rules to provide that a taxpayers other sources of income must be subordinate to farming in order for farming losses to be deductible against income from those other sources. This amendment is in response to the Supreme Court of Canada decision in *Queen v Craig* (2012 SCC 43).

In addition, the deductible limit has been increased to $17,500.

Mining expenses

Certain pre-production mine development expenses that were previously deductible in full as a Canadian exploration expense (CEE) will now be treated as a Canadian development expense (CDE) only deductible at a rate of 30% per year.

Credit unions

The preferential income tax deduction provided for credit unions will be phased out by 2017.

Insurance

Leveraged life insurance arrangements

Finance announced measures in budget 2013 intended to block what it considers unintended tax benefits resulting from the use of two leveraged life insurance products: leveraged insured annuities and 10/8 arrangements.

Leveraged insured annuities

Leveraged insured annuities are structured to utilize borrowed funds to acquire a life annuity as an investment product as well as a related life insurance policy. Each product is issued on the life of the same individual.

Although these arrangements are sold as integrated investment products, the annuity and the insurance policy are treated separately for income tax purposes. The bifurcation of the two elements for taxation results in what finance considers inappropriate tax benefits. The product design is intended to achieve tax-free investment income on a portion of the funds invested in an exempt life insurance policy, tax-deductible interest expense incurred on the borrowed funds, as well as a deduction in respect of the policy premium. These arrangements also provide tax savings on the death of the insured who was the owner of a private corporation.

The budget proposes measures to eliminate the tax benefits arising from leveraged insured annuities which it considers offend tax policy. It is proposed that new tax rules will be introduced for "LIA policies." A life insurance policy will be considered to be LIA policy if a person or partnership becomes obligated on or after budget day to repay an amount to the lender at a time determined by reference to the death of the individual, and an annuity contract, the terms of which provide that payments are to continue for the life of the individual, and the policy are assigned to the lender.

Where the arrangement is subject to the LIA rules, the income earned within the insurance policy will be annually subject to income tax on an accrual basis and a tax deduction will be denied in respect of any portion of the policy premium paid. Furthermore, the increase to a private corporation's capital dividend account normally resulting from the receipt of a life insurance death benefit will be denied. Finally, under the proposed LIA measures for the purposes of the deemed disposition on the death of the insured, the fair market value of an annuity contract assigned to the lender in connection with an LIA policy will be deemed to be equal to the total of the premiums paid under the contract.

The LIA proposals will apply to taxation years that end on or after budget day. Leveraged insured annuities for which all borrowings were entered into before budget day will not be subject to these measures.

10/8 arrangements

Under these products, an individual would purchase an exempt life insurance policy which allows for tax-free investment income and use the policy as collateral for a business loan. The insurance contract would normally specify that, to the extent the policy owner borrowed money via a collateral loan from the insurer, the return on the policy would be the loan rate of 10% less 2%. As a result, an individual would deduct interest expense of 10% for tax purposes, while 8% of the interest would be a guaranteed return on the exempt insurance policy. The basic strategy was varied to either increase the interest expense deduction or to provide other benefits.

The budget proposes new measures to deny unintended tax benefits arising from investments in 10/8 arrangements. Where a life insurance policy, or an investment account under the insurance policy, is assigned as collateral on a borrowing, and the interest rate payable on the policy investment account is determined by reference to the interest rate payable on the borrowing or the maximum value of policy investment account is determined by reference to the amount of the borrowing, the associated income tax benefits will be denied in respect of taxation years after budget day.

Under the proposed measures:

- Associated interest paid or payable that relates to a period after 2013 will be not be deductible.
- Premiums paid or payable under the policy related to a period after 2013 will not be deductible.
- The capital dividend account will not be increased by the amount of the death benefit that becomes payable after 2013 under the policy that is associated with the borrowing.

The budget also proposes measures to relieve the income tax consequences in order to accommodate the termination of existing 10/8 arrangements before 2014, if a withdrawal from a policy is made to repay the borrowing on or after budget day and before 1 January 2014.

