
Budget 2012 states that since Canada is emerging from the global economic recession, the strengths of the Canadian economy provide an opportunity to the government to take significant actions that will “fuel the next wave of job creation and position Canada for a secure and prosperous future.”

Budget 2012 does not propose any change in tax rates for corporations or individuals. Rather, tax measures are generally focused on closing down what the Department of Finance and the Canada Revenue Agency (CRA) identify as loopholes and abusive transactions.

Below is our review and analysis of key tax measures proposed in Budget 2012.

**BUSINESS MEASURES**

**Scientific Research and Experimental Development Program**

The scientific research and experimental development (SR&ED) program provides two sets of incentives to taxpayers to support research and development in Canada:

- the deduction of allowable current and capital SR&ED expenditures; and
- an investment tax credit (ITC).

In response to calls to help encourage business innovation in Canada, the federal government announced in the 2010 Budget a comprehensive review of the government’s support for research and development. In October 2011, the government-mandated Expert Review Panel released its report, *Innovation Canada: A Call to Action*, which recommended that the SR&ED program be simplified to reduce compliance and administrative costs and changed to provide direct support initiatives to help small and medium-sized
enterprises grow into larger, competitive firms. Budget 2012 proposes a number of changes to the SR&ED program intended to make it simpler and more cost-effective and predictable.

- For taxation years that end after 2013, the general 20% ITC rate for qualified SR&ED expenditures will be reduced to 15%. For a taxation year that includes January 1, 2014, the 5% reduction will be prorated based on the number of days in the taxation year that are after 2013. The enhanced 35% ITC rate for qualifying Canadian-controlled private corporations (CCPCs) in respect of qualifying SR&ED expenditures of up to $3 million annually (phased out for CCPCs with taxable income for the previous taxation year between $500,000 and $800,000 or whose taxable capital employed in Canada for the previous taxation year is between $10 million and $50 million) is not changed.

- SR&ED expenditures of a capital nature will be excluded from eligibility for SR&ED deductions and ITCs. The proposed change will apply to:
  
  o capital property acquired after 2013;
  
  o an amount paid or payable in respect of the use of, or the right to use, capital property after 2013 (e.g., lease payments); and
  
  o an otherwise eligible contract payment made by a taxpayer to another person for SR&ED to the extent the payment is in respect of a capital expenditure made in fulfillment of the contract.

- A taxpayer can include in its eligible SR&ED expenditures itemized overhead expenditures directly attributable to the conduct of SR&ED or may elect to use a simplified proxy method instead. The proxy method allows a taxpayer to include 65% of the eligible portion of salaries or wages of employees who are directly engaged in SR&ED carried on in Canada. Budget 2012 proposes to reduce the 65% rate to 60% for 2013 and to 55% after 2013. The proxy rate applicable for taxation years that include days in 2012, 2013 or 2014 will be prorated.

- A taxpayer can contract to have SR&ED performed by another person. Where the other person does not deal at arm’s length with the taxpayer, the Tax Act provides that the amount of the expenditure taken into account for ITC purposes excludes the profit element in the contract. For expenditures incurred after 2012, Budget 2012 proposes to exclude from the expenditure base for ITCs the profit element in an arm’s length SR&ED contract. This is to be achieved by way of a proxy so that only 80% of the cost of arm’s length SR&ED contracts will be eligible for SR&ED ITCs. Consistent with the measure to exclude SR&ED expenditures of a capital nature from eligibility for SR&ED deductions and ITCs, the amount of an arm’s length contract payment eligible for SR&ED tax incentives will also exclude amounts paid in respect of capital expenditures incurred by the recipient in fulfillment of the contract and the recipient will be required to advise the payer of such amounts. The 80% factor will be applied after the exclusion of amounts paid in respect of capital expenditures.

**Clean Energy Generation Equipment**

In order to encourage investment in clean energy generation and conservation equipment, the Tax Act provides for accelerated capital cost allowance (50% per year on a declining balance basis) for assets included in Class 43.2.
Budget 2012 proposes to expand the types of property that may be included in Class 43.2. More specifically:

- The requirement that heat energy produced by waste-fuelled thermal energy equipment be used in an industrial process or in a greenhouse will be eliminated.
- Equipment that is part of a direct energy system that distributes thermal energy primarily generated by waste-fuelled thermal energy equipment eligible for inclusion in Class 43.2 will be included.
- Plant residue (such as straw, corn cobs and similar organic waste produced by the agricultural sector) will be added to the list of eligible waste fuels that can be used in waste-fuelled thermal energy equipment included in Class 43.2 or a cogeneration system included in Class 43.2 (or Class 43.1).

However, the cost of an asset using eligible waste fuels will not be eligible for inclusion in Class 43.2 (or Class 43.1) if applicable environmental regulations of Canada, a province, territory, municipality or public or regulatory body are not complied with at the time the equipment first becomes available for use.

The proposed changes apply with respect to assets acquired on or after March 29, 2012 (Budget Date) that have not been used or acquired for use before that date.

**Phase Out of Corporate Mineral Exploration and Development Tax Credit**

The Tax Act provides a 10% tax credit for certain pre-production expenses (i.e., expenses for grass roots exploration in Canada and development expenses for the purpose of bringing a new mine in Canada into production) incurred by a taxable Canadian corporation in respect of certain eligible mineral resources. The eligible minerals are diamonds, base or precious metals and industrial minerals that become base or precious metals through refining.

The 10% credit for exploration expenses will continue to apply to expenses incurred in 2012 and a 5% rate will apply to expenses incurred in 2013. Thereafter, the credit will not be available.

The 10% credit for development expenses will be gradually phased out such that the 10% rate will continue to apply for expenses incurred in 2012 and 2013, a 7% rate will apply for expenses incurred in 2014, a 4% rate will apply for expenses incurred in 2015 and a nil rate will apply thereafter. However, grandfathering is proposed so that the 10% credit will continue to apply to development expenses incurred before 2016:

- pursuant to a written agreement entered into before the Budget Date; or
- as part of the development of a new mine where construction was started by, or on behalf of, the taxpayer before the Budget Date or engineering and design work for the construction of the mine, as evidenced in writing, was started by or on behalf of the taxpayer before the Budget Date. For these purposes, obtaining permits or regulatory approvals, conducting environmental assessments, community consultations, impact benefit studies and similar activities will not qualify as construction or engineering and design work.
Phase Out of the Atlantic Investment Tax Credit for Oil and Gas and Mining Activities

Budget 2012 proposes to phase out the Atlantic Investment Tax Credit to the extent that the relevant assets relate to oil and gas and mining activities. The credit will continue to be available for assets acquired for use in other eligible activities.

The 10% credit will continue to apply for assets that relate to oil and gas and mining activities acquired before 2014, will decline to 5% for assets acquired in 2014 and 2015 and will be eliminated for assets acquired after 2015. Grandfathering is proposed so that the 10% credit will continue to apply to property acquired before 2017:

- pursuant to a written agreement of purchase and sale entered into before the Budget Date; or
- as part of a project phase where construction of the phase was started by, or on behalf of, the taxpayer before the Budget Date or engineering and design work for the construction of the phase, as evidenced in writing, was started by or on behalf of the taxpayer before the Budget Date. For these purposes, obtaining permits or regulatory approvals, conducting environmental assessments, community consultations impact benefit studies and similar activities will not qualify as construction or engineering and design work.

