Tax memo

Canadian tax updates

pwc

2013 Federal budget: Staying the course

Outlines tax measures in the 2013 federal budget.

March 21, 2013

On March 21, 2013, the Federal Minister of Finance, Jim Flaherty, presented the majority government's budget. The budget does not change corporate tax rates. This *Tax memo* discusses the tax initiatives proposed in the budget.

Business Tax Measures

Corporate Loss Trading

The budget proposes to introduce an anti-avoidance measure to support the restrictions on the deductibility of losses, and the use of certain other tax benefits, where there has been an acquisition of control of a corporation. This measure will apply where a person or group or persons acquire shares of a corporation that have more than 75% of the fair market value of all of the shares of the corporation without otherwise acquiring control of the corporation, and if it is reasonable to conclude that one of the main reasons that control was not acquired was to avoid the loss restriction rules. This measure will generally apply for shares acquired after March 20, 2013, unless the shares were acquired pursuant to a written agreement entered into before March 21, 2013.

Taxation of Corporate Groups

The federal government has completed its review of the taxation of corporate groups and has determined that moving to a formal system of corporate group taxation, such as the introduction of rules governing loss transfers or consolidated reporting, is not currently a priority. The government will continue to work with provinces and territories regarding their concerns about the uncertainty of the cost associated with the current approach to loss utilization.

Manufacturing and Processing Machinery and Equipment: Accelerated Capital Cost Allowance

The temporary enhanced annual capital cost allowance (CCA) deduction for eligible manufacturing and processing machinery and equipment is extended, for two years, to property acquired before 2016. The measure provides a 50% straight-line CCA rate, subject to the half-year rule, for purchases of machinery and equipment used in manufacturing and processing in Canada of goods for sale or lease.

Clean Energy Generation Equipment: Accelerated Capital Cost Allowance

The CCA system provides accelerated CCA deductions under Class 43.2 at 50% per year on a declining balance basis for certain clean energy generation and conservation equipment acquired before 2020.

The budget expands Class 43.2 by making biogas production equipment that uses more types of organic waste eligible for inclusion. It also broadens the range of cleaning and upgrading equipment used to treat eligible gases from waste that is eligible for inclusion. These measures apply to property acquired after March 20, 2013, that had not been used or acquired before March 21, 2013.

Scientific Research and Experimental Development Program

Measures will provide the Canada Revenue Agency (CRA) with new resources and administrative tools with respect to the Scientific Research and Experimental Development (SR&ED) program.

More detailed information will be required about SR&ED program tax preparers and billing arrangements. When one or more third parties have assisted with the preparation of a claim, the Business Number of each third party will be required, along with details about the billing arrangements including whether contingency fees were used and the amount of the fees payable. If a third party was not involved, the claimant will be required to certify this.

A penalty of $1,000 will be imposed in respect of each SR&ED program claim for which the information about SR&ED program tax preparers and billing arrangements is missing, incomplete or inaccurate. When a third-party SR&ED program tax preparer has been engaged, the SR&ED program claimant and tax preparer will be jointly and severally, or solidarily, liable for the penalty.

These measures will apply to SR&ED program claims filed on or after the later of January 1, 2014, and the day of royal assent to the enacting legislation.

Mining Expenses

Pre-production mine development expenses, as described in paragraph (g) of the definition Canadian exploration expense (CEE) in subsection 66.1(6) of the *Income Tax Act*, will be treated as Canadian development expense (CDE). The transition from CEE to CDE treatment will be phased in over three calendar years (i.e., from 2015 to 2017). This measure will apply to expenses incurred after March 20, 2013. However, it will not apply to expenses incurred before 2017 meeting certain conditions.

Furthermore, the budget phases out the additional 100% allowance available for mining (other than for bituminous sands and oil shale, for which the phase-out will be complete in 2015) over the 2017 to 2020 calendar years. This measure will apply to expenses incurred after March 20, 2013. However, it will not apply to expenses incurred before 2018 meeting certain conditions.