International measures

Budget 2013 includes a number of measures and other announcements that are designed "to combat tax evasion and aggressive tax avoidance and improve the integrity of the tax system." There are also measures that would eliminate certain features of the tax system that are perceived to be obsolete or may expose Canada to international criticism.

Thin capitalization rules

Budget 2013 has extended the thin capitalization rules to all trusts and non-resident corporations that carry on business in Canada or elect to be taxed on a net basis under section 216 of the Act, as well as partnerships having members that are such entities. These rules would be structured somewhat differently than the existing thin capitalization rules, in order to account for differences between interests in trusts and shares of corporations, and differences between a Canadian branch of a non-resident entity and a Canadian subsidiary. While the effect of the new rules would be analogous to the existing regime in most respects, their application to trusts would not result in an ultimate denial of deductions as such, although the special tax under Part XII.2 of the Act and withholding taxes may be applicable.

- For a trust that is resident in Canada, the rules will apply if the trust has indebtedness owing to a non-resident beneficiary or non-arm's-length non-resident that is a "specified non-resident" in respect of the trust. Generally, a non-resident beneficiary will be a "specified beneficiary" if it holds an interest representing 25% of the fair market value of all interests in the trust. The trust's "equity amount" would be measured by reference to contributions to the trust and its "tax-paid earnings," as well as certain distributions by the trust. As an elective transitional measure, the starting point will be based on the fair market value of the trust's property minus its liabilities. Interest expense to which deductibility is denied can be treated on an elective basis as an income distribution by the trust, which would be deductible in its own right, but may give rise to Part XII.2 tax and Part XIII withholding taxes.
- For a non-resident corporation or trust, the "equity amount" will be based on 40% of its net Canadian asset base, which translates to a 1.5 to 1 ratio.

International banking centres

Budget 2013 will also eliminate the International Banking Centre rules in section 33.1 applicable to certain banking activities carried on by Canadian financial institutions through branches in Montreal and Vancouver. Apparently, these rules have not been used very much in recent years, and have attracted international criticism as a preferential regime.

Treaty shopping

Budget 2013 announces a consultation process to be undertaken with regard to "treaty shopping," noting that this practice "effectively extends tax treaty benefits to third country residents in circumstances that were not contemplated when the tax treaty was entered into and without any reciprocal benefits accruing to Canadian investors or to Canada," which "undermines the bilateral nature of tax treaties and the balance of compromises reached between Canada and its treaty partners." The government notes that it has "been largely unsuccessful in challenging treaty shopping cases in court," and signals its openness to proceed perhaps with unilateral measures in this regard, as other countries have done.

Electronic fund transfers

The *Income Tax Act*, the *Excise Tax Act* and the *Excise Act, 2001* would be amended to require that certain financial intermediaries report to the CRA international electronic fund transfers (EFTs) of $10,000 or more. Affected financial intermediaries, and reporting requirements, would be the same as those currently required with respect to reporting international EFTs to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*, including banks, credit unions, caisses populaires, trust and loan companies, money services businesses and casinos. These measures would apply as of 2015.

Information requirements regarding unnamed persons

The CRA has the power to require any person to provide information or documents for the purposes of tax administration or enforcement, but must obtain judicial authorization before issuing a requirement to a third party to provide information for the purpose of verifying compliance by unnamed persons. Currently, this process may proceed without notice to the third party (*ex parte*). Budget 2013 proposes to require the third party to be notified, in order to provide that party with an opportunity to be heard and to thus preclude subsequent proceedings to challenge any order that may have been issued in the absence of such a notice.

Stop International Tax Evasion Program

Budget 2013 also announces the introduction of a program by which rewards would be paid to individuals who provide information to the CRA concerning international tax non-compliance that leads to the collection of outstanding taxes exceeding $100,000, up to 15% of any taxes collected on the basis of that information.

Foreign reporting requirements

A Canadian resident must file a Foreign Income Verification Statement (Form T1135) with the CRA if that person owns specified foreign property costing more than $100,000 in total.