Partnership Interests and the Section 88 Bump

Following the acquisition of a corporation, it may be wound up or amalgamated with the acquiring corporation in order to increase or “bump” the cost of its underlying non-depreciable capital property to an amount not exceeding the fair market value of the property at the time of the acquisition of control. The bump may be available where, and to the extent that, the adjusted cost base of the acquiring corporation’s shares of the target corporation exceed the net tax value of the target corporation’s assets.

Non-capital properties and depreciable properties (Income Assets) are not eligible for the section 88 bump. Thus, if an Income Asset formerly held by a target corporation is sold following a section 88 wind-up or subsection 87(11) amalgamation, any latent gains and/or recapture in respect of the Income Asset will be realized.

A common technique to allow for the transfer of Income Assets held by a target corporation to non-resident or tax-exempt persons following an acquisition of control was to have the target corporation transfer the Income Assets to a partnership on a rollover basis prior to the acquisition of the target corporation. Since the partnership interest held by the target corporation would generally constitute capital property, the acquirer could bump its tax cost on the winding up or amalgamation of the target corporation. The partnership interest could then be sold by the acquirer without any capital gain being realized and, if the purchaser were a non-resident or tax-exempt person, it could generally wind up the partnership without being subject to any Canadian tax. Any income realized by the partnership in respect of the Income Assets upon the partnership’s dissolution generally would not be subject to Canadian tax in the hands of its partners due to their tax-exempt or non-resident status.

Budget 2012 proposes to introduce a measure which would eliminate structures such as the one described above. Very generally, proposed subparagraph 88(1)(d)(ii.1) will reduce the amount of the bump room
available in respect of a partnership interest by the amount of the income and/or capital gains which would have been realized if the partnership’s Income Assets had been disposed of directly by the partnership. The proposed measure will be effective in respect of wind-ups and amalgamations occurring on or after the Budget Date (other than generally wind-ups and amalgamations occurring before 2013, where control of the corporation whose property is being bumped was acquired prior to the Budget Date).

**Transfers of Partnership Interests to Non-Residents and Tax-Exempt Persons**

The purpose of section 100 of the Tax Act is to prevent a taxpayer from obtaining a capital gain on the sale of a partnership interest to an exempt taxpayer in circumstances in which the sale of the underlying assets by the partnership would have given rise to ordinary income taxable at full rates. Section 100 provides that where a taxpayer disposes of a partnership interest to a tax-exempt person, 100% (rather than the usual 50%) of the capital gain realized is subject to tax, except to the extent that it may reasonably be regarded as being attributable to an increase in the value of capital property that is not depreciable property. In the absence of section 100, a Canadian-resident taxpayer seeking to sell an Income Asset to a tax-exempt person could avoid having to pay tax at the full rate on the income which would otherwise be realized by rolling the Income Asset to a partnership in exchange for a partnership interest, selling the partnership interest to the tax-exempt person, realizing only a capital gain. The tax-exempt person would then wind up the partnership on a tax-free basis to hold the Income Asset.

Budget 2012 proposes to extend the application of section 100 to transfers of partnership interests to non-resident persons. Like tax-exempt persons, non-residents may be in a position to wind up a partnership holding Income Assets without having to pay any Canadian tax. Thus, in the absence of the new rule, such assets could be transferred to a non-resident through a partnership without causing any recapture or income gains to be realized. The new measure will not apply in respect of partnerships which use all of their property in carrying on business through a permanent establishment in Canada (i.e., partnerships which could not be wound up on a tax-free basis for their non-resident members).

Budget 2012 also proposes to extend the application of section 100 to “indirect” transfers to tax-exempt persons and non-residents. The revised version of the provision will apply where, “as part of a transaction or series of transactions or events” a taxpayer disposes of an interest in a partnership and that interest is acquired by a tax-exempt or non-resident person. Currently, section 100 simply refers to a disposition of a partnership interest “to any person exempt from tax.” Thus, in its current form section 100 arguably would not apply to a taxpayer who transferred a partnership interest to a tax-exempt person via a non-exempt third party.

Both of the above amendments will be effective for dispositions of partnership interests on or after the Budget Date (other than arm’s length dispositions before 2013 if the taxpayer is obligated to dispose of the interest pursuant to a written agreement entered into by the taxpayer before the Budget Date).

**Partnership Waivers**

Subsection 152(1.4) permits the CRA to determine the income or loss of a partnership within three years of the later of the deadline for filing its T5013 and the date it is actually filed. Where the CRA obtains a waiver
from each partner, however, the time period for making a determination is extended. The period cannot currently be extended, however, where even one of the partners does not provide a waiver.

Current subsection 165(1.15) provides that only a single member of the partnership, who has been designated for that purpose in the partnership’s T5013 or who is otherwise expressly authorized for that purpose by the partnership, is permitted to object in respect of a determination issued under subsection 152(1.4). Budget 2012 proposes a new rule (subsection 152(1.9)) which, similar to subsection 165(1.15), would permit a single member of a partnership to sign a waiver in respect of the three-year determination period provided for in subsection 152(1.4). The member in question must either be designated for that purpose in the partnership’s T5013 or be expressly authorized by the partnership to file the waiver contemplated by subsection 152(1.9). Subsection 152(1.9) will be effective on the date its implementation bill receives Royal Assent.

INTERNATIONAL MEASURES

Investments in a Foreign Affiliate

Budget 2012 will also significantly curtail investments in foreign affiliates by foreign-controlled Canadian corporations. In the report of the Advisory Panel on Canada’s System of International Taxation, certain foreign affiliate “dumping” transactions were characterized as abusive — reducing the Canadian tax base without providing any significant economic benefit to Canada. The general effect of these dumping transactions is to avoid the Canadian withholding tax that would otherwise be payable if the foreign-controlled Canadian corporation had paid an amount to its foreign parent as a dividend. Currently, the Tax Act provides Canadian corporations with an interest deduction on money borrowed to acquire shares of a foreign affiliate (which can be used to offset Canadian source income). Further, dividends received on the shares are generally deductible in computing the Canadian corporation’s taxable income. Investments in a foreign affiliate can also be undertaken as a means of extracting funds from Canada without the imposition of Canadian withholding taxes.

The transactions which Budget 2012 identified as being of concern included:

- acquisitions of shares of a foreign affiliate that are made with internal funds of the Canadian subsidiary;
- acquisitions of newly issued shares of a foreign affiliate where previously issued shares of the foreign affiliate are owned by the foreign parent or another non-resident member of the same corporate group;
- acquisitions of foreign affiliate shares from a foreign subsidiary of the foreign parent; and
- acquisitions of foreign affiliate shares from an arm’s length party at the request of the foreign parent.

