Overview

Budget Steps Up the Pace of Reform

Prime Minister Stephen Harper's administration, secure for at least three more years in a parliamentary majority, uses its latest budget to implement an array of expected reforms that Finance Minister Jim Flaherty says are designed to sustain confidence at home and abroad while addressing the deficit. The reforms include tax adjustments, reductions in spending and the public service, streamlined regulation of resource development, and changes to social programs. "Other western countries face the risk of long-term economic decline", Mr. Flaherty said in his seventh budget speech to the House of Commons on March 29, 2012. "We have a rare opportunity to position our country for sustainable, long-term growth. Others now have little room to manoeuvre; we are free to choose our future."

Mr. Flaherty also pointed out that the Organization for Economic Cooperation & Development and the International Monetary Fund expect the Canadian economy to be a world leader over the next two years. However, the government was not interested in simply maintaining that edge. "We must also position Canada to compete successfully with the world's large and dynamic emerging economies", Mr. Flaherty stated. "In a changing global economy we must ... avoid falling behind."

Reviewing personal income tax measures that the Conservatives succeeded in getting through Parliament while in a minority, Mr. Flaherty said they had reduced the taxes paid by the average family of four by more than $3,100. At the same time, lower corporate taxes had given Canada a "significant advantage" with "the lowest overall tax rate on new business investment among major advanced economies." Coupled with an infrastructure-based economic stimulus agenda in response to the latest global economic downturn, Mr. Flaherty said these measures had sustained Canada through several difficult years. "Canada is one of only two G-7 countries to have recouped all the jobs lost during the global recession. In fact, since July 2009, our economy has created more than 610,000 net new jobs."

Mixed Bag of Tax Initiatives

No substantial new personal tax measures are set out in the budget, and the government indicated in its 498-page Budget Plan that since the federal personal tax burden is the lowest in 50 years, its focus for now is "keeping taxes low for families and individuals." For corporations, the focus is on what the government describes as "enhancing the neutrality of the tax system", including further rationalization of fossil fuel subsidies by phasing out tax preferences for resource industries while promoting "responsible" resource development, expanding trade, and further reducing bureaucratic red tape.

"There are some who would raise taxes, increase government spending, and shun new trading opportunities", Mr. Flaherty said, clearly taking aim at the New Democratic Party and the election of its new leader just a few days earlier. In contrast, Mr. Flaherty said, the Conservatives would "maintain our consistent, pragmatic, and responsible approach to the economy" to bolster Canadians' confidence in the country's prospects. "To provide this confidence, we must ensure that Canada's finances are sustainable over

the long term. To that end, we will fulfill the commitment we made in the Economic Action Plan budget of 2009, to return to balanced budgets in the medium term. We are on track. In less than two years, we have already cut the deficit in half. We did it by ending our targeted and temporary stimulus measures, and by controlling the growth of new spending."

Deficit Outlook Generally Positive

The deficit for the first 10 months of 2011-2012 was reported by the Finance Department on budget day as $15.98 billion, compared with $27.7 billion one year earlier. The cumulative gain reflected an increase in revenues, to $197.5 billion from $188.8 billion, and a slight drop in expenditures, to $187.4 billion from $190.6 billion.

The balance also reflected an increase in the cost of servicing the accumulated public debt — to $26.1 billion from $25.8 billion. The cumulative public debt, currently some $581 billion, is projected to continue rising slowly until it peaks at $613.9 billion in 2014-2015 before beginning to decline gradually as the government balances its annual books and potentially moves into a surplus position, declining to 28.5% of GDP by 2016-2017.

The Budget Plan indicates the push for balanced budgets in the medium term is "on track" — the 2011-2012 deficit should be approximately $8.5 billion lower than in 2010-2011, and is forecast to decrease by an additional $3.8 billion in 2012-2013 and continue to decline to $1.3 billion in 2014-2015. Expressed as a share of gross domestic product, program spending is projected to improve from 14.7% in 2010-2011 to 12.7% in 2016-2017, representing a return to pre-recession spending ratios.

"Canada expects to achieve, well ahead of schedule, its Group of 20 commitments to halve deficits by 2013 and stabilize or reduce total government debt-to-GDP ratios by 2016, as agreed to by G-20 leaders at their summit in Toronto in June 2010", the Budget Plan adds. "The International Monetary Fund projects that by 2016, Canada's total government net debt-to-GDP ratio will remain at about one-third of the G-7 average and more than 20 percentage points of GDP below that of Germany, the G-7 country with the next-lowest ratio."

A small but symbolic sign of the Conservatives' determination to cut costs is its decision to start with the smallest unit of the economy: the lowly penny, which it plans to eliminate. "Pennies take up too much space on our dressers at home", the Finance Minister explained. "They take up far too much time for small businesses trying to grow and create jobs." Mr. Flaherty pointed out that it costs the government 1.5 cents to produce each penny, and millions of them are not recirculated every year.

Restraint Reflected in Various Ways

As signalled by the Conservatives for months, the government plans to eliminate an initial 12,000 jobs over the next three years. The Budget Plan explains that this includes attrition through retirement or "other voluntary departures". The eventual overall reduction is about 19,200 positions, or 4.8%, including elimination of approximately 600, or 7.4% of executive positions, which the government says will bring the public service more in line with the private sector. "The planned reduction in employment would reverse only about 20% of the increase in federal public sector employment that has occurred since

the late 1990s", the Budget Plan states, adding that "a large proportion of full-time-equivalent reductions will occur in the National Capital Region."

Other savings will be achieved by eliminating what Mr. Flaherty described as "waste in the internal operations of government, making it leaner and more efficient." This includes a reduction in travel and more use of videoconferencing, which the Minister said makes it "easier" for public servants and "cheaper for taxpayers." Additionally, the government plans to publish more major documents electronically for Internet-based retrieval rather than going to the expense of printing. Characterizing his plans as "common-sense moderate restraint", which will amount to less than 2% of overall federal spending, Mr. Flaherty said that "we have no need to resort to the drastic cuts being forced upon some other developed countries" or to "the radical austerity measures imposed by the federal government in the 1990s."

On a related matter, the Finance Minister says the government will ensure that public service pension plans are "sustainable and financially responsible" by adjusting them to be what the Budget Plan describes as "broadly consistent" with the private sector. The eventual goal, "over time" and subject to negotiation with unions, is a 50/50 contribution which also would be applied to members of the Canadian Forces and the RCMP, as well as to MPs and the Senate, effective in the next Parliament.

The major change to social programs is a phased increase, beginning in 2023, in the age when individuals are eligible for the Old Age Security benefit. Although the Canada Pension Plan is considered to be "sound and fully funded", the OAS — even though it can be "clawed back" incrementally from higher-income recipients — is considered to be unsustainable because it was designed "for a much different demographic future." In the 1970s, there were seven workers for every person over 65; the expectation is that the ratio will be only 2:1 in 20 years. Coupled with increased life expectancy and declining birth rates, this has effectively left the government with no option but to reverse a trend it started several decades ago. "These adjustments will not affect current recipients or those close to retirement", Mr. Flaherty said. "We will gradually increase the age of eligibility, from 65 to 67. … We will also make the program more flexible for those approaching retirement." In addition, effective July 2013, Canadians who prefer to keep working past the usual retirement age will have the option of deferring benefits.

Mr. Flaherty also said that the government plans to modernize Employment Insurance in a bid to make it easier for unemployed persons "to identify new opportunities" and for employers to find workers. "For EI recipients in areas of sporadic employment, we will initiate modest changes to the program to better focus our support for Canadians who are eager to work." He also outlined plans for First Nations reserves to "participate fully in our economy and to gain greater self-sufficiency" beginning with new investments in schools and support for early literacy.

Innovation Seen as a Key

Mr. Flaherty made it clear that while "Canadians appreciate the fact that our country is outperforming our peers", they also understand the fragility of the global economy and the fact Canada has its own challenges. "We need to promote innovation more effectively, to keep creating good quality jobs." To that end, the Budget Plan outlined how the government plans to spend $400 million to increase private-sector

investments in "early-stage" risk capital, to increase the Business Development Bank of Canada's budget by $100 million, and to add $110 million to the National Research Council's budget for its Industrial Research Assistance Program, while also giving the NRC an additional $67 million in 2012-13 as it refocuses on industry-led research.

Stressing the importance of natural resources to continued prosperity, Mr. Flaherty pointed out that the petroleum, mining, and forestry sectors directly employ more than 750,000 Canadians. "They are driving economic growth across the country (and) offer huge potential to create even more jobs and growth, now and over the next generation . . . in every region", he said, adding that it is critical to develop new export markets to reduce dependence on the United States. "The booming economies of the Asia-Pacific region are a huge and increasing source of demand, but Canada is not the only country to which they can turn. If we fail to act now, this historic window of opportunity will close."

That is why, Mr. Flaherty explained, the government will implement "responsible resource development and smart regulation for major economic projects" while "respecting provincial jurisdiction and maintaining the highest standards of environmental protection." However, in a bid to streamline the review process, the emphasis will be on "one project, one review . . . in a clearly-defined time period." Moreover, Mr. Flaherty said, in a clear challenge to opponents of major pipeline projects, "we will ensure that Canada has the infrastructure we need to move our exports to new markets."

Trade Diversification Critical for Growth

Mr. Flaherty reiterated that a key element of the government's plan for long-term prosperity is "the most ambitious trade expansion plan in Canadian history." Experience has shown that opening new export markets provides an enormous long-term benefit and that given a level playing field, Canada can compete successfully. "While acknowledging the economic reality of the United States remaining Canada's most important trading partner, Mr. Flaherty said recent events and long-term trends warrant diversification. "We need to open new export markets in the world's emerging major economies while strengthening and expanding our existing trade relationships." Mr. Flaherty promised to "strengthen and deepen" economic and security links with the U.S., and said Canada would harmonize its duty and tax exemptions for trips to the U.S. Effective June 1, the 24-hour exemption increases to $200 from $50 and the 48-hour exemption to $800 from $400. The amount for absences of more than seven days rises to $800 from $750.

Editorial Comment on Notice of Ways and Means Motion Resolutions and Supplementary Budget Information

[The editorial comments following the Resolutions have been written by CCH, Joseph Frankovic and tax practitioners at Fraser Milner Casgrain LLP.]

That it is expedient to amend the *Income Tax Act* to provide among other things:

Resolution 1: Registered Disability Savings Plans

(1) That the provisions of the Act relating to registered disability savings plans be modified in accordance with the proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Budget 2012 proposes a number of changes to the rules governing Registered Disability Savings Plans (RDSPs) in section 146.4 of the Act.

These include changes to who may qualify as a plan holder in an RDSP, the introduction of a proportional repayment rule, changes to maximum and minimum withdrawals from an RDSP, the introduction of the rollover of RESP investment income to an RDSP, a new election to extend the duration of an RDSP where the beneficiary ceases to be eligible for the Disability Tax Credit (DTC), and administrative changes.

Plan Holders

Under the current RDSP rules, the plan holder of an RDSP must be either the beneficiary or a legal representative (where the beneficiary lacks the legal capacity to enter into a contract). However, there may be difficulties in establishing an RDSP where the potential beneficiary's capacity to enter into a contract is in doubt. Matters of capacity and legal representation are subject to provincial and territorial laws, and determining capacity and appointing a legal guardian can potentially be a lengthy process.

Budget 2012 proposes a temporary measure to allow certain family members to become the plan holder of an RDSP for adult individuals unable to enter into a contract.

Where an RDSP issuer has doubts regarding an individual's ability to enter into a contract, the spouse, common-law partner, or parent of the individual will be considered a qualifying family member. This person will be able to establish the RDSP for the individual. Budget 2012 further proposes that no action will taken against RDSP issuers, who are of the opinion that an individual's legal capacity is in doubt and allow a qualifying family member to establish and become the plan holder of an RDSP for the individual.

If an RDSP issuer subsequently no longer doubts the individual's legal capacity, or the individual is determined to be legally capable to enter into a contract by an authorized public agency or tribunal, the individual may replace the qualifying family member as the plan holder.

If the RDSP has been established by a qualifying family member and a legal representative (i.e., a guardian or other person legally authorized to act on the individual's behalf) is appointed, the legal representative will replace the qualifying family member as the plan holder. This measure will not apply where the RDSP has already been established by the individual or where the individual already has a legal representative.

This measure will apply from the date of Royal Assent until the end of 2016.

Proportional Repayment Rule

Under the current RDSP rules, any Canada Disability Savings Grants (CDSGs) or Canada Disability Savings Bonds (CDSBs) paid into an RDSP in the preceding 10 years must be repaid to the Federal Government where: (i) any amount is withdrawn from the RDSP; (ii) the RDSP is terminated or deregistered; or (iii) the RDSP beneficiary dies or ceases to be eligible for the disability tax credit (DTC) under section 118.3. This is known as the "10-year repayment rule".

RDSP issuers must set aside an "assistance holdback amount" to guarantee that potential obligations under this rule will be met. The assistance holdback amount will equal the total CDSGs and CDSBs paid into the RDSP for the last 10 years less any CDSGs and CDSBs already repaid for the same period. Where one of the above events occurs, the required repayment is the amount of the assistance holdback amount immediately before the event occurs.

Budget 2012 proposes the introduction of a proportional repayment rule to replace the 10-year repayment rule where a withdrawal is made from an RDSP. (The 10-year repayment rule will remain for all other events such as RDSP termination or deregistration or where the beneficiary dies or ceases to be DTC-eligible.)

The proportional repayment rule will require that, for each $1 withdrawn from the RDSP, $3 of any CDSGs or CDSBs paid into the plan in the 10-year period preceding the withdrawal be repaid, up to a maximum of the assistance holdback amount. Repayments will be attributed to CDSGs and CDSBs that make up the assistance holdback amount in the order in which they were paid into the RDSP, starting with the oldest amounts.

This measure will apply to withdrawals made from an RDSP after 2013.

Maximum and Minimum Withdrawals

Specific rules limit the maximum amount that may be withdrawn annually from an RDSP where CDSGs and CDSBs paid into the RDSP exceed private contributions. Where this occurs, the RDSP is known as a "primarily government-assisted plan" (PGAP). The total number of withdrawals from a PGAP in a calendar year may not exceed the formula for lifetime disability assistance payments (LDAPs) for the year. The LDAP formula is based on the beneficiary's age and the fair market value of the RDSP's assets.

Budget 2012 proposes to increase the maximum annual limit for withdrawals from a PGAP to be the greater of the amount determined by the LDAP formula and 10% of the fair market value of the plan's assets at the beginning of the calendar year. A PGAP beneficiary will continue to be eligible for the maximum annual limit exemption where a medical doctor certifies in writing that the beneficiary has a life expectancy of five years or less.

Additionally, PGAPs are subject to a minimum annual withdrawal requirement beginning in the calendar year in which the beneficiary turns 60 years of age. For that calendar year and subsequent years, the total withdrawals are determined by the LDAP formula for the year. Currently, for other RDSPs, there is no specified minimum amount.

Budget 2012 proposes to extend the minimum annual withdrawal requirement for PGAPs to all RDSPs. Therefore, any RDSP that has a beneficiary reach 60 years of age will be subject to a minimum withdrawal determined by the LDAP formula for the year. The maximum and minimum withdrawal measures will apply after 2013.

Rollover of RESP Investment Income

Budget 2012 proposes a tax-free transfer ("rollover") of investment income earned in a Registered Education Savings Plan (RESP) to an RDSP if both plans have a common beneficiary.

To qualify for the rollover, the beneficiary must meet the existing age and residency requirements with respect to RDSP contributions.

In addition, one of the following conditions must be fulfilled:

- the beneficiary has a severe and prolonged mental impairment that can reasonably be expected to prevent the beneficiary from pursuing a post-secondary education;
- the RESP has existed for at least 10 years and the beneficiary is at least 21 years of age and is not pursuing a post-secondary education; or
- the RESP has existed for at least 35 years.