Reserve for Future Services

The reserve under paragraph 20(1)(m) of the *Income Tax Act* for amounts received in respect of future services will be amended to ensure it will not be available with respect to amounts received for the purpose of funding future reclamation obligations (e.g., such as a waste disposal facility that charges its customers fees to cover the future cost of reclaiming its landfill). This change will generally apply to amounts received after March 20, 2013.

Additional Deduction for Credit Unions

Credit unions are eligible for the small business deduction on the same basis as Canadian-controlled private corporations. An additional deduction, available only to credit unions, effectively provides access to this preferential income tax rate for certain income that is not eligible for the small business deduction. This additional deduction will be phased out over five calendar years, beginning in 2013 for taxation years that end after March 20, 2013.

Leveraged Life Insurance Arrangements

The budget introduces rules to eliminate certain tax benefits related to two leveraged life insurance arrangements known as "leveraged insured annuities" (or "LIAs") and "10/8 arrangements."

LIAs will be subject to an annual accrual-based taxation, no deduction will be allowed for premiums and the capital dividend account (CDA) of a private corporation will not be increased by the death benefit received. These measures will generally apply to taxation years that end after March 20, 2013, but will not apply to LIAs for which all borrowings were entered into before March 21, 2013.

For 10-8 arrangements, no deductions will be allowed for interest on related borrowings and insurance premiums that relate to a period after 2013 and no increase in CDA will arise for any death benefit that becomes payable after 2013 and that is associated with the borrowing.

Restricted Farm Losses

The budget announces a measure to ensure that farming losses of a taxpayer will be subject to the "restricted farm loss" rules where the taxpayer's chief source of income is neither farming nor a combination of farming and some other source of income that is a subordinate source of income. The budget also proposes to increase the restricted farm loss limit to $17,500 of deductible farm losses annually. These measures will apply to taxation years that end after March 20, 2013.

International Tax Measures

Thin Capitalization Rules

Thin capitalization rules limit the deductibility of interest expense in certain cases where the amount of debt owing to specified non-residents exceeds a 1.5-to-1 debt-to-equity ratio. These rules currently apply only to Canadian-resident corporations and, for such corporations, to their share of debts owing by partnerships of which they are a partner. The budget proposes to extend these rules also to Canadian-resident trusts and to non-resident corporations and trusts that operate in Canada. The rules will apply for taxation years that begin after 2013 and will apply to existing as well as new debt.

For Canadian-resident trusts, the existing rules will be modified to look to the trust beneficiaries, rather than corporate shareholders, to determine whether a person is a specified non-resident and, therefore, whether a debt owing to that person is subject to the rules. A trust's "equity" will include contributions from specified non-residents, plus the after-tax portion of income taxed in the trust, less capital distributions to specified non-residents; a transitional rule will allow existing trusts to calculate equity at March 21, 2013, based on the fair market value of the trust's net assets. The trust will be able to treat non-deductible interest under these rules as distributions of income to a non-resident beneficiary (i.e. the creditor), with the result that the amount will still be deductible to the trust but will be subject to non-resident withholding tax and potentially tax under Part XII.2 of the *Income Tax Act*, depending on the character of the trust income.

For non-resident corporations and trusts, the rules will apply to debts from a non-resident who does not deal at arm's length with the non-resident corporation or trust. Rather than using a debt-to-equity measure, the rules will be based on a debt-to-asset ratio of 3-to-5 (notionally similar to the 1.5-to-1 debt-to-equity ratio). For such entities that elect under section 216 of the *Income Tax Act* to be taxed on their net rental income from certain Canadian properties as if they were residents of Canada, rather than be subject to Part XIII non-resident withholding tax on the gross rents, the new rules applicable to non-resident corporations and trusts will be used, rather than the rules for Canadian residents.

International Tax Evasion and Aggressive Tax Avoidance

The budget introduces a number of proposals intended to help the CRA combat international tax evasion and address international aggressive tax avoidance.