The types of transactions caught by the 2012 Budget Notice of Ways and Means Motion (NWMM) are, however, much broader. Under proposed section 212.3, unless the transaction meets a “business purpose” test, an acquisition of shares or debt of a foreign affiliate, an acquisition of an option in respect of such property and a capital contribution to a foreign affiliate by a Canadian subsidiary of a foreign parent corporation will give rise to a deemed dividend to the extent that the Canadian subsidiary transfers property or incurs or assumes an obligation in respect of the investment in the foreign affiliate. The deemed dividend
will be subject to Canadian withholding tax. Further, where the Canadian subsidiary issues shares in connection with the investment in the foreign affiliate, no increase in the Canadian subsidiary’s paid-up capital is permitted. Consequential amendments to the Tax Act are also proposed to deny any tax benefit from any contributed surplus arising on the transaction. Where a foreign corporation becomes a resident of Canada owning shares of another corporation that was, or becomes, a foreign affiliate of the corporation, the paid-up capital of the shares of the corporation will be reduced and in certain circumstances a deemed dividend may arise.

The “business purpose” test is an objective test which will be satisfied where the investment may reasonably be considered to have been made by the Canadian corporation, instead of being made or retained by another non-resident member of the corporate group, primarily for *bona fide* purposes other than to obtain a tax benefit. The definition of “tax benefit” in the general anti-avoidance rule (GAAR) will apply for this purpose. The draft legislation contained in the NWMM sets out the factors that are to be given primary consideration in determining whether the “business purpose” test will be satisfied. Those factors include the degree of connection of the Canadian corporation’s business to the foreign corporation’s business, whether the Canadian corporation’s investment in the foreign corporation will enable the Canadian corporation to fully participate in the profits of the foreign corporation or any appreciation in value of the foreign corporation, whether the investment is made at the direction or request of a non-resident corporation that does not deal at arm’s length with the Canadian corporation, whether negotiations with respect to certain investments were initiated by senior officers of the Canadian corporation and who are residents in and working principally in Canada, whether such officers exercised the principal decision-making authority with respect to the investments, whether the performance or compensation of such officers is connected to the results of the foreign corporation and whether senior officers of the foreign corporation are functionally accountable to such senior officers of the Canadian corporation. Comments on the proposed factors are invited before June 1, 2012.

The proposed amendments will apply to transactions implemented on or after the Budget Date. Limited grandfathering is provided for transactions between arm’s length parties that are obligated to complete a transaction pursuant to a written agreement entered into before the Budget Date.

**Thin Capitalization**

Budget 2012 proposes significant changes to the thin capitalization regime. The proposed changes generally expand the scope of the thin capitalization rules by:

- increasing the restriction on the deductibility of interest paid to specified non-residents by reducing the permitted debt-to-equity ratio from 2:1 to 1.5:1;
- extending the rules to include debts owed by partnerships; and
- deeming interest that is disallowed under the thin capitalization rules to be a dividend for Part XIII withholding tax purposes.

The proposed changes also contain a relieving proposal that is intended to prevent double taxation in certain circumstances where a Canadian corporation borrows money from its controlled foreign affiliate.
Reduction in Debt-to-Equity Ratio

With the exception of the expansion of the thin capitalization rules to partnerships (discussed below), Budget 2012 does not propose to change how the debt-to-equity ratio of a corporation is to be calculated. However, the allowable debt-to-equity ratio, as calculated under the existing rules, is reduced from 2:1 to 1.5:1.

Budget 2012 indicates that the rationale for the reduction is that the current 2:1 ratio is high relative to world standards because the ratios in many other countries apply to broader measures of debt, such as third-party debt guaranteed by a foreign parent or, in some cases, all debt owing to third parties.

This change applies for taxation years that begin after 2012. There is no grandfathering provision for pre-existing debt. Therefore, if enacted, the proposals will require Canadian corporations with outstanding debts to specified non-residents (including partnership debts that are deemed to be owed by the corporation as described below) that result in debt-to-equity ratios in excess of the 1.5:1 to reorganize their capital structures prior to the commencement of their first taxation year beginning after 2012 in order not to be subject to the interest denial rules.

Expansion of Thin Capitalization Rules to Partnership Debts

Currently, the thin capitalization rules refer only to debts owing by corporations. Subject to the potential application of the GAAR, it is generally accepted that where a Canadian corporation holds an interest in a partnership and the partnership owes a debt to a specified non-resident shareholder of the corporate partner, the partnership debt does not need to be taken into account in determining whether the thin capitalization rules apply to the corporation.

Budget 2012 proposes to expand the thin capitalization rules to apply to debts owing by partnerships. The proposals do not provide for a separate debt-to-equity calculation at the partnership level. Instead, each member of a partnership will be deemed to owe that partner’s specified proportion (generally, the partner’s proportion of the income or loss of the partnership) of the debts owed by the partnership for the purposes of computing the debt-to-equity ratio of a corporate partner. Where the debt-to-equity ratio of the corporate partner (taking into account the partner’s portion of the partnership debt) exceeds the allowable debt-to-equity ratio, the partnership’s interest deduction will not be denied; rather, the corporate partner will be required to include an amount in its income equal to the interest on the portion of the allocated partnership debt that exceeds the allowable debt-to-equity ratio.

Budget 2012 provides the following example illustrating how these proposals are intended to operate:

Canco 1 and Canco 2 are Canadian-resident corporations and are equal partners in a partnership that earns income from a business. Canco 1 is wholly owned by Forco, a non-resident corporation. The Canco 1 shares owned by Forco have paid-up capital of $4,000 but Canco 1 has no other capital for the purposes of the thin capitalization rules. Forco lends $3,000 to the partnership and lends $8,500 directly to Canco 1.

Canco 1 has a 50-per-cent interest in the partnership and will therefore be allocated 50 per cent of the partnership loan ($1,500) for thin capitalization purposes. Canco 1 has capital of $4,000 and is
considered to have outstanding debts to a specified non-resident (Forco) of $10,000 ($8,500 debt owed by Canco 1 to Forco plus $1,500 in debt allocated from the partnership).

With a permitted debt-to-equity ratio of 1.5-to-1, Canco 1 has $4,000 of total excess debt – that is ($10,000 – 1.5 x $4,000)/$10,000, or 2/5, of $10,000. This 2/5 ratio is applied to interest on the debt owed directly to Forco by Canco 1 as well as the debt allocated from the partnership to determine how much interest is denied, or added back to income, respectively. Accordingly, 2/5 of the interest deduction in respect of the $8,500 direct loan from Forco will be denied and an amount equal to 2/5 of the deductible interest expense in respect of the $1,500 debt allocated from the partnership will be required to be included in computing the income of Canco 1 from the partnership’s business.

There does not appear to be any de minimus interest or other form of exception to the proposed rules. Therefore, it appears that the proposed rules could result in a corporation exceeding the prescribed debt-to-equity ratio in situations where the corporate partner holds an interest in a partnership but has no influence over the borrowings of the partnership. In addition, there is no clear explanation of how the proposals are intended to apply to a tiered partnership structure. Presumably, the specified proportion of a debt would flow through a tier of partnerships to a corporate partner based on the specified proportion of the top-tier partnership in the debt of the lower-tier partnership.