Currently, the above conditions would allow for the beneficiary to receive an "accumulated income payment" from an RESP. Accumulated income payments are essentially the investment income earned in the RESP that are not educational assistance payments (as the beneficiary is not attending a post-secondary institution). An accumulated income payment will generally be included in the RESP subscriber's income and is further subject to a Part X.5 penalty tax of 20%. An RESP subscriber can reduce the accumulated income payment by contributing a portion of it to a Registered Retirement Savings Plan (RRSP) subject to certain conditions. This allows the rollover amount not to be subject to income tax or the 20% penalty tax.

Under the Budget 2012 proposal, the RESP investment income will be allowed to be rolled over to an RDSP on a tax-free basis, similar to a contribution to an RRSP of an accumulated income payment. Canada Education Savings Grants and Canada Learning Bonds in the RESP will have a requirement to be repaid by the end of February of the year following the year in which the rollover is made.

The amount of RESP investment income rolled over to an RDSP may not exceed the beneficiary's available RDSP contribution room, and the amount rolled over will reduce the available RDSP contribution room. The rollover amount will be considered a private contribution for the purposes of determining whether an RDSP is a PGAP but will not attract CDSGs. The rollover amount is to be included in the taxable portion of any RDSP withdrawals.

This measure applies to rollovers made after 2013.

Termination of an RDSP following Cessation of Eligibility for the DTC

An RDSP is only available to an individual that qualifies for the DTC in section 118.3. Where a beneficiary's condition improves to the point that the beneficiary does not qualify for the DTC for the full taxation year, the RDSP must be terminated by the end of the following year. A beneficiary who becomes DTC-ineligible may become DTC-eligible again at a later point and may establish a new RDSP. However, the contribution room and repaid CDSGs and CDSBs are not restored to the new RDSP.

Budget 2012 proposes to extend the period for which an RDSP remains open when a beneficiary becomes DTC-ineligible.

An RDSP plan holder will be able to make an election in prescribed form and submit it to the RDSP issuer along with written certification from a medical doctor that the beneficiary will be eligible for the DTC again in the near future. The RDSP issuer will then be required to notify Human Resources and Skills Development Canada (HRSDC) that the election has been

made. The election must be made on or before December 31 of the year following the first full calendar year that the beneficiary is DTC-ineligible.

Where an election has been made, the following conditions apply:

- No contributions to the RDSP will be permitted, including the proposed RESP rollover. However, a rollover of proceeds from a deceased individual's RRSP or Register Retirement Income Fund to the RDSP of a financially dependent infirm child or grandchild will be permitted.
- No new CDSGs or CDSBs will be paid into the RDSP. If the beneficiary dies, the 10-year repayment rule will apply.
- No new entitlements will be generated for the purpose of the carryforward of CDSGs or CDSBs for years that the beneficiary is DTC-ineligible.
- Withdrawals from the RDSP will be permitted, subject to the proposed proportional payment rule and the proposed maximum and minimum rules. The assistance holdback amount for the period of DTC-ineligibility will be equal to the amount of the assistance holdback amount immediately preceding this period less any repayments made during or after the first calendar year of DTC-ineligibility.

The election will generally be valid for four years following the first full calendar year of DTC-ineligibility. The RDSP must be terminated by the end of the first year following the end of the election.

If a beneficiary regains DTC-eligibility during the time of the election, the standard RDSP rules will apply beginning with the year in which the beneficiary becomes eligible for the DTC. For example, contributions will be allowable and CDSGs or CDSBs may be paid into the RDSP. If the beneficiary becomes DTC-ineligible for a second time, a new election may be made.

This measure applies to elections made after 2013. RDSPs that would have to be terminated under the current rules before 2014 because the beneficiary becomes DTC-ineligible and that have not been terminated, will not be required to be terminated until the end of 2014. Plan holders of these RDSPs may use this measure if they obtain the required medical certification and make an election on or before December 31, 2014.

Administrative Changes

Under the current RDSP rules, when an RDSP is established, the plan issuer must notify HRSDC within 60 days. When an RDSP is transferred from one RDSP issuer to another, the transfer must be completed within 120 days of the new plan's establishment. Budget 2012 proposes the replacement of these deadlines with the requirement that the RDSP issuer act "without delay" in notifying HRSDC or the establishment of transfer of a RDSP. This elimination of deadlines is to give issuers more flexibility in satisfying their obligations.

Further, upon the transfer of an RDSP to a new issuer, the original plan issuer is required to provide a large amount of information to the new issuer. This information also must be filed on a regular basis with HRSDC. Budget 2012 proposes that HRSDC, rather than the issuer of the original plan, will now be responsible for providing the information to the new plan issuer when an RDSP transfer occurs.

These measures will apply on Royal Assent.

Additionally, Budget 2012 proposes that the Canada Disability Savings Regulations be amended to eliminate the 180-day deadline for a RDSP issuer to submit an application for a CDSG or a CDSB.

This measure will apply on and after the day the regulation amending the Canada Disability Savings Regulations is registered.

Resolution 2: Mineral Exploration Tax Credit for Flow-Through Share Investors

(2) That, for expenses renounced under a flow-through share agreement entered into after March 2012,

(a) paragraph (*a*) of the definition "flow-through mining expenditure"in subsection 127(9) of the Act be replaced with the following:

(*a*) that is a Canadian exploration expense incurred by a corporation after March 2012 and before 2014 (including, for greater certainty, an expense that is deemed by subsection 66(12.66) to be incurred before 2014) in conducting mining exploration activity from or above the surface of the earth for the purpose of determining the existence, location, extent or quality of a mineral resource described in paragraph (*a*) or (*d*) of the definition "mineral resource" in subsection 248(1),

and

(b) paragraphs (*c*) and (*d*) of the definition "flow-through mining expenditure" in subsection 127(9) of the Act be replaced with the following:

(*c*) an amount in respect of which is renounced in accordance with subsection 66(12.6) by the corporation to the taxpayer (or a partnership of which the taxpayer is a member) under an agreement described in that subsection and made after March 2012 and before April 2013, and

(*d*) that is not an expense that was renounced under subsection 66(12.6) to the corporation (or a partnership of which the corporation is a member), unless that renunciation was under an agreement described in that subsection and made after March 2012 and before April 2013.

Editorial Comment: The flow-through share regime permits an investor to enter into an agreement to subscribe for shares of a corporation and the corporation uses the subscription funds to incur certain qualifying resource expenses which it renounces or flows through to the investor. Certain individuals who invest in flow-through shares are also entitled to an additional benefit equal to 15% of certain qualifying expenses incurred in Canada as described in the definition of "flow-through mining expenditure" in subsection 127(9). This mineral exploration tax credit was introduced as part of the October 18, 2000 Budget and is currently scheduled to expire at the end of March 2012.

As has been the case for several consecutive budgets, Budget 2012 proposes to extend the eligibility for the 15% investment tax credit for an extra year, to flow-through share agreements entered into on or before March 31, 2013. Furthermore, flow-through share funds raised in one calendar year with the benefit of the credit can be spent on eligible exploration up to the end of the next calendar year under the existing "look-back" rule. Accordingly, flow-through share funds raised during the first three months of 2013 can support qualifying expenses until the end of 2014.

Resolution 3: Eligible Dividends — Split-Dividend Designation and Late Designation

(3) That, for dividends paid on or after Budget Day, the Act be amended by

(a) replacing paragraph (*a*) of the definition "eligible dividend" in subsection 89(1) with the following:

(*a*) the amount that is equal to the portion of a taxable dividend that is received by a person resident in Canada, paid after 2005 by a corporation resident in Canada and designated, as provided under subsection (14), to be an eligible dividend, and

(b) replacing subsection 89(14) with the following:

Dividend designation

(14) A corporation designates a particular portion of a dividend it pays at any time to be an eligible dividend by notifying in writing at that time each person or partnership to whom it pays all or any part of the dividend that the particular portion of the dividend is an eligible dividend.

and

(c) adding the following after subsection 89(14):

Late designation

(14.1) Where, in the opinion of the Minister, the circumstances of a case are such that it would be just and equitable to permit a designation under subsection (14) to be made before the day that is three years after the day on which the designation was required to be made under that subsection, the designation is deemed to have been made on the day the designation was required to be made.

Editorial Comment: Since the taxation of dividends was significantly changed by the introduction of the "eligible dividend" concept, effective for dividends paid after 2005, it has been clear that these rules required modification to deal with practical problems. Specifically, pursuant to subsection 89(14), which provides that a corporation designates a dividend to be an eligible dividend by notifying the dividend recipient in writing at the time the dividend is paid, there is no ability to (i) designate a dividend as being an "eligible dividend" after it is paid, or (ii) designate only part of a dividend as an "eligible dividend". Allowing for late designations seemed to be a reasonable request on the part of taxpayers, due to timing issues that often arise in the calculation of "general rate income pool" ("GRIP") under subsection 89(1) (for example, with respect to changes in the GRIP balance arising from a reassessment). Furthermore, requiring a second set of corporate resolutions to declare and pay "eligible dividends", in addition to the documentation required for dividends not designated as eligible dividends, often resulted in little more than additional paperwork for the dividend payer.

In spite of requests for administrative relief from the CRA with respect to the strict application of subsection 89(14) (see, for example, *Income Tax Technical News* No. 41, and CRA Document No. 2010-0387541E5 "Designation of Eligible Dividends", January 10, 2011), none was forthcoming. Accordingly, changes proposed to subsection 89(14) are contained in Budget 2012 to deal with these concerns.

Specifically, Budget 2012 amends the legislation to provide that a *portion* of a taxable dividend received by a person after 2005 can be designated as a "eligible dividend". However, the legislation is not retroactive. The Notice of Ways and Means Motion provides that the ability to designate partial eligible dividends is limited to dividends paid after March 29, 2012.

In addition, newly proposed subsection 89(14.1) will allow for a late designation of an "eligible dividend" where, in the opinion of the CRA, "the circumstances of a case are such that it would be just and equitable to permit a designation". The late designation must be made within three years after the day it should have been made, being the time that the dividend was paid. Again, the Budget 2012 measures apply only to dividends paid after March 29, 2012. It is expected that the CRA will release some guidance on what circumstances it will consider "just and equitable" for these purposes.

Resolutions 4 to 5: Group Sickness or Accident Insurance Plans

(4) That, for the 2013 taxation year, subsection 6(1) of the Act be amended by adding the following after paragraph (*e*):

(*e.1*) the total of

(i) all amounts (or the portions of those amounts) contributed by the taxpayer's employer on or after Budget Day and before 2013 that are attributable to the taxpayer's coverage after 2012 under a group sickness or accident insurance plan, except to the extent that the contributions (or portions of those contributions) are attributable to benefits under the plan that, if received by the taxpayer, would be included in the taxpayer's income under paragraph (*f*) in the year the benefits are received if that paragraph were read without regard to its subparagraph (v), and

(ii) all amounts contributed in 2013 in respect of the taxpayer by the taxpayer's employer to a group sickness or accident insurance plan, except to the extent that the contributions are attributable to benefits under the plan that, if received by the taxpayer, would be included in the taxpayer's income under paragraph (*f*) in the year the benefits are received if that paragraph were read without regard to its subparagraph (v).

(5) That, for the 2014 and subsequent taxation years, paragraph 6(1)(*e.1*) of the Act be replaced with the following:

(*e.1*) the total of all amounts contributed in the year in respect of the taxpayer by the taxpayer's employer to a group sickness or accident insurance plan, except to the extent that the contributions are attributable to benefits under the plan that, if received by the taxpayer, would be included in the taxpayer's income under paragraph (*f*) in the year the benefits are received if that paragraph were read without regard to its subparagraph (v).

Editorial Comment: Subsection 6(1) of the Act identifies specific benefits that are to be included in a taxpayer's income from an office or employment. The general rule is that employment benefits, provided either in cash or in-kind, are generally to be considered taxable to the employee.

The current tax treatment of group sickness or accident insurance plans is such that employer contributions are not deductible and, subject to certain exceptions, an amount is included in an employee's income either at the time of the employer's contribution to the plan or when the benefits are received by the employee.

Currently, where benefits are payable on a periodic basis out of a group sickness or accident insurance plan to a taxpayer in order to compensate for the loss of the taxpayer's employment, these amounts are included in income when received by the employee under paragraph 6(1)(*f*) of the Act (net of any previous contributions made by the employee taxpayer).

From a policy perspective, Budget 2012 addresses two perceived shortcomings in paragraph 6(1)(*f*). The paragraph does not apply to benefits that are not payable on a periodic basis, nor does it apply to benefits payable in respect of a sickness or accident when there is no loss of employment income. Budget 2012 proposes new paragraph 6(1)(*e.1*), which is specifically designed to remedy these perceived problems.

Essentially, an employer's contribution to a group sickness or accident insurance plan in a year will be included in the employee's income for the year to the extent the contributions are not in respect of a wage-loss replacement benefit payable on a periodic basis (i.e., benefits not taxed under paragraph 6(1)(*f*), as described above).

The change will occur in two steps: contributions made on or after March 29, 2012 and before 2013 will be included in the employee's income for 2013. For contributions made in 2013 and subsequent years, the inclusion takes place in the same year as the contribution.

Resolutions 6 to 11: Retirement Compensation Arrangements

(6) That, in respect of retirement compensation arrangements, the Act be amended by adding

(a) definitions "advantage", "prohibited investment", "significant interest" and "swap transaction", similar to the existing definitions in Part XI.01 of the Act, with such modifications as the circumstances require;

(b) a definition "RCA strip", similar to the existing definition "RRSP strip" in Part XI.01 of the Act, with such modifications as the circumstances require; and

(c) a definition "specified beneficiary" that refers to an individual who has an interest or right in respect of a retirement compensation arrangement and who has a significant interest in an employer in respect of the arrangement.

(7) That the Act be amended to require a custodian of a retirement compensation arrangement to pay a tax equal to 50 per cent of the fair market value of a prohibited investment acquired or held by the arrangement, similar to the existing tax in section 207.04 of the Act, with such modifications as the circumstances require.

(8) That the Act be amended to require a custodian of a retirement compensation arrangement to pay a tax equal to the fair market value of any advantage obtained by a specified beneficiary of the arrangement or a person who does not deal at arm's length with the specified beneficiary, similar to the existing tax in section 207.05 of the Act, with such modifications as the circumstances require.

(9) That the Act be amended to provide that a specified beneficiary of a retirement compensation arrangement that participates in acquiring or holding a prohibited investment, or in extending an advantage, in respect of the arrangement be jointly and severally, or solidarily, liable, to the extent of their participation, for the tax payable in relation to the prohibited investment or the advantage.

(10) That,

(a) subject to subparagraphs (*b*) and (*c*), paragraphs (6) and (9) apply on and after Budget Day;

(b) paragraph (7) apply in respect of investments acquired, or that become prohibited investments, on or after Budget Day; and

(c) paragraph (8) apply to advantages extended, received or receivable on or after Budget Day, other than an advantage that relates to property acquired, or transactions occurring, before Budget Day

(i) if the advantage is obtained by a specified beneficiary of the retirement compensation arrangement (or a person who does not deal at arm's length with the specified beneficiary) and the amount of the advantage is included in computing the income of the specified beneficiary, or

(ii) if the advantage is obtained by a retirement compensation arrangement and the amount of the advantage is distributed from the arrangement and included in computing the income of a beneficiary or an employer in respect of the arrangement.

(11) That, in respect of refundable tax on contributions made to a retirement compensation arrangement on or after Budget Day, section 207.5 of the Act be amended so that the election in subsection 207.5(2) is available only in circumstances where

(a) a decline in value of property of the retirement compensation arrangement is not reasonably attributable to a prohibited investment or an advantage, or

(b) the Minister of National Revenue is satisfied that it is just and equitable to accept the election having regard to all the circumstances (including the extent to which tax has been paid under another provision of the Act).

Editorial Comment: A "retirement compensation arrangement" ("RCA") is an employer-funded retirement plan with its own scheme of taxation. Specifically, employer contributions to an RCA are deductible to the employer pursuant to paragraph 20(1)(*r*), and distributions from the RCA are taxable to the employee only when received in accordance with paragraph 56(1)(*x*).