Certain financial intermediaries will be required to report, starting in 2015, to the CRA international electronic funds transfers of $10,000 or more.

The court order process for obtaining information or documents from a third party will be streamlined by eliminating the ex parte aspects, to thereby require the CRA to provide notice to the third party and require the third party to make any related representations at the hearing of the application for the court order. This measure is to apply on royal assent.

The CRA will launch the "Stop International Tax Evasion Program" under which it will provide for a payment to a person meeting certain criteria of up to 15% of tax collected, where the person provides information to the CRA that leads to the assessment or reassessment of more than $100,000 in federal tax. Further details of this program will be released by the CRA in the upcoming months.

Foreign Reporting Requirements: Form T1135

In connection with Form T1135 – Foreign Income Verification Statement, the normal assessment period for a taxation year of a taxpayer will be extended by three years if the taxpayer fails to report income from a specified foreign property and a Form T1135 for the year was not filed on time or a specified foreign property was not, or not properly, identified on the form. Form T1135 and related instructions will be modified to require more detailed information to be reported. The CRA intends to allow taxpayers to file this form electronically (they will announce when this is available), and will remind taxpayers on their assessment notices of their obligation to file this form if they have "checked the box" on their return indicating that they own specified foreign property with cost of more than $100,000. These changes will apply beginning with taxation years ending in 2013.

International Banking Centres

The International Banking Centre (IBC) rules, which exempt prescribed financial institutions from tax on certain income earned through a branch or office in the metropolitan areas of Montreal and Vancouver, will be repealed for taxation years starting after March 20, 2013.

Treaty Shopping

The federal government will consult on possible measures that would protect the integrity of Canada's tax treaties while preserving a business tax environment that is conducive to foreign investment. A consultation paper will be publicly released, so that stakeholders can comment on possible measures.

Personal Tax Measures

Synthetic Dispositions

The budget introduces rules for certain arrangements that allow a taxpayer to avoid capital gains tax or obtain other tax benefits by economically disposing of a property while retaining ownership of it for tax purposes – referred to as "synthetic dispositions." Generally, these arrangements involve the use of forward contracts, put-call collars, total return swaps, exchangeable indebtedness, or other mechanisms to eliminate the future risk of loss and opportunity for gain on the property. The taxpayer also receives other property which approximates what the taxpayer would have received if they had sold the property.

Where a synthetic disposition arrangement is undertaken, the transactions will be treated as a fair market value disposition and reacquisition of the relevant property by the taxpayer. The taxpayer will also be deemed to not own the property for the purpose of the "holding-period tests" in the stop-loss rules in section 112 and the foreign tax credit rules in subsection 126(4.2) of the *Income Tax Act*. These rules will apply to agreements and arrangements entered into, or existing agreements and arrangements that have their terms extended, after March 20, 2013.

Character Conversion Transactions

"Character conversion transactions" are arrangements that seek to convert ordinary income into capital gains through the use of derivative contracts. These arrangements typically involve the use of a forward agreement to buy or sell a capital property using a pricing formula that is not based upon the performance of the particular property but on some other measure, such as the performance of other portfolio investments that produce fully taxable income.

The budget will treat the return from the derivative investment portion of these transactions as being distinct from the disposition of the underlying capital property. This will result in ordinary income treatment for the derivative-based return. Adjustments will be made to the adjusted cost base of the property to reflect this income (or loss). These measures will apply where the derivative forward agreement has a duration of more than 180 days and generally apply to agreements entered into, or existing agreements that have their terms extended, after March 20, 2013.

Loss Trading

The budget extends the "loss trading" provisions of the *Income Tax Act*, including loss-streaming and related rules that apply where there has been an acquisition of control of a corporation, to trusts in certain situations (referred to as a "loss restriction event"). A loss restriction event will occur for a trust when a person or partnership becomes a majority-interest beneficiary of the trust or a group becomes a majority-interest group of beneficiaries of the trust. Subject to further public consultation, rules similar to the continuity of ownership rules for corporations will apply, such as the death of a beneficiary, and transactions within certain groups of beneficiaries, so that a loss restriction event will not be considered to occur in such situations.