- **Extended reassessment period —** Budget 2013 proposes to extend the normal reassessment period for a taxation year of a taxpayer by three years if the taxpayer has failed to report income from a specified foreign property on their annual income tax return, and the form was not filed on time by the taxpayer, or a specified foreign property was not identified, or was improperly identified. This measure will apply to the 2013 and subsequent taxation years.

- **Revised Form T1135 —** The form will be revised to require taxpayers to provide more detailed information regarding each specified foreign property, including the name of the specific foreign institution or other entity holding funds outside of Canada, the specific country to which the property relates, and the foreign income generated from the property.

- **Reminders, clarification and electronic filing —** The CRA will begin reminding taxpayers on their Notices of Assessment of the obligation to file Form T1135, if they have checked the "Yes" box on their income tax returns, indicating that they have specified foreign property in the taxation year with a total cost of more than $100,000. The filing instructions will also be clarified, and an electronic filing process will be developed.

Non-resident trusts

Budget 2013 proposes to expand the deemed residence rules for trusts to undo certain aspects of the Federal Court of Appeal decision in *The Queen v Sommerer* (2012 FCA 207). These rules are aimed at a situation where a Canadian-resident taxpayer maintains effective ownership over property held by a non-resident trust.

In general, these rules will apply where a non-resident trust holds property on condition that property may revert to a Canadian-resident taxpayer, pass to persons determined by that Canadian-resident taxpayer or cannot be disposed of without the Canadian resident's consent or direction. In these circumstances, a direct or indirect transfer or loan of that property (or of certain other property) made by the Canadian-resident taxpayer will be treated as a transfer or loan of restricted property.

The implications of this are that the Canadian-resident taxpayer will be treated as having made a contribution to the trust, thus triggering the deemed residence rules for the trust under section 94 of the *Income Tax Act*, with the attendant tax consequences.

This measure applies to taxation years ending on or after budget day.

It should be noted that Bill C-48 proposes to amend the *Income tax Conventions Interpretation Act* to provide that if a trust is deemed by the above-referenced provisions to be resident in Canada, it will also be deemed to be a resident of Canada (and not of the other state) for the purposes of applying the relevant tax treaty. Therefore, it will not be possible to obtain treaty relief if these deeming rules apply.

Tax relief for individuals and families

There are no individual tax rate or tax bracket changes in this budget.

Personal income tax rates

The budget does not include any changes to personal income tax rates. The 2013 personal tax rates are summarized in Table E.

Table E – Federal personal income tax rates

First bracket rate	Second bracket rate	Third bracket rate	Fourth bracket rate
15%	22%	26%	29%

Tax credits

The budget includes proposals for a number of enhanced tax credits, computed using the lowest personal tax rate (15%):

- **Adoption expense tax credit —** The adoption expense tax credit allows an individual to claim a non-refundable credit on eligible adoption expenses (up to a maximum of $11,669 per child for 2013) in the taxation year in which the adoption period ends. Recognizing that adoptive parents must incur costs prior to being matched with a child, the budget proposes to extend the time at which the adoption period begins to the earlier of the time when the adoptive parent makes an application to register with a provincial ministry or with a provincially-licensed adoption agency, and the time when the application is made to a Canadian court. This change applies to adoptions finalized after 2012.
- **First-time donor's super credit —** The budget proposes a new temporary first-time donor's super credit to supplement the current charitable donation tax credit. A first-time donor will be entitled to a one-time federal credit equal to 40% for money donations of $200 or less, and 54% for donations between $200 and $1,000. An individual is considered a first-time donor if neither the individual nor

the individual's spouse or common-law partner has claimed a charitable donation tax credit (or the new first-time donor's super credit) after 2007. The maximum donation amount that may be claimed per couple is $1,000. This one-time credit applies to donations made on or after 21 March 2013 and before 2018.

- **Mineral exploration credit** — The mineral exploration tax credit, equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors, will be extended to flow-through share agreements entered into on or before 31 March 2014. This program, initially introduced in 2000, was previously extended and scheduled to expire on 31 March 2013.