However, a special refundable tax equal to 50% of the amount of the contributions by the employer is payable within the RCA, pursuant to Part XI.3 of the Act. Income realized within the RCA is also subject to the 50% refundable tax (section 207.7). When taxable distributions are made out of the plan, for example, to a retired employee, the refundable tax is refunded at the rate of $1 for every $2 distributed.

Furthermore, a special election exists in subsection 207.5(2) to assist with circumstances where the RCA has suffered investment losses, which may prevent the RCA from making distributions sufficient to obtain a refund of the refundable tax.

Budget 2012 indicates that CRA has uncovered "tax motivated arrangements" perceived to be an abuse of the RCA rules. Budget 2012 further states that "some arrangements involve the deduction of large contributions that are indirectly returned to the contributors through a series of steps ending with the purported RCA having little or no assets but still being able to claim the refundable tax using the impaired asset exception [the 207.5(2) election]. Other arrangements use insurance products to allocate costs to the arrangement for benefits that arise outside the arrangement."

Accordingly, Budget 2012 provides that RCAs will now be subject to "prohibited investment", "advantage" and "stripping" rules, very similar to those recently enacted into law in December 2011 applicable to RRSPs and RRIFs in Part XI.01 (*Tax Topics* March 29, 2012 No. 2090).

A new definition of "specified beneficiary" will be introduced. This definition applies to an individual who has "an interest or right in respect of a retirement compensation arrangement and who has a significant interest in an employer in respect of the arrangement". A person has a significant interest in a corporation if the person, together with persons with whom the person does not deal at arm's length, owns more than 10% of the shares of any class in the capital stock of the corporation.

If an RCA has a specified beneficiary, the RCA will be subject to an additional tax equal to the fair market value of any advantage obtained by the specified beneficiary or a non-arm's length person (the "Advantage Tax"). Furthermore, the RCA will be subject to tax equal to 50% of the fair market value of a prohibited investment acquired or held by the RCA (the "Prohibited Investment Tax"). Lastly, and perhaps most importantly, the specified beneficiary of an RCA will be jointly and severally, or solitarily, liable, for the Advantage Tax and Prohibited Investment Tax.

The Prohibited Investment Tax will be payable in respect of investments acquired, or that became prohibited investments, on or after March 29, 2012. The tax 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 any such later time as the Minister considers reasonable). As with the Part XI.07 tax, the CRA will have the power to waive or cancel the tax when it is just and equitable to do so.

The Advantage Tax will be payable in respect of advantages extended, received or receivable on or after March 29, 2012. However, advantages that relate to property acquired or transactions occurring before March 29, 2012 will not be subject to the Advantage Tax if (i) the advantage is obtained by a specified beneficiary (or a non-arm's length person) and is included in computing the income of the specified beneficiary, or (ii) the advantage is obtained by the RCA and the amount of the advantage is distributed from the RCA and included in the income of a beneficiary or employer of the arrangement — in this instance the advantage will be treated as a normal RCA distribution for the purpose of determining refundable tax.

Furthermore, the election available in subsection 207.5(2) to deal with a decline in RCA asset value is to be restricted. The election will only be available where (i) the decline in value is not reasonably attributable to a prohibited investment or an advantage, or (ii) the Minister of National Revenue is satisfied that it is just and equitable having regard to all the circumstances.

Resolutions 12 to 14: Employees Profit Sharing Plans

(12) That, for the 2012 and subsequent taxation years, subsection 8(1) of the Act be amended by adding the following after paragraph (*o.1*):

(*o.2*) an amount that is an excess EPSP amount (as defined in subsection 207.8(1)) of the taxpayer for the year, except to the extent that the taxpayer's tax for the year under subsection 207.8(2) in respect of the excess EPSP amount is waived or cancelled.

(13) That, in respect of payments made on or after Budget Day to a trust governed by an employees profit sharing plan, the Act be amended by adding the following after Part XI.3:

Part XI.4 — Tax on Excess EPSP Amounts

Excess EPSP amount

207.8(1). In this Part, "excess EPSP amount", of a specified employee for a taxation year in respect of an employer, means the amount determined by the formula

$$A - (20\% \times B)$$

where

A is the portion of the total of all amounts paid by the employer of the specified employee (or by a corporation with which the employer does not deal at arm's length) to a trust governed by an employees profit sharing plan that is allocated for the year to the specified employee; and

B is the specified employee's total income for the year from employment with the employer computed without reference to paragraph 6(1)(*d*) and sections 7 and 8.

Tax payable

(2) If a specified employee has an excess EPSP amount for a taxation year, the specified employee shall pay, for the year, a tax equal to the amount determined by the formula

$$(A + B) \times C$$

where

A is 29%;

B is

(i) if the specified employee is resident in the Province of Quebec at the end of the year, 0%,

(ii) if the specified employee is resident in a province other than Quebec at the end of the year, the highest provincial personal income tax rate that applies for the year to a resident of the province, or

(iii) in any other case, 14%; and

C is the total of all excess EPSP amounts of the specified employee for the year.

Waiver or cancellation

(3) If a specified employee would otherwise be liable to pay a tax under subsection (2), the Minister may waive or cancel all or part of the liability if the Minister considers it just and equitable to do so having regard to all the circumstances.

(14) That paragraphs (12) and (13) not apply in respect of payments made before 2013 to a trust governed by an employees profit sharing plan pursuant to a legal obligation arising under a written agreement or arrangement entered into before Budget Day.

Editorial Comment: Employees Profit Sharing Plans (EPSPs), which are defined in section 144, are trust arrangements that allow employers to make tax-deductible contributions to a trust and require trustees to allocate to employees each year all of the employer contributions, profits from trust property, capital gains and losses, and certain amounts in respect of forfeitures. Employees must include these allocations in their income in the taxation year in which they are allocated (see IT-280R and IT-379R). There was concern that EPSPs have increasingly been used as a vehicle for business owners to direct business profits to members of their families to reduce or defer payment of income tax on these profits. There were also concerns that EPSPs have been used in certain situations to eliminate employee withholding requirements as well as EI and CPP payments. The 2011 federal Budget announced that the federal government would look into EPSPs and undertake consultations on the appropriate uses for EPSPs. These consultations concluded that limitations should be imposed on EPSP contributions, particularly where non-arm's length employees are involved.

To address these concerns, and reduce excessive employer contributions, a special tax is proposed in Budget 2012. The special tax is payable by a specified employee (defined in subsection 248(1) of the *Income Tax Act* and generally includes an employee that has a significant equity interest in the employer or does not deal at arm's length with the employer) on an "excess EPSP amount". Generally an "excess EPSP amount" will be the portion of the employer's EPSP contribution, allocated by the trustee to a specified employee, that exceeds 20% of the specified employee's salary for the year.

The proposed special tax will contain two components and will apply to the total of all excess EPSP amounts received by the specified employee for the year. The first component will be equal to 29% (the top federal marginal tax rate). The second component will be equal to the top marginal tax rate of the employee's province of residence (or 0% in Quebec). A new deduction will be introduced to ensure that an excess EPSP amount is not subject to regular income tax in addition to the special tax. A specified employee will not be able to claim any other deductions in respect of an excess EPSP amount.

The Minister of National Revenue will be able to waive or cancel the application of these new rules where the Minister considers it just and equitable to do so. In these circumstances, the regular rules regarding EPSPs will apply.

This measure will apply to EPSP contributions made by an employer on or after Budget Day. However, in the case of contributions to an EPSP pursuant to a legal agreement entered into before Budget Day, this measure will only apply to contributions made as of 2013.

Resolution 15: Salary of the Governor General of Canada

(15) That, for the 2013 and subsequent taxation years, paragraph 81(1)(*n*) of the Act be replaced with the following:

> (*n*) income from the office of Governor General of Canada, other than salary under the *Governor General's Act*.

Editorial Comment: Paragraph 81(1)(*n*) of the Act currently provides an exemption from tax under Part I of the Act for income from the office of the Governor General of Canada. Budget 2012 proposes to end the income tax exemption for the salary of the Governor General of Canada. This measure is in accordance with the actions of other Commonwealth countries imposing income tax on the salaries of their Governors General (i.e. Australia in 2001 and New Zealand in 2010).

This measure will apply to the 2013 and subsequent taxation years. Income from the office of the Governor General of Canada, other than salary under the *Governor General's Act*, will remain exempt from tax, although it is not immediately clear as to what this remaining exemption will apply to. It also appears that the Governor General of Canada will remain exempt from GST/HST.

Resolution 16: Life Insurance Policy Exemption Test

(16) That the provisions of the Act, and the *Income Tax Regulations*, with respect to life insurance policies be modified in accordance with the proposals related to the life insurance policy exemption test described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Under subsection 12.2(1) of the Act, where a taxpayer holds an interest in a life insurance policy, there is included in the taxpayer's income, on the anniversary day of the policy, the amount by which the accumulating fund in the policy exceeds the taxpayer's adjusted cost base of the policy.

However, this does not apply in respect of an "exempt policy", which is defined in subsection 12.2(11) and section 306 of the *Income Tax Regulations* to generally mean a life insurance policy in which the savings accumulating in the policy do not exceed a prescribed amount, namely the savings in a benchmark policy. The calculation of the prescribed amount is based on a variety of factors, including the prescribed interest rate and mortality tables. The actual savings accumulating in the life insurance policy are measured using the amount that is equal to the greater of the cash surrender value of the policy, and the modified net premium reserve in respect to the policy.

Likely as a result of increased scrutiny of certain insurance arrangements being implemented by taxpayers, the Department of Finance undertook, and has now completed, a review of the test for an "exempt policy". Budget 2012 announces that, as a result of this review, technical improvements are required to update and simplify the test. The following changes are proposed to the exemption test:

- measuring the savings in an actual policy and the benchmark 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, while improving consistency between the measurement of the savings in an actual policy and the measurement of the savings in the benchmark policy;

- increasing the endowment time of the benchmark policy from age 85 years to age 90 years, to reflect increased life expectancy;
- measuring the savings in an 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 an actual policy, while improving consistency between the measurement of the savings in the policy and the measurement of the savings in the benchmark policy; and
- reducing the pay period of the benchmark policy to 8 years from 20 years, to better reflect current industry practices and the pay period used in other countries.

Also, Budget 2012 proposes that the 15% tax payable by a life insurer on its taxable Canadian life investment income (see sections 211 to 211.6 of the Act) should be recalibrated to neutralize the impacts of the proposed changes to the investment income tax base.

Budget 2012 states that there will be consultations with key stakeholders on the changes regarding the definition of "exempt policy" and the investment income tax base, and any changes to the tax provisions with respect to life insurance policies will apply to policies issued after 2013.

Resolution 17: Corporate Mineral Exploration and Development Tax Credit

(17) That, for expenditures incurred on or after Budget Day, subsection 127(9) of the Act be amended by

(a) replacing paragraph (*a.3*) of the definition "investment tax credit" with the following:

(*a.3*) where the taxpayer is a taxable Canadian corporation, the total of

(i) the specified percentage of the taxpayer's pre-production mining expenditure described in subparagraph (*a*)(i) of the definition "pre-production mining expenditure", and

(ii) the specified percentage of the taxpayer's pre-production mining expenditure described in subparagraph (*a*)(ii) of the definition "pre-production mining expenditure",

(b) replacing paragraph (*a*) of the definition "pre-production mining expenditure" with the following:

(*a*) would be an expense

(i) described in paragraph (*f*) of the definition "Canadian exploration expense" in subsection 66.1(6) if the expression "mineral resource" in that paragraph were defined to mean a mineral deposit from which the principal mineral to be extracted is diamond, a base or precious metal deposit, or a mineral deposit from which the principal mineral to be extracted is an industrial mineral that, when refined, results in a base or precious metal, or

(ii) described in paragraph (*g*), and not described in paragraph (*f*), of the definition "Canadian exploration expense" in subsection 66.1(6) if the expression "mineral resource" in that paragraph were defined to mean a mineral deposit from which the principal mineral to be extracted is diamond, a base or precious metal deposit, or a mineral deposit from which the principal mineral to be extracted is an industrial mineral that, when refined, results in a base or precious metal, and

and

(c) deleting "and" at the end of paragraph (*i*) and by replacing paragraph (*j*) of the definition "specified percentage" with the following:

(*j*) in respect of a pre-production mining expenditure of the taxpayer described in subparagraph (*a*)(i) of the definition "pre-production mining expenditure" that is incurred

(i) before 2013, 10%,

(ii) in 2013, 5%, and

(iii) after 2013, 0%, and

(*k*) in respect of a pre-production mining expenditure of the taxpayer described in subparagraph (*a*)(ii) of the definition "pre-production mining expenditure" that is incurred

(i) before 2014, 10%,

(ii) after 2013 and before 2016, 10% if the expenditure is incurred

(A) under a written agreement entered into by the taxpayer before Budget Day, or

(B) as part of the development of a new mine and

(I) the construction of the mine was started by, or on behalf of, the taxpayer before Budget Day (and for this purpose construction does not include obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities), or

(II) the engineering and design work for the construction of the mine, as evidenced in writing, was started by, or on behalf of, the taxpayer before Budget Day (and for this purpose engineering and design work does not include obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities), and

(iii) in any other case,

(A) in 2014, 7%,

(B) in 2015, 4%, and

(C) after 2015, 0%.

Editorial Comment: In the February 18, 2004 Federal Budget, a 10% investment tax credit was introduced for taxable Canadian corporations who incurred qualifying mineral exploration expenditures. The tax credit applied to "pre-production mining expenditures" as defined in subsection 127(9). Budget 2012 proposes to phase out and eliminate this credit. According to the Budget documents, this measure proposes to preserve approximately $90 million of forgone tax revenue over the next five years.

There are generally two types of preproduction mining expenditures — those for exploring or locating mineral resources (pre-production exploration expenditures or "grass roots" exploration) which are described in paragraph (*f*) of the definition of "Canadian exploration expense" in subsection 66.1(6), and those for developing or producing the mine or mineral resource (pre-production development expenditures) which are described in paragraph (*g*) of the definition of "Canadian exploration expense" in subsection 66.1(6).

For the pre-production exploration expenditures, the investment tax credit will continue to apply at 10% for expenses incurred in 2012, but it will be reduced to 5% for expenses incurred in 2013, and it will be eliminated for expenses incurred after 2013.

For the pre-production development expenditures, the 10% credit will continue to apply for expenses incurred before 2014, will be reduced to 7% for expenses incurred in 2014, and reduced further to 4% for expenses incurred in 2015. The credit will not be available for pre-production development expenses incurred after 2015.

Budget 2012 proposes additional transitional relief for pre-production development expenses incurred by a corporate taxpayer before 2012 either:

(a) under a written agreement entered into by the corporate taxpayer before March 29, 2012; or

(b) as part of the development of a new mine where the taxpayer began construction before March 29, 2012 or the engineering and design work for the construction of the new mine, as evidenced in writing, commenced before March 29, 2012.

The 2012 Budget documents specifically exclude activities such as obtaining permits or regulatory approvals, conducting environmental assessments, community consultations, impact benefit studies and similar activities from the ambit of construction or engineering and design work.

The "grass roots" exploration and pre-production development expenses will continue to qualify as Canadian exploration expenses.