These proposals will apply to debts of partnerships that are outstanding during corporate taxation years that begin on or after Budget Date.

**Disallowed Interest Deemed to be Dividends**

Currently, interest expense of a corporation that is not deductible as a result of the application of the thin capitalization rules is treated as interest for withholding tax purposes under Part XIII of the Tax Act. Therefore, generally speaking, unless the interest is payable to a person that is not dealing at arm’s length with the payor or is participating interest, such interest is not subject to withholding tax under paragraph 212(1)(b) of the Tax Act.

Budget 2012 proposes to recharacterize interest that is disallowed by the thin capitalization rules as a dividend for the purposes of Part XIII withholding tax. For these purposes, any amount that is included in computing a corporation’s income as a result of the partnership deeming rule discussed above is deemed to be a disallowed interest expense and is recharacterized as a dividend. Since the dividend withholding tax rate under the Tax Act is 25%, and most of Canada’s tax treaties provide a maximum reduction in the dividend withholding tax rate to 5% (as opposed to the 0% rate provided for interest), in many cases this proposed recharacterization will increase the withholding tax liability associated with such “excessive” interest.

**Foreign Affiliate Loans**

The proposed changes to the thin capitalization rules contain one relieving measure. Under the current rules, in some circumstances the thin capitalization rules could apply to loans made to a Canadian-resident corporation by one or more of its controlled foreign affiliates.

For example, consider the situation where a Canadian-resident corporation (Canco) is a wholly-owned subsidiary of a Canadian public company (Parent) and a non-resident wholly-owned subsidiary of Canco (CFA)
loans money to Canco (CFA Loan). Parent and CFA are related, and therefore deemed not to be dealing at arm’s length, with the result that under the current definitions of “outstanding debts to specified non-residents” and “specified shareholder” in subsection 18(4) of the Tax Act, the CFA Loan will be included in calculating Canco’s debt-to-equity ratio. The interest received by CFA on the CFA Loan may also be included in computing Canco’s foreign accrual property income (FAPI), which is taxed currently on an accrual basis. Therefore, where the thin capitalization rules apply, Canco is prevented from deducting interest on the CFA Loan and is at the same time subject to tax on the interest in the form of FAPI.

In order to avoid this inappropriate result, Budget 2012 proposes to exclude an interest expense of a Canadian-resident corporation from the thin capitalization rules to the extent it is included in computing the corporation’s FAPI. Generally, the amount of interest excluded from the application of the thin capitalization rules is reduced by the amount of any deduction to which the Canadian-resident corporation is entitled under subsection 91(4) in respect of foreign taxes paid.

Possible Relieving Measure for Canadian Banks

Budget 2012 proposes to amend the “base erosion” rules in the foreign affiliate regime to:

- facilitate access by Canadian banks to the liquidity of their foreign affiliates for use in the their Canadian operations; and
- ensure that certain securities transactions undertaken in the course of a bank’s business of facilitating trades for arm’s length customers are not inappropriately caught by the rules.

The FAPI of a controlled foreign affiliate of a Canadian taxpayer is subject to Canadian tax on an accrual basis. FAPI includes not only passive-type income of a foreign affiliate, but also certain income of the foreign affiliate that would otherwise be income from an active business except for the application of certain deeming rules (known as the base erosion rules).

Introduced as part of the 1994 Budget, the base erosion rules were intended to prevent undue erosion of the Canadian tax base by subjecting certain types of active business income of a foreign affiliate perceived to have been diverted from Canada to current tax in Canada under the FAPI regime. Subject to certain exceptions, the rules deem income of a foreign affiliate from debt or lease obligations of Canadian residents, from the sale of property (to a related Canadian) and from the provision of certain services to be income from a business other than an active business and thus included in computing the FAPI of the foreign affiliate.

The rules have proven to be particularly restrictive to Canadian banks in accessing funds held by their foreign affiliates and in facilitating certain types of securities transactions with clients. The current exceptions to the rules are not sufficiently broad.

Budget 2012 states that amendments will be developed in conjunction with industry representatives to alleviate the tax cost to Canadian banks of using excess liquidity of their foreign affiliates in their Canadian operations and that amendments will also be developed to ensure that certain securities transactions undertaken in the course of a bank’s business of facilitating trades for arm’s length customers are not inappropriately caught by the base erosion rules.
Transfer Pricing Secondary Adjustments

Transfer pricing rules are intended to ensure that prices charged between non-arm’s length parties reflect prices that would have been charged had those parties been dealing at arm’s length. Generally, subsection 247(2) provides that where a taxpayer (or a partnership) and a non-resident person with whom the taxpayer does not deal at arm’s length are participants in a transaction (or a series of transactions) and the terms or conditions made or imposed, in respect of the transaction, between any of the participants in the transaction differ from those that would have been made between persons dealing at arm’s length, or the transaction would not have been entered into between persons dealing at arm’s length and can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit, the CRA may adjust the quantum or nature of the amounts in respect of the taxpayer to reflect such amounts that would have been determined had the participants been acting at arm’s length. This is commonly referred to as a “primary adjustment”. However, the CRA also generally makes a so-called “secondary adjustment,” such as under section 15 and paragraph 214(3)(a), deeming the non-resident shareholder of the Canadian taxpayer to have received a dividend subject to withholding tax under Part XIII of the Tax Act. Currently, there is no specific provision in the transfer pricing rules that deals with secondary adjustments.

Deemed dividends to non-residents

In accordance with the recommendations issued by the Transfer Pricing Subcommittee of the Advisory Panel on Canada’s System of International Taxation, Budget 2012 proposes to amend section 247 of the Tax Act to treat secondary adjustments as dividends for Part XIII tax purposes. Generally, if a Canadian corporation would have a transfer pricing adjustment for a taxation year if the Canadian corporation had undertaken no transactions other than those in which a non-arm’s length, non-resident person was a participant, a dividend is deemed to have been paid by the Canadian corporation and received by the non-resident person at the end of that taxation year regardless of whether the non-resident person is a shareholder of the Canadian corporation. The amount of the dividend would be equal to the amount of the primary adjustment that relates to the non-resident person.

Budget 2012 also provides that where a secondary adjustment dividend is deemed to have been paid by a Canadian corporation and received by a non-resident person, and a repatriation amount has been paid (with the concurrence of the Minister of National Revenue) by the non-resident person to the Canadian corporation, the amount of the dividend may be reduced to the amount the Minister of National Revenue considers appropriate having regard to all the circumstances, including the amount of the dividend and the amount of the payment.

In addition, it is proposed that section 15, subsection 56(2) and section 246 not apply where a secondary adjustment dividend is deemed to have been paid by a Canadian corporation and received by a non-resident person.

These proposed changes are generally a codification of the current CRA administrative policy, except that they may in certain cases change the person who is deemed to have received a secondary adjustment dividend. Whereas previously the non-resident shareholder was deemed to have received a dividend regardless of whether such shareholder was a party to a transaction, Budget 2012 proposes to deem the non-resident party
to the transaction to have received the dividend whether or not the non-resident party is a shareholder of the Canadian corporation.