In addition, the budget proposes changes to the following credits:

- **Dividend tax credit for non-eligible dividends** – The budget proposes to increase the effective tax rate on non-eligible dividends (i.e., dividends paid out of corporate earnings subject to a preferential tax rate, such as the small-business rate). Currently, non-eligible dividends are subject to a gross-up of 25% and a dividend tax credit of 13.33%. The budget proposes to reduce the gross-up to 18% and the dividend tax credit to 11%. This results in an increase in the top marginal federal rate on non-eligible dividends from 19.58% to 21.22%. This change applies to non-eligible dividends paid after 2013.

- **Labour-sponsored venture capital corporations (LSVCCs) tax credit** – The current 15% federal credit for an investment of up to $5,000 in LSVCC shares will be phased out beginning in 2015. The credit rate will be reduced to 10% in 2015, 5% in 2016 and eliminated thereafter. In addition, applications for registration of LSVCCs received after 21 March 2013 will not be accepted.

Other personal measures

Lifetime capital gains exemption

The budget proposes to increase the current $750,000 lifetime capital gains exemption limit to $800,000. The increase is effective for dispositions of qualified small-business corporation shares, qualified farm property and qualified fishing property after 2013. In addition, for taxation years after 2014, the exemption limit will be indexed to inflation.

Tax shelters and reportable transactions

The normal reassessment period for most taxpayers is three years after the initial date of assessment of the tax return. The budget proposes to extend the normal reassessment period for participants in a tax shelter or reportable transaction where the required information return for the tax shelter or reportable transaction is filed late.

The reassessment period will be extended to three years after the date the relevant information return is filed, effective for taxation years that end on or after 21 March 2013.

Collection action related to charitable donation tax shelters

Currently, the CRA may not take collection action where a taxpayer has objected to an assessment of tax, interest or penalties resulting from the disallowance of a tax shelter deduction or credit involving a charitable donation.

Effective for amounts assessed for 2013 and subsequent taxation years, the CRA will be permitted to collect 50% of the disputed tax, interest or penalties, pending the ultimate determination of the taxpayer's liability.

Registered pension plans

The budget proposes to allow registered pension plan (RPP) administrators to make refunds of RPP contributions to correct reasonable errors without first obtaining approval from the CRA. This measure will only apply if the refund is made no later than 31 December of the year following the year in which the contribution error was made.

Refunds to employees are included in income in the year received, and refunds to employers will generally reduce the RPP expense for the year to which the refund relates.

Deduction for safety deposit boxes

The budget proposes to eliminate the deduction of safety deposit box fees paid to a financial institution.

Consultation on graduated rate taxation of trusts and estates

A trust established under a will is considered to be a testamentary trust. Testamentary trusts, subject to certain exceptions, are taxed in a more favourable way than inter vivos trusts. An inter vivos trust is taxed at the top marginal tax rate on every dollar of income, while a testamentary trust enjoys the graduated rates of tax that are also applicable to individuals.

Some wills for high-net-worth individuals with many children and other beneficiaries establish multiple testamentary sub-trusts to multiply this tax-saving opportunity after death.

Finance expressed a concern in budget 2013 that the tax base is being increasingly eroded by the use of multiple testamentary trusts. Additionally, Finance is concerned that the winding-up of estates are delayed solely to extend access to multiple sets of graduated rates. Finance announced today that it will release a consultation paper that will provide the public with an opportunity to comment on possible measures targeting what it perceives as inappropriate exploitation of graduated tax rates applicable to testamentary trusts.

Sales and excise tax measures

GST/HST and health-care services

The government announced two changes that are designed to extend the relief that currently applies in respect of certain home care services, and to clarify that tax will apply to certain medico-legal reports or examinations supplied by health-care providers. Both of these changes will apply after budget day.

- The GST/HST legislation currently exempts certain publicly subsidized or funded homemaker services that are rendered to an individual in their residence, where the individual requires assistance as a consequence of their age, infirmity or disability. Exempt services currently include cleaning, laundry, meal preparation and child care services, all of which are currently funded by provincial and territorial governments. The definition of exempt "home care services" will be expanded to include additional services that are also funded by these governments, including bathing, feeding and assistance with dressing and medication.