Resolution 18: Atlantic Investment Tax Credit — Oil and Gas and Mining Activities

(18) That, in respect of property acquired on or after Budget Day, subsection 127(9) of the Act be amended by

(a) replacing the portion of the definition "qualified property" before paragraph (*a*) with the following:

"qualified property", of a taxpayer, means property (other than a qualified resource property) that is

(b) replacing subparagraphs (*c*)(iv) to (xiii) of the definition "qualified property" with the following:

(iv) storing grain, or

(v) harvesting peat,

(c) replacing the reference to "subparagraphs (*c*)(i) to (xiii)" in paragraph (*d*) of the definition "qualified property" with "subparagraphs (*c*)(i) to (v)",

(d) adding the following after paragraph (*a*) of the definition "specified percentage":

(*a.1*) in respect of a qualified resource property acquired by a taxpayer primarily for use in the Province of Nova Scotia, New Brunswick, Prince Edward Island or Newfoundland and Labrador, the Gaspé Peninsula or the prescribed offshore region and that is acquired

(i) on or after Budget Day and before 2014, 10%,

(ii) after 2013 and before 2017, 10% if the property

(A) is acquired by the taxpayer under a written agreement of purchase and sale entered into by the taxpayer before Budget Day, or

(B) is acquired as part of a project phase and

(I) the construction of the phase was started by, or on behalf of, the taxpayer before Budget Day (and for this purpose construction does not include obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities), or

(II) the engineering and design work for the construction of the phase, as evidenced in writing, was started by, or on behalf of, the taxpayer before Budget Day (and for this purpose engineering and design work does not include obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities), and

(iii) in any other case,

(A) in 2014 and 2015, 5%, and

(B) after 2015, 0%,

and

(e) adding the following definitions in alphabetical order:

"project phase" means a phase of a project of a taxpayer that is a discrete expansion in the extraction, processing or production capacity of the project beyond a capacity level that was attained before Budget Day and which expansion in capacity was the taxpayer's demonstrated intention immediately before Budget Day;

"qualified resource property", of a taxpayer, means property that is a prescribed building or prescribed machinery and equipment, that is acquired by the taxpayer on or after Budget Day, that has not been used, or acquired for use or lease, for any purpose whatever before it was acquired by the taxpayer and that is

(*a*) to be used by the taxpayer in Canada primarily for the purpose of any of the activities referred to in subparagraphs (*c*)(iv) to (xi) of the definition "qualified property" as that definition read immediately before Budget Day, or

(*b*) to be leased by the taxpayer to a lessee (other than a person exempt from tax under this Part because of section 149) that can reasonably be expected to use the property in Canada primarily for the purpose of any of the activities referred to in subparagraphs (*c*)(iv) to (xi) of the definition "qualified property" as that definition read immediately before Budget Day, but this paragraph does not apply to prescribed machinery and equipment unless use of the property by the first person to whom it was leased begins on or after Budget Day and

(i) the property is leased in the ordinary course of carrying on a business in Canada by a corporation whose principal business is leasing property, lending money, purchasing conditional sales contracts, accounts receivable, bills of sale, chattel mortgages or hypothecary claims on movables, bills of exchange or other obligations representing all or part of the sale price of merchandise or services, or any combination of these activities,

(ii) the property is manufactured and leased in the ordinary course of carrying on a business in Canada by a corporation whose principal business is manufacturing property that it sells or leases, or

(iii) the property is leased in the ordinary course of carrying on business in Canada by a corporation whose principal business is selling or servicing property of that type.

Editorial Comment: The current investment tax credit of 10% of the capital cost of qualified property applies to certain property acquired primarily for use in Nova Scotia, New

Brunswick, Prince Edward Island or Newfoundland or the Gaspé Peninsula, or a prescribed offshore region. Budget 2012 proposes to phase out and eliminate certain parts of the credit.

Resolution 18 proposes that the credit will be phased out over a four-year period for assets acquired on or after March 29, 2012 for use in oil and gas and mining activities. In particular, the resolution will apply to assets acquired after that day and used in the activities described in current subparagraphs (*c*)(iv) through (xi) of the definition of "qualified property" in subsection 127(9), namely:

(iv) operating an oil or gas well or extracting petroleum or natural gas from a natural accumulation of petroleum or natural gas,

(v) extracting minerals from a mineral resource,

(vi) processing

(A) ore (other than iron ore or tar sands ore) from a mineral resource to any stage that is not beyond the prime metal stage or its equivalent,

(B) iron ore from a mineral resource to any stage that is not beyond the pellet stage or its equivalent, or

(C) tar sands ore from a mineral resource to any stage that is not beyond the crude oil stage or its equivalent,

(vii) producing industrial minerals,

(viii) processing heavy crude oil recovered from a natural reservoir in Canada to a stage that is not beyond the crude oil stage or its equivalent,

(ix) Canadian field processing,

(x) exploring or drilling for petroleum or natural gas, or

(xi) prospecting or exploring for or developing a mineral resource.

Paragraph (*d*) of the definition of "qualified property", which allows certain assets to qualify for the credit if leased to a qualified lessee, is also amended to exclude the assets used in the above-noted activities.

The credit in respect of these assets will continue to apply at a rate of 10% for assets acquired before 2014. It will be reduced to a rate of 5 per cent for assets acquired in 2014 and 2015, and it will not be available for such assets acquired after 2015.

There is some transitional relief where the asset is acquired under a written agreement entered into before March 29, 2012. There is also relief if the asset is acquired as part of a "project phase", where the construction of the phase was started by or on behalf of the taxpayer before March 29, 2012, or the engineering and design work for the construction phase was started by or on behalf of the taxpayer before March 29, 2012. In either such case, the credit rate of 10% will apply if the property is acquired after 2013 and before 2017. According to the Budget documents, this measure proposes to preserve approximately $135 million of foregone tax revenue over the next five years.

The investment tax credit for other qualified property will not be affected by resolution 18.

Resolution 19: Atlantic Investment Tax Credit — Electricity Generation Equipment

That, in respect of property acquired on or after Budget Day,

(a) the definition "qualified property" in subsection 127(9) of the Act be amended by

(i) deleting "or" at the end of paragraph (*a*), by adding "or" at the end of paragraph (*b*) and by adding the following after paragraph (*b*):

(*b.1*) prescribed energy generation and conservation property acquired by the taxpayer on or after Budget Day,

and

(ii) replacing the portion of paragraph (*c*.1) before subparagraph (i) with the following:

(*c.1*) property (other than prescribed energy generation and conservation property) to be used by the taxpayer in Canada primarily for the purpose of producing or processing electrical energy or steam in a prescribed area, where

and

(b) that for the purposes of the definition "qualified property" in subsection 127(9) of the Act, prescribed energy generation and conservation property be depreciable property (other than property that is a prescribed building or prescribed machinery and equipment) of the taxpayer included in Class 43.1, 43.2 or 48 or in Class 17 because of subparagraph (a.1)(i) of that Class, of Schedule II to the *Income Tax Regulations*.

Editorial Comment: Budget 2012 proposes to extend the 10% credit in respect of qualified property to include "prescribed energy generation and conservation property" acquired on or after March 29, 2012, if it is used primarily for one of the remaining eligible uses in paragraph (*c*) of the definition of "qualified property", namely, manufacturing and processing, farming, fishing, and logging. For these purposes, "prescribed energy generation and conservation property" will include clean energy generation and conservation equipment described in Class 43.1 or 43.2 of the CCA schedules, and electricity generation equipment described in Class 17 or 48.

Resolutions 20 to 21: Scientific Research and Experimental Development Program

(20) That,

(a) for taxation years that end after 2013, the reference to "20%" in paragraph (*a*.1) of the definition "investment tax credit" in subsection 127(9) of the Act be replaced with "15%", except that for taxation years that include January 1, 2014, it shall be read as a reference to the percentage that is the total of

(i) 20% multiplied by the proportion that the number of days that are in the taxation year and before 2014 is of the number of days in the taxation year, and

(ii) 15% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

(b) for taxation years that end after 2013, the reference to "15%" in subsection 127(10.1) of the Act be replaced with "20%", except that for taxation years that include January 1, 2014, it shall be read as a reference to the percentage that is the total of

(i) 15% multiplied by the proportion that the number of days that are in the taxation year and before 2014 is of the number of days in the taxation year, and

(ii) 20% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

(*c*) for expenditures incurred after 2012, subparagraph (*a*)(ii) of the definition "qualified expenditure" in subsection 127(9) of the Act be amended to include only 80% of an expenditure that

(i) would otherwise be included under that subparagraph,

(ii) is for scientific research and experimental development performed for or on behalf of the taxpayer by another person or partnership with whom the taxpayer deals at arm's length, and

(iii) has been reduced to exclude any amount of a capital nature incurred by the other person or partnership in the performance of the scientific research and experimental development;

(d) the percentage at which the prescribed proxy amount, for a taxation year, referred to in paragraph (*b*) of the definition "qualified expenditure" in subsection 127(9) of the Act is calculated be, for taxation years that end after 2012, the percentage that is the total of

(i) 65% multiplied by the proportion that the number of days that are in the taxation year and before 2013 is of the number of days in the taxation year,

(ii) 60% multiplied by the proportion that the number of days that are in the taxation year and in 2013 is of the number of days in the taxation year, and

(iii) 55% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

and

(e) for expenditures made by a taxpayer after 2013,

(i) section 37 of the Act be amended to exclude an expenditure in respect of the use or the right to use property that would, if it were acquired by the taxpayer, be capital property of the taxpayer,

(ii) paragraph 37(1)(*b*) of the Act be repealed,

(iii) subparagraphs (*a*)(i) and (iii) of the definition "qualified expenditure" in subsection 127(9) of the Act be repealed, and

(iv) section 127 of the Act be amended to exclude from the SR&ED qualified expenditure pool an expenditure in respect of the use or the right to use property that would, if it were acquired by the taxpayer, be capital property of the taxpayer.

(21) That such other amendments to the Act be made as are necessary to give effect to the proposals relating to scientific research and experimental development described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Changes to the scientific research and experimental development (SR&ED) tax incentive program were anticipated for this Budget, owing largely to an Expert Review Panel on SR&ED which submitted its report to the government in October 2011. The Panel suggested a "simplified and more focused approach" to improve the SR&ED program, which includes the investment tax credit system. According to the Budget documents, the

changes introduced in the Budget support these objectives, and make the program more cost effective and predictable". Most of the tax changes are described in resolutions 17 through 21.

Other SR&ED Investment Tax Credit Changes

Currently, qualifying SR&ED expenditures are deductible pursuant to subsection 37(1) in computing income, whether they are current expenditures or capital expenditures. Furthermore, for investment tax credit purposes, they form part of the "SR&ED qualified expenditure pool", as defined in subsection 127(9), which can be claimed as a credit at a rate of 20%. Resolution 20 proposes to reduce this rate to 15% for taxation years after 2013, with the rate being pro-rated for taxation years that straddle January 1, 2014. The refundable investment tax credit, which is currently 40% of the 20% investment tax credit amount, will be reduced accordingly to 40% of the new 15% amount.

The enhanced 35% investment tax credit that applies to certain Canadian-controlled private corporations on up to $3 million of qualified SR&ED expenditures is not affected by this measure due to proposed amendments to subsection 127(10.1) to offset the rate change, nor is the refundable investment tax credit for such expenditures.

As noted above, SR&ED capital expenditures currently qualify for an income deduction and for the investment tax credit. Budget 2012 somewhat surprisingly eliminated this treatment for capital expenses made starting in 2014. Capital expenditures made after 2013 will not be deductible under subsection 37(1), nor will they form part of the SR&ED pool for investment tax credits. Furthermore, this new rule (non-deduction, no credit) will apply to any payments in respect of the use or the right to use property after 2013 that would, if it were acquired by the taxpayer, be capital property of the taxpayer.

The Budget documents indicate that the SR&ED capital expenditures "will be accorded the treatment otherwise applicable to such expenditures under the *Income Tax Act*". Presumably, in most cases, this means that no immediate deduction will be available, and the appropriate capital cost allowance (CCA) deduction will apply.

In computing SR&ED expenditures, a taxpayer can elect to use a "proxy method" to calculate qualifying overhead expenses pursuant to clause 37(8)(*a*)(ii)(B). The prescribed proxy amount is determined under Regulation 2900 and is currently 65% of the portion of salaries and wages of employees directly engaged in SR&ED activities carried on in Canada. Budget 2012 proposes to reduce the 65% rate to 60% for 2013 and to 55% after 2013, prorated for taxation years that straddle the beginning of the 2012, 2013 or 2014 calendar years.

SR&ED contract payments are also affected by Budget 2012. Currently, contract payments made to a non-arm's length performer of the SR&ED are eligible for the investment tax credit pursuant to subparagraph (*a*)(ii) of the definition of "qualified expenditure" in subsection 127(9), but generally only to the extent of the performer's costs of carrying out the SR&ED in other words, the credit does not apply to the profit element, if any, in the contract payment made by the payer to the performer.

Resolution 20 proposes a similar restriction for contract payments made to an arm's length performer of SR&ED. Using an arbitrary rate, the resolution proposes that 80% of the contract payment will qualify for the investment tax credit. However, the payment for these purposes (prior to calculating the 80% amount) will be reduced to the extent it reflects capital expenses incurred by the performer that are no longer themselves eligible for investment tax credit treatment (i.e. for capital expenses incurred after 2013 — see above).

Resolutions 22 to 26: Tax Avoidance Through the Use of Partnerships

(22) That paragraph 88(1)(*d*) of the Act be amended by deleting "and" at the end of subparagraph (ii) and by adding the following after subparagraph (ii):

(ii.1) for the purpose of calculating the amount in subparagraph (ii) in respect of an interest of the subsidiary in a partnership, the fair market value of the interest at the time the parent last acquired control of the subsidiary is deemed to be the amount determined by the formula

$$A - B$$

where

A is the fair market value of the interest at that time, and

B is the portion of the amount by which the fair market value of the interest at that time exceeds its cost amount as may reasonably be regarded as being attributable at that time to the total of all amounts each of which is

(A) in the case of a depreciable property held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the amount by which the fair market value (determined without reference to liabilities) of the property exceeds its cost amount,

(B) in the case of a Canadian or foreign resource property held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the fair market value (determined without reference to liabilities) of the property, or

(C) in the case of a property that is neither a capital property or resource property and that is held directly by the partnership or held indirectly by the partnership through one or more other partnerships, the amount by which the fair market value (determined without reference to liabilities) of the property exceeds its cost amount, and

(23) That paragraph (22) apply to amalgamations that occur and windings-up that begin on or after Budget Day, other than — where a taxable Canadian corporation (referred to in this paragraph as the "parent corporation") that has acquired control of another taxable Canadian corporation (referred to in this paragraph as the "subsidiary corporation") — an amalgamation of the parent corporation and the subsidiary corporation that occurs before 2013, or a winding-up of the subsidiary corporation into the parent corporation that begins before 2013, if

(a) the parent corporation acquired control of the subsidiary corporation before Budget Day, or was obligated as evidenced in writing before Budget Day to acquire control of the subsidiary (except that the parent corporation shall not be considered to be obligated if, as a result of amendments to the Act, it may be excused from the obligation to acquire control), and

(b) the parent corporation had the intention as evidenced in writing before Budget Day to amalgamate with, or wind up, the subsidiary corporation.

(24) That section 100 of the Act be amended by

(a) replacing the portion of subsection 100(1) before paragraph (*a*) with the following:

Disposition — partnership to tax-exempt or non-resident

100. (1) If, as part of a transaction or event or series of transactions or events, a taxpayer disposes of an interest in a partnership and that interest is acquired by a person exempt from tax under section 149 or by a non-resident person, notwithstanding paragraph

38(a), the taxpayer's taxable capital gain for a taxation year from the disposition of the interest is deemed to be

and

(b) adding the following after subsection 100(1):

Exception — non-resident person

(1.1) Subsection (1) does not apply to a taxpayer's disposition of an interest in a partnership to a non-resident person if the partnership, immediately before and immediately after the acquisition of the interest by the non-resident person, uses all the property of the partnership in carrying on business through a permanentestablishment in Canada.

(25) That paragraph (24) apply to dispositions of an interest in a partnership made by a taxpayer on or after Budget Day, other than an arm's length disposition by the taxpayer before 2013 if the taxpayer is obligated to dispose of the interest pursuant to a written agreement entered into by the taxpayer before Budget Day. A taxpayer shall not be considered to be obligated if, as a result of amendments to the Act, the taxpayer may be excused from the obligation.