The aforementioned measures are proposed to apply to transactions (including transactions that are part of a series of transactions) that occur on or after the Budget Date.

**Overseas Employment Tax Credit**

Currently, employees who are resident of Canada and who qualify for the Overseas Employment Tax Credit (OETC) are entitled to a tax credit equal to the federal income tax otherwise payable (calculated using the employee’s average tax rate) on 80% of their qualifying foreign employment income, up to a maximum foreign employment income of $100,000. The OETC is deductible in determining an employee’s tax payable.

Budget 2012 proposes to phase out the OETC over four years, beginning with the 2013 taxation year, as follows:

- 60% for the 2013 taxation year;
- 40% for the 2014 taxation year;
- 20% for the 2015 taxation year; and
- 0% for the 2016 and subsequent taxation years.

The phase-out will not apply to qualifying foreign employment income earned by an employee in connection with a project or activity to which the employee’s employer had committed in writing before the Budget Date. An irrevocable bid tendered in writing before the Budget Date will be considered a commitment in writing for these purposes. Where the phase-out does not apply, the OETC will remain at 80% for the 2013 through 2015 taxation years and will be eliminated for the 2016 and subsequent taxation years.

**PERSONAL MEASURES**

**Extension of the Mineral Exploration Tax Credit for Flow-Through Share Investors**

Budget 2012 proposes a further one-year extension of the tax credit for individuals who invest in flow-through shares. The credit is equal to 15% of specified mineral exploration expenses (generally grass roots exploration) incurred in Canada and renounced to individual flow-through share investors.

The extension will apply to specified mineral exploration expenses incurred by a corporation after March 2012 and before 2014 pursuant to a flow-through share agreement entered into before April 2013. The one year look-back rule will apply so that if the conditions for the application of the rule are met, expenses incurred on or before December 31, 2014 and renounced effective December 31, 2013 will qualify.

**Life Insurance Policies**

Life insurance contracts provide protection (i.e., insurance) and may also provide a savings or investment component. The investment component is not subject to taxation on an accrual basis if the policy qualifies as an exempt policy. In order to be an exempt policy, the policy must meet certain conditions set out in the
Regulations under the Tax Act which, in general terms, require that the accumulating fund of the policy (the savings element) may not exceed the accumulating fund of an exemption test policy.

Budget 2012 proposes to change the exemption test as follows:

- measuring the savings in the actual policy and the exemption test policy using the Canadian Institute of Actuaries 1986-1992 mortality tables and an interest rate of 3.5% to better reflect mortality rates and investment returns;
- increasing the endowment time of the exemption test policy from age 85 years to age 90 years to reflect increased life expectancy;
- measuring the savings in the actual policy using the greater of the cash surrender value of the policy (before the application of surrender charges) and the net premium reserve in respect of the policy to capture all savings in the actual policy; and
- reducing the pay period of the exemption test policy from 20 years to eight years to reflect current industry practices and the pay period used in other countries.

Budget 2012 proposes that the tax imposed under Part XII.3 of the Tax Act on the investment income of life insurers be recalibrated to neutralize impacts of these changes on the investment income tax base. Consultations with key stakeholders are proposed.

The amendments will apply to life insurance policies issued after 2013.

**Eligible Dividends – Split-Dividend Designations and Late Designation**

When corporate profits are distributed as taxable dividends to individual shareholders, the Tax Act permits them to claim dividend tax credits (DTCs) against their taxes otherwise payable. This provides partial relief against double taxation.

The amount of the DTC depends on the type of dividend paid by a corporation to a shareholder. Eligible dividends, which generally are dividends paid out of income that was taxed at the general corporate income tax rate, qualify for an enhanced DTC. Taxable dividends that are not eligible dividends are generally paid out of income which was taxed at a lower rate (e.g., the small business income tax rate) and they only qualify for the regular DTC.

The current provisions of the Tax Act permit the payment by a corporation of an eligible dividend only if, at the time the dividend is paid, the corporation notifies each shareholder in writing that the dividend is designated as an eligible dividend. Late designations are not permitted, even where a corporation had sufficient income taxed at the general corporate rate to make an eligible dividend designation. Further, the Tax Act currently does not permit a corporation to designate only a portion of a dividend paid as an eligible dividend.

Budget 2012 proposes relieving measures that will permit a corporation to designate any portion of a taxable dividend paid to be an eligible dividend and to permit the Minister of National Revenue to accept a corporation’s late designation of an eligible dividend.
In respect of dividends paid on or after the Budget Date:

- A corporation paying a taxable dividend will be permitted to designate, at the time it pays a taxable dividend, any portion of the dividend as an eligible dividend. The portion of the dividend so designated will qualify for the enhanced DTC, and the remaining portion will qualify for the regular DTC.
- The Minister will be authorized to accept a late designation by a corporation provided that:
  - the late designation is made within three years of payment of the dividend; and
  - the Minister of National Revenue is of the opinion that accepting the late designation would be just and equitable in the circumstances, including to affected shareholders.

**Retirement Compensation Arrangements**

Retirement Compensation Arrangements (RCAs) are generally used to fund the portion of a higher-income employee’s pension benefits that exceed the maximum pension benefit permitted under the registered pension plan rules. RCAs are exempt from regular Part I income tax, and contributions made to an RCA are generally deductible in computing income. However, a 50% refundable RCA tax is imposed on contributions to any RCA and on income and gains earned or realized by an RCA. The RCA tax is generally refunded as taxable distributions are made from the RCA. A special rule permits an RCA to obtain a refund of RCA tax where the RCA has suffered investment losses.

The CRA is currently challenging certain tax-motivated arrangements that are considered not to be consistent with the policy intent of the RCA rules (e.g., certain arrangements that in effect indirectly strip out the RCA’s investment assets while allegedly still permitting refundable tax to be claimed). In addition, Budget 2012 proposes specific measures to prevent the use of similar schemes in the future.

Budget 2012 proposes a new restriction on RCA tax refunds in circumstances in which RCA property has lost value. In addition, Budget 2012 proposes new prohibited investment and advantage rules, modeled very closely on similar rules applicable to tax-free savings accounts (TFSAs) and to registered retirement savings plans (RRSPs), to prevent RCAs from engaging in non-arm’s length transactions.

Specifically:

- For RCA tax on RCA contributions made on or after the Budget Date, the RCA tax will be refunded in respect of a decline in value of RCA property only where the decline in value of the property is not reasonably attributable to prohibited investments or advantages, unless the Minister is satisfied that it is just and reasonable to refund the RCA tax, having regard to all the circumstances.
- The prohibited investment rules (which are to apply in respect of investments acquired, or that become prohibited investments, on or after the Budget Date) will apply in respect of RCAs that have a “specified beneficiary,” generally an employee entitled to benefits under the RCA who has a significant interest in his or her employer. The RCA will be liable to pay a 50% tax on the fair market value of any prohibited investment acquired or held by the RCA. The specified beneficiary will be jointly and severally, or solidarily, liable, to the extent of his or her participation, for the tax.
• The tax on prohibited investments will be refundable if the RCA disposes of the prohibited investment by the end of the year following the year in which it was acquired, or such later time as the Minister of National Revenue considers reasonable, unless any of the persons liable for the tax knew or ought to have known that the investment was a prohibited investment.