- The budget also proposes to clarify the application of GST/HST to medico-legal reports or examinations that may be supplied by health-care professionals but that are not specifically performed for purposes of the protection, maintenance or restoration of the health of a person or for palliative care. Taxable supplies will now include, for example, any report or examination performed solely for the purposes of determining liability in a court proceeding or under an insurance policy. Related property and services will also be taxable, including, for example, charges for an x-ray or lab test conducted for purposes of the examination or report. Any such reports or examinations that are currently covered under a provincial or territorial health insurance plan will continue to be exempt.

GST/HST pension plan rules

Under existing rules, employers that participate in a registered pension plan operated on behalf of their employees are deemed to have supplied and collected tax on certain property or services acquired for use in activities related to the pension plan. These "deemed supply" rules require tax to be accounted for even in circumstances where tax is also required to be collected on the same transaction as an "actual supply" under the normal rules of the legislation.

The deeming provisions also require an employer to account for tax under these rules on everything acquired, used or consumed in pension activities, even where the employer's involvement in the pension plan is minimal.

The government proposes two changes designed to simplify compliance with these complex rules, both of which are to take effect after budget day.

- The budget proposes to permit an affected employer to jointly elect with a pension trust or corporation (the pension entity) to treat an actual taxable supply by the employer to the pension entity as being made for no consideration where the employer accounts for and remits tax on the deemed supply, thus removing the requirement for tax to be accounted for and remitted twice on the same supply. Once made, the election will remain in effect until it is revoked by the parties or cancelled by the minister of national revenue, for example where the minister determines that the employer failed to remit tax as required on the actual supply.
- A "de minimis" threshold will be introduced to relieve an employer's obligation to apply the deemed supply rules in any fiscal year where the amount of GST (and the federal component of the HST) accounted for and remitted under the rules during the previous fiscal year is both less than $5,000 and less than 10% of the total net GST (and the federal component of the HST) paid by all pension entities of the pension plan in that preceding fiscal year. This relief will not be available where the new joint election is made to relieve the requirement to account for tax on actual taxable supplies.
- Where employers do not satisfy the new de minimis thresholds, more limited relief will be available. Specifically, there will be no requirement for an employer to apply the deemed supply rules in respect of certain pension-related activities which are internal to the employer's organization and which do not involve an actual supply to the pension entity. Examples of these "internal pension activities" would include, for example, time spent by payroll personnel in determining an employee's pension contribution. The employer will not be required to apply the deemed taxable supply rules where the amount of GST (and the federal component of the HST) that would otherwise be required to be accounted for and remitted in respect of these internal pension activities falls below the de minimis thresholds identified above. This limited relief will be available even where the new joint election is in place.
- Specific rules will apply with respect to the application of the new de minimis thresholds in the case of related employers who participate in the pension plans and mergers, amalgamations or wind-ups of participating employers.

GST/HST business information requirement

The CRA currently collects certain information from businesses at the time of registration, which it uses to manage taxpayer accounts and monitor tax compliance. The legislation currently provides for a penalty of $100 in cases where the required information is not provided.

The budget proposes to enhance the effect of this penalty by providing the minister of national revenue with additional authority to withhold any GST/HST refunds claimed by a business until all required business information is provided. This amendment is scheduled to take effect on Royal Assent.

GST/HST on paid parking

Because the supply of parking is considered to be a commercial activity, it is generally subject to tax when supplied either by a private commercial entity or by a public-sector body (PSB). The budget proposes to introduce two measures to clarify that certain existing exemptions for PSBs do not apply to the supply of paid parking.