(26) That such other amendments to the Act be made as are necessary to give effect to the proposals relating to the avoidance of tax through the use of partnerships that hold income assets described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: *Resolutions 22-23 —Amalgamations and Windings-up*

When a parent corporation amalgamates with a subsidiary under a vertical amalgamation, or if the subsidiary is wound up into the parent, the governing provisions of subsection 88(1) contain the so-called bump rule (the section 88 bump). The section 88 bump effectively allows the parent to add certain amounts to the cost of the capital property distributed by the subsidiary to the parent on the vertical amalgamation or winding-up. The total bump for all such properties is limited to the amount by which the adjusted cost base of the parent's former shares in the subsidiary exceeds the total of the subsidiary's cost amounts of its properties and the money owned immediately before the vertical amalgamation or winding-up (with certain further adjustments).

Among other restrictions, the parent can bump up the cost of a particular capital property only to the extent that the fair market value of the property at the time the parent last acquired control of the subsidiary exceeds the cost amount of the property immediately before the amalgamation or winding-up. (See the proposed changes to this rule, below, in respect of property that is a partnership interest.)

Furthermore, the property must have been owned by the subsidiary at the time the parent last acquired control of the subsidiary and thereafter without interruption, until it was distributed to the parent on the amalgamation or winding-up.

The bump does not apply to depreciable property, inventory or other income assets, since these properties could have accrued gains or profit that, from a policy perspective, should not benefit from a bumped-up cost attributable to non-depreciable capital property (i.e., the parent's shares in the subsidiary).

According to the Budget papers, corporate partnership structures have been used with increasing frequency to attempt to circumvent the denial of the section 88 bump in respect of a subsidiary's inventory or income assets. The income assets would be held by the subsidiary through a partnership. Upon the acquisition of control of the subsidiary, the parent winds up the subsidiary and then claims the bump for the cost of the partnership interest, even in

circumstances where all of the fair market value of the partnership interest is derived from inventory or other income assets.

Resolution 22 provides that the section 88 bump will not apply to a partnership interest to the extent that the accrued gain in respect of the partnership interest is reasonably attributable to the amount by which the fair market value of income assets of the partnership exceed their cost amount. More particularly, the fair market value of the partnership interest at the time the parent last acquired control of the subsidiary will be reduced to the extent that the accrued gain of the interest at that time was attributable to accrued gains of depreciable property, Canadian or foreign resource property, or inventory or other property (other than capital property or resource property). Since the amount by which the fair market value of the partnership interest exceeds the cost of the interest to the subsidiary will be thus reduced, the amount by which the parent can bump up the cost of the partnership interest will also be reduced.

Resolution 23 provides that Resolution 22 will apply to amalgamations that occur, and windings-up that begin, on or after March 29, 2012. An exception is provided where a taxable Canadian corporation amalgamates with a subsidiary before 2013, or begins to wind up its subsidiary before 2013, generally if the parent acquired control of the subsidiary before March 29, 2012 or was obligated in writing before March 29, 2012 to acquire control of the subsidiary and the parent had the intention as evidenced in writing before Budget Day to amalgamate with or wind up the subsidiary.

Resolutions 24-26 —Application of Section 100

Subsection 100(1) ensures that accrued profits from inventory or other income property, where the property is held in a partnership, is subject to income tax if the interest in the partnership is sold to a person exempt from tax under section 149 (“a tax-exempt entity”). Generally, subsection 100(1) provides that a taxpayer’s taxable capital gain for a year from the disposition of an interest in a partnership to any tax-exempt entity is ½ of the portion of the capital gain that can reasonably be attributed to increases in value of non-depreciable capital property of the partnership, plus the whole of the remaining portion of such capital gain (i.e., the amount that would relate to inventory, recapture, or other ordinary income of the property in the partnership, etc.).

Resolution 24 extends this rule to indirect dispositions of partnership interests to tax-exempt entities. This resolution also extends this rule to direct and indirect dispositions of partnership interests to non-resident purchasers. These measures will apply to dispositions of interests in partnerships that occur on or after March 29, 2012, other than an arm’s length disposition made by a taxpayer before 2013 that the taxpayer is obligated to make pursuant to a written agreement entered into by the taxpayer before March 29, 2012 (Resolution 25).

Resolution 24 does not apply to the disposition of the partnership interest to a non-resident if the partnership, immediately before and after the sale, is carrying on business in Canada through a permanent establishment, in which all of the assets of the partnership are used. In such cases, as the Budget documents note, “the income assets remain within the Canadian income tax base.”

Resolution 26 states that other amendments will be made to the Act in order to give effect to proposals relating to the avoidance of tax through the use of partnerships that own income assets. In this regard, the Budget documents state generally that corporate partnership structures have been used with increasing frequency to circumvent the denial of the section 88 bump rules. No specific proposals were referred to in the Budget documents, and presumably the Department of Finance is reviewing this issue.

Resolution 27: Partnership Waivers

(27) That, effective on Royal Assent to the enacting legislation, section 152 of the Act be amended by adding the following after subsection (1.8):

Waiver of determination limitation period

(1.9) A waiver in respect of the period during which the Minister may make a determination under subsection (1.4) in respect of a partnership for a fiscal period may be made by one member of the partnership if that member is

(*a*) designated for that purpose in the information return made under section 229 of the *Income Tax Regulations* for the fiscal period; or

(*b*) otherwise expressly authorized by the partnership to so act.

Editorial Comment: Resolution 27 is intended to provide a more administratively efficient means of allowing a partnership to waive the statutory limitation period under subsection 152(1.4) during which the Minister may make a determination of the partnership's income or loss.

Subsections 152(1.4) through 152(1.8) deal with the Minister's authority to make determinations at the partnership level. Pursuant to subsection 152(1.4), the Minister may, within a defined limitation period, make a determination in connection with any income or loss of a partnership, for a particular fiscal period of the partnership. In addition, the Minister may make a determination, within the specified time, with respect to any deduction, amount or matter at the partnership level or relating to the partnership, that is relevant in determining the tax liability of, amounts payable by, or refundable to any member of the partnership under Part I of the Act. Once the Minister makes a determination or redetermination pursuant to subsection 152(1.4), paragraph 152(1.7)(a) stipulates that, subject to the rights of objection and appeal of the partnership's designated member (as provided for in subsection 165(1.15)), such determination or redetermination is binding on the Minister and all members of the partnership.

The difficulty with the current law is that, if the partnership desires to waive the limitation period, there is no mechanism allowing for such in the absence of the Minister receiving a waiver from each partner. This may prove administratively difficult in certain circumstances, particularly in partnerships having numerous partners.

Resolution 27 proposes to remedy this situation by allowing the partnership to appoint a single designated partner as having the authority to waive the limitation period in subsection 152(1.4), which is similar to the designation that partners can currently make in respect of the authority to file notices of objection on behalf of the partnership.

This measure will apply on Royal Assent.

Resolution 28: Transfer Pricing Secondary Adjustments

(28) That, for transactions that occur on or after Budget Day, section 247 of the Act be amended by adding the following after subsection (11):

Deemed dividends to non-residents

(12) For the purposes of Part XIII, if a particular corporation would have a transfer pricing capital adjustment or a transfer pricing income adjustment, for a taxation year, if the particular corporation, or a partnership of which the particular corporation is a member, had undertaken no transactions or series of transactions other than those in which a particular non-resident person that does not deal at arm's length with the particular

corporation (other than a corporation that was a controlled foreign affiliate, as defined in subsection 17(15), of the particular corporation throughout the period during which the transaction or series of transactions occurred) was a participant,

(*a*) a dividend is deemed to have been paid by the particular corporation and received by the particular non-resident person at the end of that taxation year; and

(*b*) the amount of the dividend is the amount, if any, by which

(i) the amount that would be the portion of the total of the particular corporation's transfer pricing capital adjustment, and transfer pricing income adjustment, for the taxation year that could reasonably be considered to relate to the particular nonresident person if

(A) the only transactions or series of transactions undertaken by the particular corporation were those in which the particular non-resident person was a participant, and

(B) the definition "transfer pricing capital adjustment" in subsection (1) were read without reference to the references therein to "1/2 of" and "3/4 of"

exceeds

(ii) the amount that would be the portion of the total of the particular corporation's transfer pricing capital setoff adjustment, and transfer pricing income setoff adjustment, for the taxation year that could reasonably be considered to relate to the particular non-resident person if

(A) the only transactions or series of transactions undertaken by the particular corporation were those in which the particular non-resident person was a participant, and

(B) the definition "transfer pricing capital adjustment" in subsection (1) were read without reference to the references therein to "1/2 of" and "3/4 of".

Repatriation

(13) Where a dividend is deemed by paragraph (12)(*a*) to have been paid by a corporation and received by a non-resident person, and an amount has been paid, with the concurrence of the Minister, by the non-resident person to the corporation, the amount of the dividend may be reduced to the amount that the Minister considers appropriate, having regard to all the circumstances, including the amount of the dividend and the amount of the payment.

Repatriation — interest

(14) Where the amount of a dividend has been reduced because of the application of subsection (13), interest on the amount of the dividend (calculated without reference to subsection (13)) payable in respect of insufficient payments of tax under Part XIII on the amount of the dividend so calculated shall remain payable for the period that begins at the time the dividend was deemed by subsection (12) to have been paid and that ends at the time at which the payer of the dividend received the amount referred to in subsection (13) from a non-resident person in respect of the dividend.

Repatriation — interest

(15) Where the amount of a dividend has been reduced because of the application of subsection (13), the amount of interest payable by a taxpayer because of subsection (14) may be reduced to the amount that the Minister considers appropriate, having regard to all the circumstances, including whether the country in which the non-resident person described in subsection (13) is resident provides reciprocal treatment.

Non-application of ss. 15, 56(2) and 246

(16) Section 15, subsection 56(2) and section 246 do not apply in respect of an amount in respect of which a dividend is deemed by paragraph (12)(*a*) to have been paid by a corporation and received by a non-resident person.

Editorial Comment: Transfer pricing is the practice of determining the appropriate price at which a person purchases or sells goods or services from or to a non-arm's length person. Canada's transfer pricing rules are contained in section 247 of the Act and generally attempt to enforce an "arm's length" principle, meaning that the price agreed to between non-arm's length parties should reflect the market price that would otherwise be paid by parties who are dealing at arm's length.

Subsection 247(2) provides that where (i) a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) enter into one or more transactions, and (ii) where either:

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length; or

(b) the transaction series 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 amounts paid or received by the parties will be adjusted to reflect an arm's length amount (see paragraph 247(2)(*a*)), or will be adjusted based on a recharacterization of the transitions themselves to conform to an arm's length standard (see paragraph 247(2)(*b*)). Moreover, subsection 247(10) of the Act provides that the Minister may decrease the value of a transaction (i.e., to reduce the amount that a resident of Canada has paid a related non-resident for goods or services) pursuant to subsection 247(2), when it is appropriate under the circumstances. Subsections 247(2) and (10) therefore work in concert to provide the Minister with the authority to make downward transfer pricing adjustments to the Canadian resident. These adjustments are commonly referred to as "primary adjustments".

However, a primary adjustment does not change the fact that, in the case of a downward adjustment, the Canadian resident will have paid an excessive amount to the non-resident. For example, if the amount actually paid by a Canadian resident for goods or services is $100, but the Minister has made a primary adjustment reducing the amount to $80 for tax purposes, the non-resident has nevertheless received the full $100 payment, which includes a $20 excessive amount. The issue then becomes how to characterize this excessive payment for Canadian tax purposes.

In practice, the Minister has taken the position that these excessive payments are benefits under section 15, subsection 56(2), or section 246 of the Act, and are recharacterized as dividends subject to Canadian withholding tax pursuant to paragraph 214(3)(*a*) of the Act (see, e.g., *General Electric Capital Canada Inc. v. The Queen*, 2010 DTC 1007 (T.C.C.), aff'd 2011 DTC 5011 (FCA)). These administrative adjustments are commonly referred to a "secondary adjustments". However, there is no specific statutory provision in the transfer pricing rules addressing such secondary adjustments. This absence of clear statutory authority was raised by the Transfer Pricing Subcommittee of the Advisory Panel on Canada's System of International Taxation (the "Subcommittee") in 2008, with a recommendation to add a specific rule authorizing the Minister to make secondary adjustments.

Resolution 28 adopts the Subcommittee's recommendations and proposes to add new subsections 247(12) to (16) clarifying the Minister's authority to make secondary adjustments.

Proposed subsection 247(12) generally provides that a secondary adjustment will result in a dividend being deemed to have been paid by a Canadian corporation that has been the subject of a primary adjustment. The dividend will be deemed to have been paid to each non-arm's length non-resident participant in the relevant transaction or series of transactions in proportion to the amount of the primary adjustment that relates to the non-resident. This dividend treatment will apply regardless of whether the non-resident is a shareholder of the Canadian corporation.

Proposed subsection 247(13) provides the Minister with discretionary power to reduce the amount of the deemed dividend where the non-resident dividend recipient has repaid a portion of the deemed dividend to the Canadian corporation. The CRA's administrative repatriation policy is presently set out in Transfer Pricing Memorandum TPM-02 dated March 27, 2003, and proposed subsection 247(13) will legislate the existing administrative policy. The non-resident must first obtain the concurrence of the Minister before any such payment is made. The Minister's discretion must be exercised having regard to all of the circumstances, including the amount of the deemed dividend and the amount repaid by then non-resident. Proposed subsections 247(14) and (15) provide a measure of interest relief to the Canadian corporation in respect of underpayments of Part XIII tax where the Minister has exercised his discretion under proposed subsection 247(13).

Proposed subsection 247(16) clarifies that secondary adjustments and their resulting deemed dividends are governed solely under proposed subsection 247(12) and that section 15, subsection 56(2), and section 246 are inapplicable for this purpose.

This measure will apply to transactions (including transactions that are part of a series of transactions) that occur after March 29, 2012.

It should be noted that the Subcommittee made a number of other recommendations in its 2008 report relating to transfer pricing, primarily relating to dispute resolution and administration, which are not addressed in Budget 2012.

Resolution 29: Thin Capitalization — Debt-to-Equity Ratio

(29) That, for taxation years that begin after 2012, the reference to "two" in subparagraph 18(4)(*a*)(ii) of the Act be replaced with "1.5".

Resolution 30: Thin Capitalization — Partnerships

(30) That, for taxation years that begin on or after Budget Day,

(a) in determining whether the debt-to-equity ratio of a corporation resident in Canada exceeds the debt-to-equity ratio set out in subsection 18(4) of the Act, each member of a partnership be deemed to owe that member's specified proportion, within the meaning proposed to be assigned by subsection 248(1) of the Act as set out in Department of Finance news release 2010-068 (dated July 16, 2010), of the debts owed by the partnership; and

(b) there be included in computing the income of the corporation an amount equal to the interest on the portion of the debts owing by the partnership to specified non-residents, that are allocated to the corporation under subparagraph (*a*), that exceeds the debt-to-equity ratio set out in subsection 18(4) of the Act.

Resolution 31: Thin Capitalization — Disallowed Interest Treated as a Dividend

(31) That, for taxation years that end on or after Budget Day,

(a) for the purposes of Part XIII of the Act, interest paid or credited, by a corporation resident in Canada or by a partnership of which the corporation is directly or indirectly a member (referred to in this paragraph as the "payer"), in a taxation year of the corporation to a non-resident person be deemed to have been paid by the corporation as a dividend and, except for this paragraph, not to have been paid or credited by the payer as interest to the extent that

(i) the interest is not deductible to the corporation because of the application of subsection 18(4) of the Act, or

(ii) an amount in respect of the interest is included in computing the income of the corporation because of the application of any measure giving effect to subparagraph (30)(*b*);

(b) for the purposes of this paragraph, interest that is payable at a time that is in the taxation year referred to in subparagraph (*a*) but that has not been paid or credited in that taxation year be deemed to have been paid immediately before the end of that taxation year and not at any other time;

(c) for the purpose of determining the time at which a deemed dividend, that arises because of the application of subparagraph (*a*) to a taxation year, is considered to have been paid to a particular specified non-resident, the corporation may designate, on or before the corporation's filing-due date for the taxation year, which amounts paid or credited in the taxation year as interest to the particular specified non-resident are to be recharacterized as dividends; and

(d) where the taxation year includes Budget Day, the amount of each dividend deemed by subparagraph (*a*) to have been paid in the taxation year be the proportion of the amount of the dividend otherwise determined that the number of days that are in the taxation year that are on or after Budget Day is of the number of days that are in the taxation year.