• The Tax Act currently includes advantage rules, subjecting an RCA to a special tax equal to the fair market value of the advantage. Budget 2012 proposes that the definition of “advantage” be adapted to address the specific forms of tax planning that have been identified in relation to RCAs, including in respect of what will be called “RCA strips,” a new definition that will be similar to the analogous definition applicable to RRSPs. RCA strips will include situations in which an RCA holds a promissory note issued by a non-arm’s length debtor in respect of the RCA where the debtor fails to make commercially reasonable payments of principal and interest on the promissory note. RCA strips will also include situations in which an RCA buys a property, the value of which is later intentionally eroded or transferred from the RCA without adequate consideration.

• Similar to the proposals dealing with the tax on prohibited investments, a specified beneficiary of the RCA that participates in extending the advantage will be jointly and severally, or solidarily, liable, to the extent of his or her participation, for the special tax in respect of RCA advantages.

• The special tax on RCA advantages will generally apply to advantages extended, received or receivable on or after the Budget Date, including advantages that relate to RCA property acquired, or transactions occurring, before the Budget Date. However, elective transitional rules will be available in respect of property acquired, or transactions occurring, before the Budget Date. These rules provide that if the amount of an advantage conferred on a specified beneficiary is included in computing the income of the specified beneficiary, the amount will not be subject to the special tax. Further, if the RCA property acquired, or transaction occurring, before the Budget Date causes an advantage to be obtained by the RCA on or after the Budget Date, the amount of the advantage will not be subject to the special tax provided that the amount is distributed from the RCA and included in the income of a beneficiary or an employer in respect of the RCA. Such distributions will be treated as regular taxable distributions for the purpose of determining RCA tax.

• The Minister of National Revenue will have the power to waive or cancel the tax on prohibited investments or the special tax on advantages, as the case may be, where the Minister of National Revenue is satisfied that it is just and equitable to do so, having regard to all the circumstances.

Employee Profit Sharing Plans

Employee profit sharing plans (EPSPs) are arrangements intended to allow employers to share profits with employees, assist employees to save, and better align the economic interests of employers and employees.

Contributions by an employer to an EPSP trust are tax-deductible. Such contributions, together with profits from the trust property, capital gains and losses, and certain amounts in respect of forfeitures, are allocated by the trustee to beneficiaries annually and must generally be included in computing the income of the beneficiaries at such time.
There is currently no limit on the amount of employer contributions that can be made to an EPSP other than the general restriction in section 67 precluding the deduction of an amount in excess of a reasonable amount. In addition, there is no withholding on employer contributions to an EPSP.

Budget 2012 expresses a concern that EPSPs are being used by some business owners to direct profits to family members in order to reduce or defer the payment of taxes on such profits. Budget 2012 therefore proposes a measure to discourage excessive employer contributions.

Pursuant to this proposal, a special tax will be payable under new Part XI.4 of the Tax Act by a “specified employee” on an “excess EPSP amount”. In this regard:

- A specified employee of an employer is an employee who is a specified shareholder of the employer (i.e., who owns or is deemed to own at least 10% of the issued shares of any class or series of the employer) or who does not deal at arm’s length with the employer.
- The “excess EPSP amount” of a specified employee for a taxation year in respect of an employer is the amount by which the employer’s EPSP contribution allocated to the employee for the year exceeds 20% of the employee’s income for the year from employment with the employer (computed without reference to stock option benefits and employment-related deductions).
- The special tax will consist of two components. The first is the top federal marginal tax rate of 29%. The second depends on the employee’s residence at the end of the year. It will be 0% if the employee is resident in Québec (presumably because Québec is expected to harmonize its legislation with the Tax Act), the highest provincial personal rate of the employee’s province of residence, or 14% in any other case.
- The specified employee will be entitled to deduct the excess EPSP amount for the year in computing the employee’s income from employment (except to the extent that the tax has been waived or cancelled in respect of the excess EPSP amount) in order that it not also be subject to regular income tax.
- The Minister of National Revenue may waive or cancel all or part of the specified employee’s liability to pay the special tax if the Minister of National Revenue considers it just and equitable to do so.

The new measures will apply in respect of EPSP contributions made by an employer on or after the Budget Date, other than contributions made before 2013 pursuant to a legal obligation arising under a written agreement or arrangement entered into before the Budget Date.

**Group Sickness or Accident Insurance Plans**

Where an employer contributes to a group insurance plan in respect of an employee, an amount is normally included in the employee’s income either when the employer contributions are made to the plan or when benefits are received under the plan.

Wage-loss replacement benefits payable on a periodic basis under a group sickness or accident insurance plan to which an employer has contributed are included in an employee’s income for tax purposes when the benefits are received.
However, under the current rules, no amount is included in the employee’s income to the extent that the benefits are either:

- not payable on a periodic basis; or
- payable in respect of a sickness or accident insurance plan when there is no loss of employment income.

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.

These measures, which will not apply in respect of private health services plans (or other plans described in paragraph 6(1)(a) of the Tax Act), will apply in respect of employer contributions made on or after the Budget Date to the extent that the contributions relate to coverage after 2012. However, pursuant to grandfathering provisions, contributions made on or after the Budget Date and before 2013 will be included in the employee’s income for 2013.

**Registered Disability Savings Plans**

A Registered Disability Savings Plan (RDSP) may be established for an individual who is eligible for the disability tax credit. The individual eligible for the credit is the plan beneficiary. The plan holder (the individual who generally opens the RDSP and who makes decisions regarding contributions, investments and withdrawals) can be the beneficiary, a legal representative of the beneficiary or, where the plan is opened for a minor, a parent of the beneficiary.

Parents, beneficiaries and others wishing to save on behalf of the beneficiary are allowed to contribute to an RDSP until the end of the year in which the beneficiary turns 59, up to a lifetime maximum contribution in respect of the RDSP beneficiary of $200,000. Subject to specific rules and thresholds, annual RDSP contributions attract Canada Disability Savings Grants up to a lifetime maximum of $70,000. In addition, the Government provides up to $1,000 in Canada Disability Savings Bonds annually to RDSPs established by modest-income families, up to a lifetime maximum of $20,000. The grants and bonds may be received until the end of the year in which the beneficiary turns 49.

Contributions to an RDSP are not deductible and are not included in the beneficiary’s income when withdrawn. Investment income in an RDSP grows tax-free. However, the grants, bonds and investment income earned in an RDSP are included in the beneficiary’s income for tax purposes when withdrawn from the RDSP. Such withdrawals, which must commence by the end of the year in which the beneficiary turns 60, comprise a taxable portion and a non-taxable portion based upon the relative proportion of taxable assets (including grants, bonds and investment income) and non-taxable assets (private contributions) in the plan.