These measures will generally apply after March 20, 2013.

Non-Resident Trusts

The budget proposes to extend certain previously announced rules that deem a non-resident trust to be a resident of Canada. As a result, a non-resident trust other than an "immigration trust" will now be deemed to be resident in Canada if a Canadian-resident taxpayer transfers or loans property to the trust (regardless of the consideration received by the person for the transfer of the property) and the property held by the trust may revert to the taxpayer, may pass to persons to be determined by the taxpayer, or may not be disposed of without the taxpayer's consent. In such circumstances, the trust will also be prevented from making certain tax-deferred distributions of property. Measures that apply to Canadian-resident trusts in similar circumstances will not apply to deemed resident trusts.

These rules will apply to taxation years that end after March 20, 2013.

Graduated Rates – Testamentary Trusts and Estates

The budget announces the government's intention to consult on possible measures to eliminate the tax benefits that arise from the graduated tax rates allowed to be used by certain grandfathered inter-vivos trusts, testamentary trusts and estates. A consultation paper will be released for public comment.

Adoption Expense Tax Credit

For adoptions finalized after 2012, the budget extends the adoption period in which eligible adoption expenses may be claimed for the Adoption Expense Tax Credit by having the period begin:

- at the time that an adoptive parent makes an application to register with a provincial ministry responsible for adoption or with an adoption agency licensed by a provincial government; or
- if an adoption-related application is made to a Canadian court at an earlier time, that earlier time.

First-Time Donor's Super Credit

The budget introduces a temporary First-time Donor's Super Credit (FDSC) that can be claimed by first-time donors only once in a taxation year after 2012 and before 2018. The FDSC is an additional 25% tax credit (on top of claiming the Charitable Donations Tax Credit (CDTC)) on up to $1,000 of donations made after March 20, 2013. An individual is a first time donor if neither the individual nor the individual's spouse or common-law partner has claimed the CDTC or FDSC in any taxation year after 2007.

Lifetime Capital Gains Exemption

The budget increases the Lifetime Capital Gains Exemption (LCGE) to up to $800,000 (from up to $750,000) of capital gains realized on the disposition of qualified property, effective for the 2014 taxation year. The LCGE will also be indexed for taxation years after 2014.

Safety Deposit Boxes

The cost of renting safety deposit boxes will no longer be deductible for income tax purposes, for taxation years beginning after March 20, 2013.

Dividend Tax Credit – Non-eligible

The budget increases the non-eligible dividend tax rate as follows:

	Non-eligible dividends paid	
	2013	**After 2013**
Dividend gross-up	25%	18%
Dividend tax credit (on grossed-up dividend)	13.3333%	11.0169%
Top federal rate	19.58%	21.22%

Registered Pension Plans

Administrators of registered pension plans (RPPs) will be able to make refunds of contributions to correct reasonable errors without first obtaining approval from the CRA, if the refund is made no later than December 31 of the year following the year in which the inadvertent contribution was made. If an RPP administrator seeks to correct a contribution error after the deadline, the existing procedure of seeking authorization from the CRA continues to apply. This measure applies to RPP contributions made on or after the later of January 1, 2014, and the day the legislation receives royal assent.

Tax Shelters and Reportable Transactions

The budget extends the normal reassessment period for participants in a tax shelter or reportable transaction in respect of which an information return that is required for the tax shelter or reportable transaction is not filed on time. For taxation years that end after March 20, 2013, the normal reassessment period is extended to three years after the date that the relevant information return is filed.

Charitable Donation Tax Shelters

For charitable donation tax shelters, in respect of which the taxpayer has objected to an assessment of tax, interest or penalties, the budget will permit the CRA to collect 50% of the disputed tax, interest or penalties. This measure applies to amounts assessed for 2013 and subsequent taxation years.