Resolution 32: Thin Capitalization — Foreign Affiliate Loans

(32) That, for taxation years that end on or after Budget Day,

(a) an amount of interest, the deductibility of which by a corporation resident in Canada would otherwise be denied because of the application of subsection 18(4) of the Act, shall not be denied to the extent of any portion of the interest that is included in computing the income of the corporation in respect of the foreign accrual property income of a controlled foreign affiliate of the corporation (net of any amount deductible in respect of that portion of the interest because of the application of subsection 91(4) of the Act); and

(b) an amount in respect of interest, that would otherwise be required to be included in computing the income of a corporation resident in Canada because of the application of subparagraph (30)(*b*), shall not be included to the extent of any portion of the interest that is included in computing the income of the corporation in respect of the foreign accrual property income of a controlled foreign affiliate of the corporation (net of any amount deductible in respect of that portion of the interest because of the application of subsection 91(4) of the Act).

Editorial Comment: Resolutions 29 to 32 relate to Canada's thin capitalization rules in subsections 18(4) to 18(6) of the Act and largely reflect the recommendations made by the Advisory Panel on Canada's System of International Taxation (the "Advisory Panel") in 2008.

Current subsections 18(4) through 18(6) are directed at preventing non-residents of Canada who own significant shareholdings (generally over 25%) in Canadian resident corporations from withdrawing the profits of that Canadian resident corporation from Canada in the form of excessive interest payments (which would otherwise be deductible in computing the Canadian corporation's income), rather than in the form of after-tax dividends paid by the Canadian corporation. Since interest is, but for the limitation in subsection 18(4), deductible in computing the income of a Canadian resident corporation, it could be to a non-resident's advantage to finance the operation of a Canadian resident corporation through interest bearing debt rather than through share capital, where the non-resident is taxed on the interest at a lower rate than the rate applicable to the Canadian corporation. Excessive leverage could therefore lead to thinly capitalized corporations and an undesirable erosion of the Canadian tax base.

The Advisory Panel concluded that Canada's thin capitalization rules are generally effective, transparent and relatively simple to administer and comply with. However, the Advisory Panel concluded that certain aspects of the rules merit strengthening, in order to ensure the rules remain effective in maintaining and protecting Canada's tax base.

Resolution 29 relates to the acceptable debt to equity ratio of a Canadian corporation. The amount of interest which is currently disallowed as a deduction under subsection 18(4) is a prorated portion of the interest payable on debts owing to specified non-residents, based on the amount by which such debts exceeds two times the equity of the Canadian resident corporation. The Advisory Panel noted that this 2 to 1 debt to equity ratio is too high compared to actual industry ratios in the Canadian economy, as well as general global standards. Resolution 29 adopts the recommendation of the Advisory Panel to reduce the debt to equity ratio to 1.5 to 1, which will be effective for taxation years that begin after 2012.

Resolution 30 relates to the application of the thin capitalization rules to partnerships in which a Canadian corporation is a partner. The current wording of subsection 18(4) does not address partnerships. However, a decision of the Ontario courts held the debt of a partnership to be a debt of a corporate member of the partneship for purposes of applying the thin capitalization rules (see *Wildenburg Holdings Ltd.*, 98 DTC 6462) (Ont. (Gen. Div.), aff'd 2001 DTC 5145 (OCA)). The Canada Revenue Agency has stated that in certain circumstances, they would apply the thin capitalization rules to partnership debt as well (see *Income Tax Technical News* No.16.) A further recommendation of the Advisory Panel was to extend the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations. Resolution 30 adopts the Advisory Panel's recommendation as it pertains to partnerships of which a Canadian corporation is a member. Pursuant to this proposed amendment, a Canadian corporate partner will be attributed its proportionate share of any partnership debt, and will be required to include in income any interest on the portion of the allocated partnership debt that exceeds the corporate partner's debt to equity ratio under subsection 18(4). This proposed change will be effective for taxation years ending after March 29, 2012.

Resolution 31 relates to the character of interest paid to non-residents in circumstances where the Canadian payor has been denied an interest deduction in respect of a portion of the amount paid. Currently, interest paid by a Canadian corporation on debt that exceeds the corporation's debt to equity ratio under subsection 18(4) retains its character as interest for withholding tax purposes under Part XIII of the Act. Generally, Canada does not levy withholding tax on interest paid to a non-arm's length resident of the United States pursuant to the Canada–US Tax Treaty; however, interest paid to non-arm's length parties in generally any other treaty jurisdiction attracts Canadian withholding tax at a rate of 10% under the

applicable tax treaty. Compare this to the general 5% Canadian withholding tax rate on dividends paid to a resident of a treaty country holding a substantial interest in the Canadian dividend payor. From a Canadian withholding tax perspective, a resident of the U.S. would likely prefer that any interest that is denied deductibility under subsection 18(4) retain its character as interest, whereas a resident of any other treaty country would likely prefer that the amount be recharacterized as a dividend. The Advisory Panel recommended that the government consider this issue further to ensure that non-residents were prevented from inappropriately reducing their withholding tax obligations.

Resolution 31 suggests that that the government has completed its review of this issue and provides that disallowed interest expense (including interest on partnership debt included in income under Resolution 30) will be recharacterized as a dividend for Canadian withholding tax purposes. For this purpose, interest that is payable at any time in a taxation year, but that has not been paid or credited in the year, will be deemed to have been paid immediately before the end of that taxation year (i.e., the accrual of interest will not negate the application of deemed dividend treatment). There is a mechanism that will generally allow the Canadian corporation flexibility to allocate the disallowed interest expense to the latest interest payments made to any particular specified non-resident in the taxation year. This measure will apply to taxation years that end on or after March 29, 2012, with pro-rating for taxation years that straddle March 29, 2012.

Resolution 32 relates to the application of the thin capitalization rules in the context of debts owing to controlled foreign affiliates. The restrictions in subsection 18(4) apply to interest paid in respect of "outstanding debts to specified non-residents", which can sweep within its ambit loans made to a Canadian corporation by its controlled foreign affiliates. In such circumstances, there exists a potential for double tax since: (i) the Canadian corporation will be unable to claim a deduction for any interest expense denied under subsection 18(4), and (ii) the Canadian corporation may be required to include all or a portion of the interest received by the non-resident affiliate (including any amount in respect of the denied interest expense) in computing its foreign accrual property income (FAPI). Resolution 32 proposes to carve out from the application of subsection 18(4) any interest paid by a Canadian corporation (or included in the income of a corporate partner under Resolution 30) that would be included in the income of the Canadian corporation as FAPI from a controlled foreign affiliate (net of certain amounts deductible in respect of foreign taxes). This measure will apply to taxation years ending on or after March 29, 2012.

Resolutions 33 to 40: Foreign Affiliate Dumping

(33) That, for contributed surplus that arises on or after Budget Day,

(a) clause 18(4)(*a*)(ii)(B) of the Act be replaced with the following:

(B) the average of all amounts each of which is the corporation's contributed surplus (other than any portion of such contributed surplus that arose from a transaction or event in respect of which subsection 212.3(2) applied) at the beginning of a calendar month that ends in the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation, and

(b) paragraphs 84(1)(c.1) and (c.2) of the Act be replaced with the following:

(*c.1*) where the corporation is an insurance corporation, any action by which it converts contributed surplus related to its insurance business (other than any portion of such contributed surplus that arose from a transaction or event in respect of which subsection 212.3(2) applied) into paid-up capital in respect of the shares of its capital stock,

(*c.2*) where the corporation is a bank, any action by which it converts any of its contributed surplus that arose on the issuance of shares of its capital stock (other than any portion of

such contributed surplus that arose from a transaction or event in respect of which subsection 212.3(2) applied) into paid-up capital in respect of shares of its capital stock, or

(*c*) subparagraphs 84(1)(*c*.3)(i) and (ii) of the Act be replaced with the following:

(i) on the issuance of shares of that class or shares of another class for which the shares of that class were substituted (other than an issuance to which section 51, 66.3, 84.1, 85, 85.1, 86 or 87, subsection 192(4.1), 194(4.1) or section 212.1 applied, or an issuance in respect of which subsection 212.3(2) applied),

(ii) on the acquisition of property by the corporation (other than an acquisition in respect of which subsection 212.3(2) applied) from a person who at the time of the acquisition held any of the issued shares of that class or shares of another class for which shares of that class were substituted for no consideration or for consideration that did not include shares of the capital stock of the corporation, or

(34) That, effective Budget Day, references to paragraph 128.1(1)(*c*.3) and section 212.3 of the Act be added to subparagraph (*b*)(iii) of the definition "paid-up capital" in subsection 89(1) of the Act.

(35) That, effective Budget Day, the portion of subsection 93.1(1) of the Act before paragraph (*a*), as proposed in Department of Finance news release 2011-070 (dated August 19, 2011), be replaced with the following:

Shares held by a partnership

93.1. (1) For the purposes of determining whether a non-resident corporation is a foreign affiliate of a corporation resident in Canada for the purposes of subsections (2) and 20(12), sections 90, 93 and 113, paragraphs 128.1(1)(*c*.3) and (*d*) and section 212.3, (and any regulations made for the purposes of those provisions), section 95 (to the extent that it is applied for the purposes of those provisions) and section 126, where based on the assumptions contained in paragraph 96(1)(*c*), at any time shares of a class of the capital stock of a corporation are owned by a partnership or are deemed under this subsection to be owned by a partnership, each member of the partnership is deemed to own at that time the number of those shares that is equal to the proportion of all those shares that

(36) That, effective Budget Day, subsection 93.1(3) of the Act, as proposed in Department of Finance news release 2011-070 (dated August 19, 2011), be amended by deleting "and" at the end of paragraph (*b*), by adding "and" at the end of paragraph (*c*) and by adding the following after paragraph (*c*):

(*d*) section 212.3.

(37) That, in respect of taxpayers that become resident in Canada on or after Budget Day, subsection 128.1(1) of the Act be amended by adding the following after paragraph (*c*.2):

(*c.3*) if the taxpayer is a corporation that was, at the time (referred to in this paragraph as the "prior time") that is immediately before the particular time, controlled by a particular non-resident corporation and the taxpayer owned at the prior time one or more shares of another non-resident corporation that, immediately after the particular time, was — or that became, as part of a transaction or event or series of transactions or events that includes the taxpayer having become resident in Canada — a foreign affiliate of the taxpayer, then

(i) in computing the paid-up capital at or after the particular time of any particular class of shares of the capital stock of the taxpayer, there is to be deducted that proportion of the amount that is the lesser of the paid-up capital in respect of all of the shares of the capital stock of the taxpayer at the particular time, computed without reference to this

paragraph, and the fair market value, at the particular time, of the shares owned by the taxpayer of the foreign affiliate that the paid-up capital, as so computed, in respect of the shares of the particular class is of the paid-up capital, as so computed, in respect of all of the issued shares of the capital stock of the taxpayer, and

(ii) for the purposes of Part XIII, the taxpayer is deemed, immediately after the particular time, to have paid to the particular non-resident, and the particular non-resident is deemed, immediately after the particular time, to have received from the taxpayer, a dividend equal to the amount, if any, by which the fair market value, at the particular time, of the shares owned by the taxpayer of the foreign affiliate exceeds the paid-up capital in respect of all of the shares of the capital stock of the taxpayer, computed without reference to this paragraph.

(38) That, in respect of transactions or events that occur on or after Budget Day, the Act be amended by adding the following after section 212.2:

Foreign affiliate dumping — conditions for application

212.3.

(1) Subsection (2) applies to an investment in a non-residentcorporation (referred to in this section as the "subject corporation") that is made, at any time, by a corporation resident in Canada (referred to in this section as the "CRIC") if

(*a*) the subject corporation is, immediately after that time, or becomes, as part of a transaction or event or series of transactions or events that includes the investment, a foreign affiliate of the CRIC;

(*b*) the CRIC is at that time controlled by another non-resident corporation (referred to in this section as the "parent"); and

(*c*) the investment may not reasonably be considered to have been made by the CRIC, instead of being made or retained by the parent or another non-resident person that does not deal at arm's length with the parent, primarily for *bona fide* purposes other than to obtain a tax benefit (as defined in subsection 245(1)).

Foreign affiliate dumping — consequences

(2) If this subsection applies to an investment in a subject corporation,

(*a*) for the purposes of this Part, the CRIC is deemed to have paid to the parent at the time the investment was made, and the parent is deemed to have received from the CRIC at that time, a dividend equal to the total of all amounts each of which is the fair market value, at that time, of any property (not including, for greater certainty, shares of the capital stock of the CRIC) transferred, or obligation assumed or incurred, by the CRIC in respect of the investment; and

(*b*) in computing the paid-up capital at any time on or after Budget Day of any class of shares of the capital stock of the CRIC, there is to be deducted the amount of any increase, because of the investment, in the paid-up capital in respect of the shares of the class, computed without reference to this section.

Investment in subject corporation

(3) For the purposes of this section, an investment made in a subjectcorporation by a CRIC means any of

(*a*) an acquisition of shares of the capital stock of the subject corporation by the CRIC;

(*b*) a contribution of capital to the subject corporation by the CRIC;

(*c*) a transaction under which an amount became owing by the subject corporation to the CRIC, other than an amount owing that arises in the ordinary course of the business of the CRIC and that is repaid within a commercially reasonable period;

(*d*) an acquisition of a debt obligation of the subject corporation by the CRIC from another person, other than, if the acquisition was made in the ordinary course of the business of the CRIC, an acquisition from a person with which the CRIC dealt, at the time of the acquisition, at arm's length;

(*e*) an acquisition by the CRIC of an option in respect of, or an interest in, or for civil law a right in, shares of the capital stock, or a debt obligation, of the subject corporation; and

(*f*) any transaction or event that is similar in effect to any of the transactions described in paragraphs (*a*) to (*e*).

Multiple controllers

(4) For the purposes of this section and paragraph 128.1(1)(c.3), a CRICthat is controlled by more than one non-resident corporation is deemed not to be controlled by any such non-resident that controls another non-resident corporation that controls the CRIC, unless the application of this subsection would otherwise result in no non-resident corporation controlling the CRIC.

Bona fide purpose — primary factors

(5) In determining whether paragraph (1)(*c*) applies, the followingfactors are to be given primary consideration:

(*a*) whether the business activities carried on by the subject corporation and any other corporation in which the subject corporation has, at the time referred to in subsection (1), an equity percentage (as defined in subsection 95(4)) are at that time, and are expected to remain, more closely connected to the business activities carried on by the CRIC (or by a corporation resident in Canada that is a subsidiary wholly-owned corporation of the CRIC or that is a corporation of which the CRIC is a subsidiary wholly-owned corporation) than to the business activities carried on by any nonresident corporation (other than the subject corporation or any corporation in which the subject corporation has such an equity percentage) with which the CRIC, at that time, does not deal at arm's length;

(*b*) whether the terms or conditions of any shares of the subject corporation that are owned by the CRIC at that time, or any agreement in respect of the shares or their issue, are such that the CRIC does not fully participate in the profits of the subject corporation or any appreciation in the value of the subject corporation (for greater certainty, the fact that the shares owned by the CRIC do fully participate in the profits of the subject corporation and any appreciation in the value of the subject corporation is not a relevant factor);

(*c*) whether the investment was made at the direction or request of a non-resident corporation with which the CRIC was not, at that time, dealing at arm's length;

(*d*) whether, in the case of an investment described in paragraph (3)(*a*), (*d*), (*e*) or (*f*), negotiations with the vendor in respect of the investment were initiated by senior officers of the CRIC who were resident in, and worked principally in, Canada or, if the vendor initiated the transaction, the vendor's principal point of contact was an officer of the CRIC who was resident in, and worked principally in, Canada;

(*e*) whether senior officers of the CRIC who were resident in, and worked principally in, Canada had and exercised the principal decision-making authority in respect of the making of the investment, and have and exercise the principal decision making authority in respect of the investment;

(*f*) whether the performance evaluation or compensation of senior officers of the CRIC who are resident in, and work principally in, Canada is connected to the results of operations of the subject corporation to a greater extent than the performance evaluation or compensation of any senior officers of a non-resident corporation (other than the subject corporation or a corporation controlled by the subject corporation) that does not deal at arm's length with the CRIC is so connected; and

(*g*) whether senior officers of the subject corporation report to, and are functionally accountable to, senior officers of the CRIC who are resident in, and work principally in, Canada to a greater extent than to any senior officers of any non-resident corporation (other than the subject corporation) that does not deal at arm's length with the CRIC.