Budget 2012 proposes a number of changes to the rules governing RDSPs. The following discussion provides an overview of the proposed changes.
**Plan Holders**

Current rules require that when an RDSP is established for a beneficiary who has attained the age of majority, the plan holder must be either the beneficiary or, if the beneficiary lacks the capacity to enter into a contract, the beneficiary’s guardian or other legal representative.

In many provinces and territories, the only way that an RDSP can be opened where there is doubt as to the legal capacity of an adult with disabilities is for the individual to be declared legally incompetent and to have someone named as their legal representative. This process can be time-consuming and expensive, and may have significant repercussions for the individual.

Budget 2012 proposes to allow, from the date of Royal Assent until the end of 2016, certain family members to become the plan holder of the RDSP for an adult individual who may be legally incompetent. This proposed measure is only temporary, to permit the provinces and territories to develop more appropriate, long-term solutions to address RDSP legal representation issues.

These proposals will permit a qualifying family member (the individual’s spouse, common law partner or parent) to establish an RDSP for the individual where, in the opinion of the RDSP issuer, the individual’s ability to enter into a contract is in doubt. The proposals will require RDSP issuers to notify an individual when a qualifying family member establishes an RDSP for which the individual is the beneficiary and will include provisions that in particular circumstances will replace the qualifying family member with the individual or the individual’s legal representative, as appropriate.

**Proportional Repayment Rule**

The current RDSP rules generally provide for repayment to the Government of grants and bonds paid to an RDSP in the preceding 10 years where any amount is withdrawn from the RDSP, the RDSP is terminated or deregistered, or the RDSP beneficiary ceases to be eligible for the disability tax credit or dies.

Budget 2012 proposes to introduce a proportional repayment rule applicable to RDSP withdrawals. Simplified, this rule will require that, for each $1 withdrawn from an RDSP, $3 of any grants or bonds paid into the plan in the 10 years preceding the withdrawal be repaid.

**Maximum and Minimum Withdrawals**

Budget 2012 proposes changes applicable after 2013 to the rules governing maximum and minimum withdrawals from RDSPs. The changes will provide greater flexibility to make withdrawals from certain RDSPs by increasing the annual maximum withdrawal limit that applies to these RDSPs, and ensure that RDSP assets are used to support a beneficiary during his or her lifetime by requiring a minimum amount to be withdrawn from all RDSPs beginning in the year in which a beneficiary turns 60.

**Rollover of RESP Investment Income**

Budget 2012 proposes to allow investment income earned in a Registered Education Savings Plan (RESP) to be transferred on a tax-free basis to an RDSP if the plans share a common beneficiary.
The rollover will be available after 2013 provided that:

- the beneficiary meets the age and residency requirements applicable to RDSP contributions generally; and
- one of the following conditions is met:
  - the beneficiary has a severe and prolonged mental impairment that can reasonably be expected to prevent the beneficiary from pursuing post-secondary education;
  - the RESP has been in existence for at least 10 years and each beneficiary is at least 21 years of age and is not pursuing post-secondary education; or
  - the RESP has been in existence for more than 35 years.

Under this proposal, when RESP investment income is rolled over to an RDSP, contributions in the RESP will be returned to the RESP subscriber on a tax-free basis. The subscriber can contribute these amounts to the RDSP, immediately or over time, if he or she so chooses. On such a rollover, Canada Education Savings Grants and Canada Learning Bonds in the RESP will be required to be repaid to the Government and the RESP terminated. However, the rollover amount will not be subject to tax. The rollover amount may not exceed, and will reduce, the beneficiary’s available RDSP contribution room, and will be subject to certain specific provisions.

**Cessation of Eligibility for the Disability Tax Credit**

Currently, where the condition of an RDSP beneficiary improves such that the beneficiary no longer qualifies for the disability tax credit for a taxation year, the RDSP must be terminated by the end of the following year.

Budget 2012 proposes that, where an election is made on or before December 31 of the year following the first full calendar year for which the beneficiary is ineligible for the credit, the period for which an RDSP may remain open is extended provided that a medical practitioner certifies in writing that the nature of the beneficiary’s condition makes it likely that the beneficiary will, because of the condition, be eligible for the credit in the foreseeable future. Special rules will apply where an election is in force (e.g., prohibiting new contributions and new grants and bonds). The election will generally be valid until the end of the fourth calendar year for which a beneficiary is ineligible for the credit, following which the RDSP must generally be terminated. Very generally, this measure will apply to elections made after 2013.

**Medical Expense Tax Credit**

The Medical Expense Tax Credit provides federal income tax relief equal to 15% of eligible medical and disability-related expenses in excess of the lesser of:

- 3% of the taxpayer’s net income; and
- an indexed dollar amount ($2,109 in 2012).

Budget 2012 will expand slightly the list of expenses eligible for the credit.
Such eligible expenses will include the cost of a blood coagulation monitor for use by an individual who requires anti-coagulation therapy, including associated disposable peripherals such as pricking devices, lancets and test strips, provided that:

- the expenses were incurred after 2011; and
- the monitor was prescribed by a medical practitioner.

**OTHER INCOME TAX MEASURES**

**Gifts to Foreign Charitable Organizations**

While foreign charities are generally not qualified donees under the Tax Act so that donations to such charities are not eligible for the credit or deduction for charitable donations, a foreign charitable organization to which the Government of Canada has made a gift within a prescribed time period will be a qualified donee if it is registered with the Minister of National Revenue. A small number of organizations currently qualify.

Budget 2012 proposes to modify the rules for registering foreign charitable organizations as qualified donees. A foreign charitable organization that receives a gift from the government of Canada may be designated as a qualified donee by the Minister of National Revenue, in consultation with the Minister of Finance, if the Minister of National Revenue is satisfied that the charitable organization is pursuing activities:

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

The designation will apply for a 24-month period that includes the time that the government made its gift.

The new rule will apply to applications made by foreign charitable organizations on or after the later of January 1, 2013 and the date that the enacting legislation receives Royal Assent. Foreign charitable organizations that have received qualified donee status under the existing rules will continue to be qualified donees until the expiration of their current status.

**Political Activities of Charities**

The Tax Act requires registered charities to operate exclusively for charitable purposes. In addition, a registered charity may devote part of its resources to political activities that are ancillary and incidental to its charitable purposes where such activities do not include the direct or indirect support of, or opposition to, any political party or candidate for political office. Analogous rules apply to a registered Canadian amateur athletic association (RCAAA).

Under the Tax Act, the amount of a gift made by a registered charity to another qualified donee is treated as having been devoted by the former to its charitable purposes and activities even if it is used by the latter for political activities. Budget 2012 states that this may allow a charity to pursue indirectly political activities beyond which it would be permitted to do directly. Budget 2012 proposes that where a gift is made to a qualified donee and it can be reasonably considered that a purpose of the gift is to support the political...
activities of the qualified donee (e.g., if it were earmarked for this purpose), the making of the gift will be considered to be a political activity and will not be treated as a charitable purpose.

Budget 2012 proposes that the Minister may suspend for a one-year period the ability of a registered charity or RCAAA to issue donation receipts if it devotes resources to political activities that are not treated as being devoted to its charitable purposes or activities or, in the case of an RCAAA, to its exclusive purpose and exclusive function.