- An existing exemption relieves the requirement for charities and other PSBs to charge GST/HST on a particular supply of property or a service, where 90% or more of the PSB's supplies of that property or service are made for free. The budget will clarify that this exemption does not apply to supplies of paid parking that are made by way of lease, licence or similar arrangement in the course of a business carried on by a PSB, even where the PSB provides a significant amount of parking at no charge. Taxable supplies include, for example, supplies of parking spaces or parking facilities operated by a municipality or a hospital. Occasional supplies of parking by a PSB, for example as part of a special fundraising event, continue to be exempt. This change will apply retroactive to the introduction of the GST legislation in 1991.
- Another exemption currently applies to parking provided by charities that are not also a particular type of PSB (a municipality, university, public college, school or hospital.) It is proposed that the exemption will be amended to clarify that the exemption will not apply in the case of parking that is supplied by way of lease, licence or similar arrangement in the course of a business carried on by a charity set up or used by such a PSB to operate a parking facility. This amendment will apply to supplies of parking made after budget day.

GST/HST treatment of the Governor General

A special provision in the GST/HST legislation currently provides that GST/HST does not apply to purchases made for use of the Governor General. With the agreement of the Governor General, this exemption will be revoked, effective for supplies made after 30 June 2013.

Information requirements regarding unnamed persons

Sections 102.1 (for non-GST/HST purposes) and 289.1 (for GST/HST purposes) of the *Excise Tax Act* provide for the minister of national revenue to apply for judicial authorization to issue a notice that information is required to be provided in respect of an unnamed person or group of persons.

These provisions will be amended, effective at Royal Assent, to provide that the application will be made to a judge of the Federal Court and that there will no longer be a requirement for the judicial authorization to be served or a process for it to be further reviewed.

Other measures

Excise duty rate on manufactured tobacco

Effective budget day, the excise duty on manufactured tobacco (including, for example, chewing tobacco or fine-cut tobacco used in "roll-your-own cigarettes") will be increased to $5.3125 per 50 grams or fraction thereof.

Electronic suppression of sales software sanctions

Taxpayers are currently required to maintain adequate books and records relevant to their determination of GST/HST payable, any income tax liabilities and any benefits or refunds to which they may be entitled. The budget proposes to introduce new administrative monetary penalties (AMPs) and criminal offences which would apply where electronic suppression of sales (ESS) or "zapper" software is used by businesses to modify or delete transaction records with a view to hiding sales and evading GST/HST and income taxes.

The measures described below will apply on the later of 1 January 2014 and Royal Assent:

- New AMPs will include a penalty of $5,000 for the first infraction involving any use, possession or acquisition of ESS software, with the penalty increased to $50,000 for subsequent infractions and a penalty in the amount of $10,000 for the first infraction involving manufacture, development, sale, possession for sale, offer for sale or otherwise making available ESS software, to be increased to $100,000 for subsequent infractions. With the exception of the penalty in respect of use of the software, these penalties will be subject to a due diligence defence.
- New criminal offences will also apply in respect of the activities subject to the AMPs described above. On summary conviction, a person will be liable to a fine of not less than $10,000 and not more than $500,000 or imprisonment for a term of not more than two years, or both. On conviction by indictment, the fines will be increased to a minimum of $50,000 and a maximum of $1 million, or imprisonment for a term of not more than five years, or both.

Aboriginal tax policy

To date, the government has entered into 34 sales tax arrangements under which Indian bands and self-governing Aboriginal groups levy a sales tax within their reserves or on their settlement lands. The budget reiterated the government's support of these direct taxation arrangements and its willingness to enter into additional agreements with interested Aboriginal governments.

Customs tariff measures

Tariff relief for Canadian consumers

The budget proposes to permanently eliminate all existing tariffs on baby clothes and sports and athletic equipment (except for bicycles). For the products in question, the Most Favoured Nation (MNF) rates of duty will be reduced to "free."

In some cases, these reductions will result in consequential reductions to the rates of duty under other tariff treatments, including the General Preferential Tariff. The amendments to give effect to these reductions will apply in respect of goods imported into Canada on or after 1 April 2013.

Modernization of Canada's General Preferential Tariff regime for developing countries

The budget proposes significant changes to Canada's existing General Preferential Tariff (GPT) regime under the Customs Tariff. Specifically, the government will withdraw GPT eligibility from 72 higher-income and export-competitive countries, including all G-20 countries. The criteria that will be used to determine whether a particular country continues to qualify for GPT treatment will be applied every two years on a forward basis.