Indirect investment

(6) A particular investment by a CRIC in a subject corporation thatwould, in the absence of this subsection, be excluded from the application of subsection (2) because of paragraph (1)(*c*) is not to be so excluded to the extent that one or more properties, if any, received by the subject corporation from the CRIC as a result of the particular investment, or property substituted for any such property, may reasonably be considered to have been used by the subject corporation, directly or indirectly as part of a transaction or event or series of transactions or events that includes the particular investment, to make another investment in a non-resident corporation that would, if the other investment had been made by the CRIC, have been subject to subsection (2).

Partnerships

(7) For the purposes of this section, paragraph 128.1(1)(*c*.3) and subsection 219.1(2)

(*a*) any transaction entered into by a partnership is deemed to have been entered into by each member of the partnership in proportion to the fair market value of the member's direct or indirect interest in the partnership;

(*b*) property that would, in the absence of this paragraph, be owned by a partnership is deemed to be owned by each member of the partnership in proportion to the fair market value of the member's direct or indirect interest in the partnership; and

(*c*) amounts that would, in the absence of this paragraph, be owing by a partnership are deemed to be owed by each member of the partnership in proportion to the fair market value of the member's direct or indirect interest in the partnership.

(39) That paragraph (38) not apply to a transaction that occurs before 2013 between persons that deal at arm's length and that are obligated to complete the transaction pursuant to the terms of an agreement in writing between the persons that was entered into before Budget Day. A person will be considered not to be obligated to complete a transaction if the person may be excused from completing the transaction as a result of amendments to the Act.

(40) That, in respect of taxpayers that cease to be resident in Canada on or after Budget Day, section 219.1 of the Act be renumbered as subsection 219.1(1) and that section 219.1 be amended by adding the following after that subsection (1):

Foreign affiliate dumping — corporate emigration

(2) For the purposes of paragraph (1)(*b*), if any shareholder of the corporation referred to in that paragraph (referred to in this subsection as the "emigrating corporation") is, at the time the emigrating corporation ceases to be resident in Canada, a corporation resident in Canada that is controlled, at that time, by a non-resident corporation, the amount that would, in the absence of this subsection, be the paid-up capital in respect of

all of the issued and outstanding shares of each class of the capital stock of the emigrating corporation immediately before that time is deemed to be nil.

Editorial Comment: Resolution 38 proposes a new anti-avoidance rule relating to investments by a Canadian corporation in the shares of a foreign corporation generally where (i) following the investment, the foreign corporation is a foreign affiliate of the Canadian corporation; (ii) the Canadian corporation is controlled by another foreign corporation; and (iii) it is reasonable to conclude that the investment was not made primarily for *bona fide* purposes other than to obtain a tax benefit. Resolutions 33 to 37 and 39 to 40 contain consequential amendments reflecting the proposed rule in Resolution 38.

In 2008, the Advisory Panel on Canada's System of International Taxation (the "Advisory Panel") recommended that Canada curtail tax-motivated "debt dumping" within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian corporation of an equity interest in a related foreign corporation. In response to the Advisory Panel's suggestions, resolution 38 generally targets certain transactions that are capable of generating interest deductions in Canada in respect of the acquisition of shares of a foreign affiliate (and that are not otherwise caught under the thin capitalization rules of subsection 18(4)) or that strip cash out of a Canadian corporation without triggering Canadian dividend withholding tax (and that are not otherwise caught under existing section 212.1).

Resolution 38 provides that a corporation resident in Canada (referred to as the "CRIC") will be deemed to have paid a dividend to a non-resident corporation that controls the CRIC (referred to as the "parent") at the time the CRIC makes certain "investments" (which is defined to include the acquisition of shares, debt or options, contributions to capital and transactions under which an amount becomes owing to the CRIC) in a corporation that is immediately after the investment (or becomes, as a part of a transaction or event, or series of transactions and events, that includes the investment) a foreign affiliate of the CRIC. As described further below, investments that can reasonably be considered to have been made primarily for *bona fide* purposes other than to obtain a tax benefit are generally excluded from this rule.

The dividend will generally be based on the fair market value of any property (other than shares of the CRIC) transferred by the CRIC in respect of the investment and will be subject to Canadian dividend withholding tax, subject to a reduction under any applicable tax treaty. There are also proposed adjustments to prevent an increase in the paid-up capital of the class of shares of the CRIC issued in connection with the investment.

According to the Budget materials, the transactions that seem to be the focus of these proposed measures include:

- A Canadian subsidiary of foreign parent using borrowed funds to acquire shares of a foreign affiliate from its foreign parent corporation (expectation under current law is that interest paid by the Canadian subsidiary on such borrowed money is deductible in computing income for tax purposes while, at the same time, most dividends received by the Canadian subsidiary on the shares of the foreign affiliate are exempt from taxation);

- Acquisitions of shares of a foreign affiliate by a foreign-controlled Canadian corporation that are made with internal funds of the Canadian corporation (expectation under current law is that the foreign parent corporations will be able to extract earnings from their Canadian subsidiaries free of Canadian dividend withholding tax);

- Acquisitions by a foreign-controlled Canadian corporation of newly-issued shares of a foreign affiliate, whether financed with internal or borrowed funds, where previ-

ously-issued shares of the foreign affiliate are owned by the foreign parent or another non-resident member of the same corporate group;

- Acquisitions by a foreign-controlled Canadian corporation of shares of a foreign affiliate from a foreign subsidiary of the foreign parent;
- Acquisitions by a foreign-controlled Canadian corporation of shares of a foreign affiliate from an arm's length party at the request of the foreign parent.

As indicated above, *bona fide* business transactions are excluded from the operation of this rule. Resolution 38 defines certain factors that are to be given primary (although not exclusive) consideration for this purpose. These factors generally relate to whether it is reasonable to conclude that the investment in the foreign affiliate by the Canadian corporation "belongs" in the Canadian corporation more than any other entity in the foreign parent's corporate group. Given the inherent subjectivity of this sort of business purpose test, the government has invited comments from the public prior to June 1, 2012 concerning the factors outlined in resolution 38.

This measure will apply to transactions that occur on or after March 29, 2012, other than transactions that occur before 2013 between parties that deal at arm's length and that are obligated to complete the transaction pursuant to the terms of an agreement in writing between the parties that is entered into before March 29, 2012.

Resolution 41: Overseas Employment Tax Credit

(41) That, for the 2013 and subsequent taxation years, section 122.3 of the Act be amended by

(a) replacing the reference to "$80,000" in paragraph 122.3(1)(*c*) with "the specified amount for the year";

(b) replacing the reference to "80%" in paragraph 122.3(1)(*d*) with "the specified percentage for the year"; and

(c) adding the following after subsection 122.3(1):

Specified amount

(1.01) For the purposes of paragraph (1)(*c*), the specified amount for a taxation year of an individual is

(*a*) for the 2013 to 2015 taxation years, determined by the following formula:

$$[\$80,000 \times A/(A + B)] + [C \times B/(A + B)]$$

where

A is the individual's income described in paragraph (1)(*d*) for the taxation year that is earned in connection with a contract that was committed to in writing before Budget Day by a specified employer of the individual,

B is the individual's income described in paragraph (1)(*d*) for the taxation year, other than income included in the description of A, and

C is

(i) for the 2013 taxation year, $60,000,

(ii) for the 2014 taxation year, $40,000, and

(iii) for the 2015 taxation year, $20,000, and

(*b*) for the 2016 and subsequent taxation years, nil.

Specified percentage

(1.02) For the purposes of paragraph (1)(*d*), the specified percentage for a taxation year of an individual is

(*a*) for the 2013 to 2015 taxation years, determined by the following formula:

$$[80\% \times A/(A + B)] + [C \times B/(A + B)]$$

where

A is the value of A in subsection (1.01),

B is the value of B in subsection (1.01), and

C is

(i) for the 2013 taxation year, 60%,

(ii) for the 2014 taxation year, 40%, and

(iii) for the 2015 taxation year, 20%, and

(*b*) for the 2016 and subsequent taxation years, 0%.

Editorial Comment: Under section 122.3 of the Act, an individual may be eligible for the Overseas Employment Tax Credit ("OETC"), where the individual is employed by a "specified employer" (generally, a resident of Canada), in connection with a contract under which the specified employer carried on business outside Canada on a resource, construction, installation, agriculture or engineering activity, and all or substantially all of the employment duties were performed outside Canada.

The OETC allows a taxpayer to reduce the Canadian tax on income earned from the employment by 80%, up to a maximum of $80,000.

Budget 2012 proposes to phase out the OETC over four taxation years, beginning in 2013.

During this phase-out period, the tax credit will be reduced by 20% annually. The current factor of 80% will be reduced to 60% for the 2013 taxation year, 40% for the 2014 taxation year, and 20% for the 2015 taxation year. The OETC will be completely eliminated for the 2016 taxation year and all subsequent years.

Budget 2012 has made one major exception to the phase-out of the OETC. 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 employer had committed in writing before March 29, 2012. In such case, the OETC will remain at 80% throughout the 2013–2015 taxation years.

Resolution 42: Gifts to Foreign Charitable Organizations

(42) That, for applications made by a foreign organization on or after the later of January 1, 2013 and the date of Royal Assent to the enacting legislation,

(a) subparagraph (*a*)(v) of the definition "qualified donee" in subsection 149.1(1) of the Act be replaced with the following:

(v) a foreign organization designated under subsection 149.1(26),

and

(b) section 149.1 of the Act be amended by adding the following after subsection 149.1(25):

Designated foreign charitable organizations

(26) For the purposes of the definition "qualified donee" in subsection (1),

(*a*) the Minister may designate, in consultation with the Minister of Finance, a foreign organization for a 24-month period that includes the time at which Her Majesty in right of Canada has made a gift to the foreign organization, if

(i) the foreign organization is a charitable organization that is not resident in Canada,

(ii) the Minister is satisfied that the foreign organization is

(A) carrying on relief activities in response to a disaster,

(B) providing urgent humanitarian aid, or

(C) carrying on activities in the national interest of Canada, and

(iii) the foreign organization has applied to the Minister for designation under this subsection; and

(*b*) a foreign organization designated under paragraph (*a*) is deemed to have been registered by the Minister at the beginning of the 24-month period.

Editorial Comment: Subject to certain exceptions, a gift made by a Canadian taxpayer to a foreign charity is not eligible for the donation tax credit (or deduction in the case of a corporation) that would otherwise be available if the gift was made to a registered charity.

Currently, a foreign charity that has received a gift from the Government of Canada during the year (or the twelve month period preceding the year) can become a "qualified donee" and thereby become able to issue charitable donations receipts. For a list of foreign entities that currently qualify, see the attachment to IC84-3R.

In order to allow Canadians to receive tax relief for donations to charitable entities undertaking activities of significance to and in the interest of the Canadian public, the ability to obtain "qualified donee" status is to be amended in Budget 2012. In particular, where a foreign charitable organization has received a gift from the Government, such organization may apply for "qualified donee" status if they pursue activities that are (i) related to (a) disaster relief or (b) urgent humanitarian aid, or (ii) in the national interest of Canada.

The Minister of National Revenue (in consultation with the Minister of Finance) will have the discretionary power to grant "qualified donee" status to foreign charities that meet the foregoing requirements. If granted, the status as "qualified donee" will be valid for a 24-month period that begins on a date to be chosen by the Minister of National Revenue, which date will normally not be later than the date of the gift from the Government. The granting of "qualified donee" status will be made public. The Canada Revenue Agency will be developing guidance regarding the administration of this measure.

If a foreign charity already qualifies as a "qualified donee" under the exiting rules, the status will continue until the expiry of their current status.

The proposed amendment will apply to applications made by foreign charities who seek designation on or after the later of January 1, 2013 and Royal Assent of the enacting legislation.

Resolution 43: Charities — Enhancing Transparency and Accountability

(43) That, effective on Royal Assent to the enacting legislation,

(a) the definition "charitable purposes" in subsection 149.1(1) of the Act be replaced with the following:

"charitable purposes" includes the disbursement of funds to a qualified donee, other than a gift the making of which is a political activity;

(b) subsection 149.1(1) of the Act be amended by adding the following definition in alphabetical order:

"political activity" includes the making of a gift to a qualified donee if it can reasonably be considered that a purpose of the gift is to support the political activities of the qualified donee;

(c) paragraphs 149.1(6)(*b*) and (*c*) of the Act be replaced with the following:

(*b*) it disburses income to qualified donees, other than income disbursed by way of a gift the making of which is a political activity, if the total amount of income of the charitable organization that is disbursed to qualified donees in a taxation year does not exceed 50% of its income for the year; or

(*c*) it disburses income to a registered charity that the Minister has designated in writing as a charity associated with it, other than income disbursed by way of a gift the making of which is a political activity.

(d) subsection 149.1(10) of the Act be replaced with the following:

Deemed charitable activity

(10) An amount paid by a charitable organization to a qualified donee that is not paid out of the income of the charitable organization is deemed to be a devotion of a resource of the charitable organization to a charitable activity carried on by it, unless the amount paid is a gift the making of which is a political activity.

(e) subsection 188.2(2) of the Act be amended by deleting "or" at the end of paragraph (c) and by adding the following after paragraph (d):

(*e*) in the case of a registered charity that is a charitable foundation, if the foundation devotes resources to political activities that are not considered under subsection 149.1(6.1) to be devoted to charitable purposes;

(*f*) in the case of a registered charity that is a charitable organization, if the organization devotes resources to political activities that are not considered under subsection 149.1(6.2) to be devoted to charitable activities; or

(*g*) in the case of a registered Canadian amateur athletic association, if the association devotes resources to political activities that are not considered under subsection 149.1(6.201) to be devoted to its exclusive purpose and exclusive function.

(f) section 188.2 of the Act be amended by adding the following after subsection (2):

Suspension — failure to report

(2.1) If a registered charity or a registered Canadian amateur athletic association fails to report information that is required to be included in a return filed under subsection 149.1(14), the Minister may give notice by registered mail to the charity or association that its authority to issue an official receipt referred to in Part XXXV of the *Income Tax*

Regulations is suspended from the day that is seven days after the day on which the notice is mailed until such time as the Minister notifies the charity or association, as the case may be, that the Minister has received the required information in prescribed form.

(g) the portion of subsection 188.2(3) of the Act before paragraph (a) be replaced with the following:

Effect of suspension

(3) If the Minister has issued a notice to a qualified donee undersubsection (1), (2) or (2.1), subject to subsection (4),

and

(h) subsection 188.2(4) of the Act be replaced with the following:

Application for postponement

(4) If a notice of objection to a suspension under subsection (1), (2) or (2.1) has been filed by a qualified donee, the qualified donee may file an application to the Tax Court of Canada for a postponement of that portion of the period of suspension that has not elapsed until the time determined by the Court.

Editorial Comment: Charities are required to operate exclusively for charitable purposes and to devote their resources exclusively to charitable activities. Notwithstanding the foregoing, a registered charity can engage in political activities (which is not a charitable activity or purpose at law) but only so long as such activities (i) utilize a very limited amount of the charity's resources, (ii) are non-partisan, and (iii) are ancillary and incidental to the charity's purposes and activities. For additional information see Political Activities, CPS-022 and the Advisory on Partisan Political Activities.