Budget 2012 also proposes to allow the Minister of National Revenue to suspend the ability of a registered charity or RCAAA to issue a donation receipt if it fails to report information required to be included in its annual information return.

These amendments are to be effective on Royal Assent to the enacting legislation.

**Tax Shelter Administrative Changes**

Budget 2012 proposes to modify the tax shelter registration and reporting regime by:

- providing for a potential increase in the penalties associated with tax shelter promoters that participate in unregistered charitable donation tax shelters;
- introducing a new penalty for promoters that fail to comply with a demand to file an annual return or to report in the return the information prescribed by paragraphs 237.1(7)(a) and (b) of the Tax Act (being the name, address and SIN or business number of each person that acquires or invests in the tax shelter and the amount paid by each such person in respect of the tax shelter, respectively); and
- limiting the period for which a tax shelter identification number is valid to one calendar year.

Each of these proposals is summarized briefly.

**Unregistered Charitable Donation Tax Shelters**

Subsection 237.1(7.4) of the Tax Act imposes a penalty on any person (normally the tax shelter promoter) who sells an interest in, or accepts consideration in respect of, a tax shelter that is not registered with the CRA, or who files false or misleading information in an application to register a tax shelter. Currently, the penalty is the greater of $500 and 25% of the consideration received or receivable from a person in respect of the tax shelter before the correct information is filed with the Minister of National Revenue or the identification number is issued, as applicable.

Budget 2012 expresses the concern that, in the context of some charitable donation tax shelters, the cost to participants of the property acquired may be relatively small in relation to the tax savings that the promoter asserts are available to participants and that, in these cases, the penalty may not be effective in encouraging compliance by the promoter.

Budget 2012 proposes that the penalty imposed under subsection 237.1(7.4) be equal to the greater of the amount determined under the pre-Budget 2012 rules and 25% of the amount asserted by the promoter to be
the value of property that participants in the tax shelter can transfer to a qualified donee. This change is to be effective on Royal Assent to the enacting legislation.

**Unreported Tax Shelter Sales**

Under the current rules, a promoter who accepts consideration or acts as a principal or agent in respect of a tax shelter and fails to file the required return is subject to a maximum penalty of $2,500.

Budget 2012 proposes to impose an additional penalty on promoters who fail to file the required return, or fail to include certain required information in the return. The new penalty will be equal to 25% of the greater of:

- the consideration received or receivable by the promoter in respect of interests in the tax shelter that should have been, but were not, reported in the return; and
- if the tax shelter is a gifting arrangement, the total of the amounts stated or represented to be the value of property that the particular person could donate to a qualified donee.

This new penalty is to be effective on Royal Assent to the enacting legislation.

**Limit on Period of Validity for Tax Shelter Identification Numbers**

Currently, tax shelter identification numbers do not have an expiration date. Therefore, once a promoter obtains a tax shelter identification number, the promoter may market that tax shelter for an indefinite period. Budget 2012 proposes that tax shelter identification numbers issued in respect of applications made on or after the Budget Date be valid only for the calendar year identified in the tax shelter identification number application. Tax shelter identification numbers issued as a result of applications made before the Budget Date will be valid until the end of 2013.

**GST AND CUSTOMS MEASURES**

**Goods and Services Tax, Harmonized Sales Tax and Excise Tax**

Most small businesses and public service bodies (PSBs) can elect to use the Quick or Special Quick Method of accounting to determine the amount of GST/HST to remit. Under the current rules, small businesses can elect to use the Quick Method if their annual taxable sales (including those of associates) do not exceed $200,000; a sales threshold does not apply to PSBs. Also, most small businesses and PSBs can elect to use the Streamlined Input Tax Credit Method, which is generally available to a business or a PSB with annual taxable sales (including the sales of associates) not exceeding $500,000 and annual taxable purchases (excluding zero-rated purchases) not exceeding $2 million. To further simplify GST/HST compliance for small businesses and PSBs, Budget 2012 proposes to double the existing streamlined accounting dollar thresholds.

Basic health care services are exempt from GST/HST and certain drugs and medical devices are zero-rated. Budget 2012 proposes to improve the application of GST/HST to health care services, drugs and medical devices. Under the current rules, pharmacists’ drug dispensing services are zero-rated. Budget 2012 proposes to also zero-rate certain other non-dispensing health care services provided by pharmacists. With respect to corrective eyewear, Budget 2012 proposes to zero-rate corrective eyewear dispensed by an optician where certain conditions are met. Medical devices are eligible for zero-rating only when supplied on the written
order of a medical practitioner. Budget 2012 proposes to expand this exemption such that it will also be available when the devices are supplied on the written order of a registered nurse, occupational therapist or physiotherapist as part of his or her professional practice. Budget 2012 also proposes to add blood coagulation monitoring or metering devices (and associated test strips and reagents) to the zero-rated medical device list and to add the drug “Isosorbide-5-mononitrate” to the list of zero-rated prescription drugs.

Budget 2012 proposes to allow charities and qualifying non-profit literacy organizations prescribed by regulation to claim a rebate of the GST (and the federal portion of the HST) they pay to acquire printed books to be given away. Additionally, Budget 2012 proposes to provide tax relief in respect of foreign rental vehicles temporarily imported by Canadian residents.

Following the Minister of National Resources’ announcement that Canada will change its vehicle fuel consumption testing requirements to better align with the United States, the Excise Tax Act will be amended to ensure this does not affect the application of the Green Levy to certain fuel-inefficient vehicles.

**Trade and Tariff Measures**

To support the energy industry, effective in respect of goods imported after March 29, 2012, Budget 2012 proposes to eliminate the 5% Most-Favoured-Nation (MFN) rate of duty applicable to certain imported fuels used as production inputs in gas and oil refining as well as electricity production.

Effective in respect of travellers returning to Canada after May 31, 2012, Budget 2012 proposes to increase the specified dollar limits of the exemption that allows returning residents to bring back goods without having to pay duties or taxes. The dollar limit for returning Canadian residents who are out of the country for 24 hours or more will increase from $50 to $200. Also, the dollar limit for travellers who are out of the country for 48 hours or more will increase to $800, replacing the current 48-hour exemption of $400 and the current seven-day exemption of $750.

Other key trade measures addressed in Budget 2012 include:

- Legislation will be introduced to consolidate Canada’s trade remedy functions into the Canadian International Trade Tribunal (CITT); under the current trade remedy regime, the Canada Border Services Agency investigates whether imported goods are dumped and/or subsidized and the CITT conducts an inquiry into whether the dumping and/or subsidization of imports has caused or is threatening to cause injury to domestic production.
- The Costing Trade Act, which controls the entry of foreign vessels into Canada, will be amended to improve access to modern and reliable seismic data for offshore oil and gas development.
- Canada’s General Preferential Tariff regime, which accords preferential market access to imports from developing countries, will be reviewed to ensure alignment with Canada’s development policy objectives.
- Extensive consultations will be undertaken with the business community to refresh Canada’s Global Commerce Strategy and identify priority market for trade and investment opportunities.