The *General Preferential Tariff and Least Developed Country Tariff Rules of Origin Regulations* will be amended to ensure that they continue to allow duty-free importation of textiles and apparel from least developed countries, where they are produced using textile inputs from current GPT beneficiaries.

The changes to GPT treatment will be effective in respect of goods imported into Canada on or after 1 January 2015 and will apply until 31 December 2024.

Pending legislation

Bill C-48, *Technical Tax Amendments Act, 2012*

Bill C-48 is the long-awaited, 1,000-page omnibus tax technical bill that covers proposed amendments from the past decade or so. These include the foreign affiliate amendments, the non-resident trust rules, the restrictive covenant rules, the aggressive tax planning reporting rules, and a myriad of other changes.

Bill C-48 received second reading on 8 March 2012 and was referred to the Standing Committee on Finance. Some of the measures contained in the bill had been substantively enacted before — on 15 June 2007 with Bill C-33 and on 29 October 2007 with Bill C-10 — but were never enacted, because Parliament was either prorogued or dissolved. So, in terms of accounting, the amendments that had been previously accounted for that haven't been subsequently modified remain substantively enacted.

All other measures were substantially enacted as of first reading on 21 November 2012.

Previously announced measures

The government confirmed its intention to introduce a number of previously announced corporate measures, as modified to take into account consultations and deliberations since their release.

Income tax technical amendments

On 21 December 2012, Finance released a new package of draft legislative proposals relating to a number of technical changes to the *Income Tax Act* and the Income Tax Regulations, including the following:

- Anti-deferral rules for corporate partnerships
- Section 55 anti-avoidance rules in respect of capital gains stripping
- Winding-up rules
- Canadian renewable and conservation expense
- Refundable investment tax credits
- Cooperative corporations
- Credit unions
- Transfer pricing rules
- Capital cost allowance rules
- Railway companies

Base erosion rules for Canadian banks

On 27 November 2012, the government released for consultation draft amendments to the "base erosion" rules for Canadian-based banks with foreign affiliates first announced in the 2012 federal budget. The proposed measures are generally effective for taxation years that begin after 31 October 2012.

25 July 2012 draft legislative proposals

On 25 July 2012, Finance released for public comment a package of draft legislative proposals and explanatory notes to implement measures first announced on 20 July 2011 relating to the taxation of specified investment flow-through entities (SIFTs), real estate investment trusts (REITs) and publicly traded corporations.

GST/HST provisions for investment plans and pensions

On 28 January 2011, Finance announced proposals to modify its intricate scheme for levelling the GST/HST playing field for investment plans (e.g., mutual funds, pooled funds, pension plans and segregated funds of insurers) in response to concerns expressed by stakeholders. Read more in our Tax Alert 2011 Issue No. 04.

Consultation papers or reports

Tax incentives for charitable giving

On 11 February 2013, the Standing Committee on Finance released its report, *Tax incentives for charitable giving in Canada*. The report made 12 recommendations, including six in respect of tax matters. Subject to the government's stated intention to balance the budget in the medium term, the report includes recommendations to adopt a stretch tax credit, extend the donation carryforward period, lower or eliminate the capital gains tax on donations of private company shares and real estate when donated to a charitable organization, and encourage charitable giving by the corporate sector.

Webcasts

On Thursday evening, members of the Ernst & Young tax team who attended the budget lock-up will record their analysis and insights on the tax measures in the 2013 budget. View our webcast at ey.com/ca/Budget.

And on Friday, 22 March 2013, at 8:00 a.m. EDT, we'll be broadcasting live from the budget breakfast hosted by the Ottawa Chamber of Commerce and the *Ottawa Business Journal*. Andrew Coyne, *National Post* columnist and long-time member of the CBC's popular "At Issue" panel on *The National,* will join our presenters to discuss the political priorities and economic and tax impact of the 2013 federal budget. View our webcast at http://eycast.eycan.com/2013PostBudgetBreakfast.

Learn more

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