Budget 2012 states that, in spite of these restrictions, concerns have been raised regarding the political activities undertaken by certain registered charities. Accordingly, Budget 2012 seeks to introduce sanctions applicable to registered charities (and registered Canadian amateur athletic associations) who violate these rules. Previously, the intermediate sanctions available to the Canada Revenue Agency did not apply to political activities undertaken by a charity. Budget 2012 also attempts to fine tune existing sanctions applicable to charities generally.

With respect to political activities, Budget 2012 will amend the provisions which deal with donations made by a charity to another qualified donee. Currently, such donations are considered to have been made for charitable purposes even if the recipient uses the gift for political activities.

This is accomplished by a new definition for "political activity" to be added to subsection 149.1(1). "Political activity" is defined as including the making of a gift to a qualified donee if it can reasonably be considered that a purpose of the gift is to support the political activities of the qualified donee. The definition of "charitable purposes" will exclude disbursements which constitute "political activities". Related changes will also be made to the definitions of when a charitable organization is devoting its resources to charitable activities.

Specifically, the CRA will have the authority to suspend registered charities (and registered Canadian amateur athletic associations) that violate the restrictions on political activities from issuing donation receipts for a period of one year.

With respect to enforcement of existing rules applicable to charities in general, new subparagraph 188.2(2.1) provides that CRA will have similar authority to issue a suspension of receipting privileges if the entity provides inaccurate or incomplete information in its annual

information return required pursuant to subsection 149.1(14), and such suspension will continue until the entity provides the required information.

These measures will apply upon Royal Assent to the enacting legislation.

Resolutions 44 to 47: Tax Shelter Administrative Changes

(44) That, effective on Royal Assent to the enacting legislation, paragraph 227(10)(*b*) of the Act be replaced with the following:

(*b*) subsection 237.1(7.4) or (7.5) by a person or partnership,

(45) That, for applications for identification numbers made

(a) before Budget Day, subsection 237.1(4) of the Act be replaced with the following:

Sales prohibited

(4) A person may, at any time, whether as a principal or an agent, sell or issue, or accept consideration in respect of, a tax shelter only if

(*a*) the Minister has issued before that time an identification number for the tax shelter; and

(*b*) the time is before 2014.

and

(b) on or after Budget Day, paragraph 237.1(4)(*b*) of the Act, as enacted in accordance with paragraph (*a*), be replaced with the following:

(*b*) the time is during the calendar year designated by the Minister as being applicable to the number.

(46) That, in respect of applications for identification numbers made, sales or issuances of tax shelters made and consideration in respect of tax shelters accepted, after Royal Assent to the enacting legislation, paragraph 237.1(7.4)(b) of the Act be replaced with the following:

(*b*) 25% of the greater of

(i) the total of all amounts each of which is the consideration received or receivable from a person in respect of the tax shelter before the correct information is filed with the Minister or the identification number is issued, as the case may be, and

(ii) the total of all amounts each of which is an amount stated or represented to be the value of property that a particular person who acquires or otherwise invests in the tax shelter could donate to a qualified donee, if the tax shelter is a gifting arrangement and consideration has been received or is receivable from the particular person in respect of the tax shelter before the correct information is filed with the Minister or the identification number is issued, as the case may be.

(47) That, in respect of demands to file an information return that are made and in respect of failures to report an amount in an information return filed, after Royal Assent to the enacting legislation, section 237.1 of the Act be amended by adding the following after subsection (7.4):

Penalty

(7.5) Every person who is required under subsection (7) to file an information return and who fails to comply with a demand under section 233 to file the return or to report in the return information required under paragraph (7)(*a*) or (*b*), is liable to a penalty equal to 25% of the greater of

(*a*) the total of all amounts each of which is the consideration received or receivable by the person in respect of the tax shelter from a particular person in respect of whom information required under paragraph (7)(*a*) or (*b*) had not been reported at or before the time the demand was issued or the return was filed, as the case may be; and

(*b*) if the tax shelter is a gifting arrangement, the total of all amounts each of which is an amount stated or represented to be the value of property that the particular person could donate to a qualified donee.

Editorial Comment: Continuing on the theme contained in several recent Budgets to curtail "abusive tax shelters", including those involving charitable donation arrangements, additional measures are contained in Budget 2012.

Specifically, a new penalty contained in proposed subsection 237.1(7.5) is to be levied upon promoters of such schemes who do not comply with demands under section 233 to properly file an information return required pursuant to subsection 237.1(7), including a T5004. The penalty will equal 25% of the *greater* of (a) the total consideration received by the promoter from the particular person who is the subject of the request for information by CRA, and (b) if the tax shelter is a gifting arrangement, the total of all amounts stated or represented to be the value of property that the particular person could donate to a qualified donee. The purpose of this change is to provide a stronger incentive for tax shelter promoters to provide the required information, than the current maximum penalty of $2,500.

Additionally, the existing penalty for selling an interest in a tax shelter before the issuance of the tax shelter identification number is issued is to be increased similarly. Paragraph 237(7.4)(*b*) is to be amended to equal 25% of the greater of (a) the total of all amounts each of which is the consideration received or receivable by the promoter from a person in respect of the tax shelter before the tax shelter identification number is issued, and (b) the total of all amounts each of which is an amount stated or represented to be the value of property that the person could donate to a qualified donee, if the tax shelter is a gifting arrangement and if the consideration is received or receivable by the promoter before the tax shelter identification number is issued. Where this provision applies, the changes enacted by Budget 2012 will presumably result in a much greater penalty than would have otherwise arisen under existing legislation.

For both penalties referred to above, the effective date will be upon Royal Assent of the enacting legislation.

Lastly, a provision has been introduced to limit the period during which a tax shelter identification number is valid. Budget 2012 provides that a tax shelter identification number will be valid only for the calendar year identified in the application. Tax shelter identification numbers currently issued as a result of applications made prior to March 29, 2012 will be valid until the end of 2013.

Other Tax Measures Not in the Notice of Ways and Means Motion

Capital Cost Allowance

Under the capital cost allowance ("CCA") system, Class 43.2 of Schedule II to the *Income Tax Regulations* provides an accelerated CCA rate (50% per year on a declining balance basis) for investments in specified clean energy generation and conservation equipment. This Class sets out a detailed list of eligible equipment. The 50% rate is fairly high in the Canadian tax system, and the Department of Finance notes in Budget 2012 that this rate is an exception to the general practice of setting CCA rates based on the useful life of assets. In Budget 2012, the government proposes to expand Class 43.2 with respect to waste-fuelled thermal energy equipment and equipment of a district energy system that uses thermal energy provided primarily by eligible waste-fuelled thermal energy equipment. Budget 2012 also proposes to expand Class 43.2 to include equipment that uses the residue of plants to generate electricity and heat.

Class 43.2 presently includes waste-fuelled thermal energy equipment, subject to the requirement that the heat energy generated from the equipment is used in an industrial process or a greenhouse. Budget 2012 proposes to expand Class 43.2 by removing this requirement. This measure will apply to assets acquired on or after March 29, 2012 that have not been used or acquired for use before that date.

In addition, Class 43.2 will be expanded to include waste-fuelled thermal energy equipment used for a broader range of applications than is presently permitted. Specifically, equipment that is part of a district energy system that distributes thermal energy primarily generated by waste-fuelled thermal energy equipment will be permitted.

Presently, equipment that uses the residue of plants to produce heat, electricity, bio-fuels and other bio-products is eligible for inclusion in Class 43.2. The Budget proposes to add the residue of plants 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 43.1 or Class 43.2. An example is a greenhouse that produces heat for its operation using a heating system fuelled by the residue of plants.

The foregoing changes broaden the eligible assets which are included in Class 43.1 and Class 43.2. However, Budget 2012 provides that to benefit from Class 43.1 or Class 43.2, taxpayers must do so in an environmentally responsible manner and that equipment using eligible waste fuels will not be eligible under Class 43.1 or Class 43.2 if the applicable environmental laws and regulations of Canada or a province, territory, municipality or a public regulatory body are not complied with at the time the equipment first becomes available for use. This measure will apply to assets acquired on or after March 29, 2012 that have not been used or acquired for use before that date.

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 an amount that is the lesser of (a) 3% of the taxpayers net income, and (b) an indexed dollar amount which in 2012 is $2,109. Regulation 5700 provides a list of specific expenses which are eligible for the

medical expense tax credit, and Budget 2012 proposes to add to the list blood coagulation monitors for use by individuals who require anti-coagulation therapy, including associated disposable peripherals such as pricking devices, lancets and test strips. The cost of these devices will be eligible for the medical expense tax credit when they are prescribed by a medical practitioner and this addition will apply to expenses incurred after 2011.

Previously Announced Measures

The government announced its intention to proceed with the following previously announced measures:

- legislative proposals relating to income tax technical and bijuralism amendments, released on July 16, 2010;
- legislation released on August 27, 2010 relating to foreign affiliates and to certain measures announced in the 2010 Budget;
- legislative proposals relating to income tax technical amendments, released on November 5, 2010;
- legislative proposals relating to real estate investment trust rules, released on December 16, 2010;
- proposed changes to GST/HST rules for financial institutions, released on January 28, 2011;
- draft proposals relating to the deductibility of contingent amounts, withholding tax on interest paid to certain non-residents, and the tax treatment of certain life insurance corporation reserves, released on March 16, 2011;
- measures announced on July 20, 2011 relating to specified investment flow-through entities, real estate investment trusts, and publicly traded corporations;
- legislative proposals released on August 19, 2011 relating to foreign affiliates;
- legislative proposals released on October 31, 2011 relating to income tax and sales and excise tax technical amendments;
- measures announced on November 10, 2011 relating to improving the caseload management of the Tax Court of Canada;
- income tax and GST/HST amendments to accommodate the introduction of Pooled Registered Pension Plans (including legislative proposals released on December 14, 2011);
- automobile expense amounts for 2012 announced on December 29, 2011; and
- measures announced on February 17, 2012 relating to transitional rules for the elimination of the Harmonized Sales Tax in British Columbia.

BUDGET 2012 — GST/HST and Customs

Amendments to the *Excise Tax Act* address health services including medical and assistive devices, the book rebate for literacy organization, tax on imported rental vehicles, and streamlined accounting thresholds. Customs Tariff initiatives increase the duty-free thresholds for returning residents, and remove a duty on certain oils used for energy production.

Health / Medical

Pharmacists — Amendments to the Health Care Services exempting schedule broaden the exemptions surrounding the services of pharmacists. A new section has been added to the exempting schedule, as section 7.3 of Part II of Schedule V. This addition to the list of exemptions excludes dispensing services, which are already zero-rated through the zero-rating schedule. Section 10 of Part II of Schedule V lists as exempt a supply of a prescribed service rendered to an individual, but only if made on the order of a medical practitioner, or registered nurse. This section is expanded to now also include pharmacists which are licensed as such under the laws of a province and are permitted to order such a service. These changes apply to any supply made after Budget Day.

Federally controlled drugs — A new drug is added to the list of zero-rated federally controlled drugs in section 2 of Part I of Schedule VI, which is *(vi.1) Isosorbide-5-mononitrate*. This is a drug used for the treatment of angina pectoris; that is, it is taken in order to prevent or at least reduce the occurrence of angina. This zero-rating applies to a supply made after Budget Day; or on or before Budget Day if tax was not charged on the supply.

Medical Professionals — The definition of medical practitioner in the zero-rating schedule was repealed. The term “specified professional” was added to the definitions of Part II “Medical and Assistive Devices” of the zero-rating schedule. A “specified professional” is any provincially licensed practitioner in the areas of medicine, physiotherapy or occupational therapy, as well as a registered nurse. Corresponding to this change, sections 3,4, 5.1, 7, 14.1, 21.1, 21.2, 23, 24.1, 30, 35, 36, and 41 of that Part were amended to replace the term “medical practitioner” with “specified professional”. These sections refer to the provision of various medical devices and services, such as heart-monitoring equipment, among others, which are zero-rated on the condition of the identity of the person who orders the device or service. These changes apply in respect of any supply made after Budget Day.

Eyeglasses, Contact Lenses — Section 9 of the Medical and Assistance Devices part of the zero-rating schedule is amended to expand who can provide the written order (prescription) for corrective eyewear. In the past, the order was required to be from an eye-care professional. In the amended section, the order may come from anyone provincially licensed to provide such a prescription. This zero-rating applies to a supply made after Budget Day; or on or before Budget Day if tax was not charged on the supply.

Blood Monitor — A new section is added to the list of medical and assistive devices, to zero-rate the supply of blood coagulation devices and materials. This addition applies to supplies made after Budget Day.

Book Rebate for Literacy Organizations

A rebate is available with respect to the GST or federal component of the HST paid on "printed books" by certain public sector bodies which satisfy the definition of "specified person", with a significant purpose of the promotion of literacy. The amended wording of subsection 259.1(2) refers to the new definition of "specified property", which was also added. This term lists the exact types of books which were previously included in the rebate section. The original wording prohibits the rebate if the "specified person" had purchased the book for resale. The new wording also includes this restriction, but with a different application to a literacy-promoting prescribed charity or prescribed qualifying non-profit organization. Such a charity or non-profit is not eligible for the rebate if the purpose is to resell the book for consideration. Hence, these specific entities may resupply the books for free, and still be eligible for the rebate. All other categories of "specified person" continue to have the original restriction, so are not entitled to the rebate if the book is to be resupplied either for free or for an amount of consideration. This change applies to acquisitions and importations in respect of which tax becomes payable after Budget Day.

Temporary Importation — Foreign Rental Vehicles

The provincial portion of HST applies to the value of "non-commercial" imported goods acquired by a resident of a participating province. This includes foreign rental vehicles temporarily imported into Canada by a Canadian resident. Relief has been proposed such that no tax will be payable if the resident has been outside Canada for at least 48 hours. If the resident has been outside Canada for less than 48 hours, the tax will be levied based on a prescribed weekly value, intended to measure the approximate weekly rental cost of the same vehicle in Canada. ($200 for cars, $300 for trucks and vans, and $1000 for recreational vehicles). To effect these changes, the charging provision found in section 212.1 for the provincial component of the tax on imported goods, has been amended, along with the *Non-Taxable Imported Goods (GST/HST) Regulations*. These changes apply to vehicles imported for a period not exceeding 30 days on or after June 1, 2012.

The Green Levy

Schedule 1 of the *Excise Tax Act* imposed a "green levy" on energy inefficient vehicles. The determination of which vehicles are considered inefficient is based on fuel consumption tests. Since the government had announced in February 2012 that it is making changes to its fuel consumption testing requirements, amendments to Schedule 1 were required to retain the integrity of the Green Levy, so that it will continue to be calculated in accordance with the consumption ratios which currently apply.

Streamlined Accounting Thresholds

Streamlined Accounting methods may be used by public service bodies and small businesses if their sales fall under specific thresholds. Currently, that threshold is taxable sales of $200,000. To allow more businesses to use streamlined accounting, that threshold is raised in the *Streamlined Accounting (GST/HST) Regulations* to $400,000 of taxable sales. Also, the streamlined input tax credit method has thresholds of annual sales of $500,000,

and taxable purchases of $2 million. These thresholds are also raised, to $1 million and $4 million respectively. These amendments apply for the purpose of determining the net tax of a registrant for reporting periods commencing after 2012.

Also to adjust the thresholds, similar amendments to the *Public Service Body Rebate (GST/HST) Regulations* are proposed, in respect of the prescribed method for calculating rebates. These new thresholds apply in respect of claim periods beginning after 2012.

Customs Tariff Measures

The 5% duty on certain imported oils used in oil, gas, and electricity production will be eliminated, effective for importations of such goods after March 29, 2012. Also, personal exemptions which limit the duty-free value of goods brought into Canada by returning Canadian residents will be increased effective June 1, 2012, to $200 for an absence of 24 hours or more, and to $800 for absences of 48 hours or more.