Mineral Exploration Tax Credit

The mineral exploration tax credit is extended by one year to flow-through share agreements entered into before April 1, 2014.

Labour-Sponsored Venture Capital Corporations Tax Credit

The federal Labour-Sponsored Venture Capital Corporations (LSVCCs) tax credit will be phased out as follows:

Taxation year	LSVCC tax credit rate
2013	15%
2014	
2015	10%
2016	5%
After 2016	Nil

In addition, the budget ends new federal registrations of LSVCC's, and provincially registered LSVCC will no longer be prescribed for the federal LSVCC if applications are submitted after March 20, 2013.

Sales and Excise Tax Measures

GST/HST and Health Care Services

For supplies made after March 21, 2013:

- the GST/HST exemption for homemaker services will be expanded to exempt publicly subsidized or funded personal care services, such as bathing, feeding, and assistance with dressing and taking medication, rendered to an individual who, due to age, infirmity or disability, requires assistance in his or her home; and
- the rules will clarify that GST/HST applies to reports, examinations and other services that are not performed for the purpose of the

- protection, maintenance or restoration of the health of a person or for palliative care.

GST/HST Pension Plan Rules - Simplified Employer Compliance

An employer participating in a registered pension plan will be permitted to jointly elect with a pension entity of that pension plan to treat an actual taxable supply by the employer to the pension entity as being for no consideration when the employer accounts for and remits tax on the deemed taxable supply.

The election would remain in effect until it is jointly revoked by the employer and the pension entity effective from the beginning of a fiscal year of the employer. Also, the Minister of National Revenue would have discretion to cancel the election in certain circumstances. This measure will apply to supplies made after March 21, 2013.

Another measure that applies in respect of any fiscal year of an employer that begins after March 21, 2013, relieves an employer from applying the deemed taxable supply rules for a fiscal year of the employer when the amount of the GST (and the federal component of the HST) that the employer was (or would have been, but for this measure) required to account for and remit under the deemed taxable supply rules in the preceding fiscal year of the employer is less than each of the following amounts:

- $5,000; and
- 10% of the total net GST (and the federal component of the HST) paid by all pension entities of the pension plan in that preceding fiscal year.

Employers that do not satisfy the $5,000 and 10% thresholds may qualify for more limited relief.

GST/HST Business Information Requirement

Upon royal assent to the enacting legislation, the Minister of National Revenue will be given the authority to withhold GST/HST refunds claimed by a business until all the prescribed business identification information has been provided.

GST/HST on Paid Parking

A special provision exempts from GST/HST all of a public sector body's (PSB's) supplies of a property or a service if all or substantially all – generally 90% or more – of the supplies of the property or service are made for free.

The budget clarifies that this special exempting provision does not apply to supplies of paid parking that are made by way of lease, licence or similar arrangement in the course of a business carried on by a PSB. GST/HST will apply to commercial paid-parking facilities and spaces operated by a PSB, even when the PSB provides a significant amount of parking at no charge. This measure will be effective the date the GST legislation was enacted.

A further clarification that applies to supplies made after March 21, 2013, will ensure that the special GST/HST exemption for parking supplied by charities does not apply to supplies of paid parking that are made by way of lease, licence or similar arrangement in the course of a business carried on by a charity set up or used by a municipality, university, public college, school or a hospital to operate a parking facility.

GST/HST Treatment of the Governor General

For supplies made after June 30, 2013, the GST/HST exemption for the Governor General will end. GST/HST will be payable on purchases for the use of the Governor General. The Governor General and his Office will be able to recover the GST/HST they pay on purchases for official use in the same way as federal departments.

Excise Duty Rate on Manufactured Tobacco

Effective after March 21, 2013, the rate of excise duty on manufactured tobacco will increase to $5.3125 from $2.8925 per 50 grams or fraction thereof.

Other Tax Measures

Electronic Suppression of Sales Software Sanctions

New administrative monetary penalties and criminal offences under the *Income Tax Act* and the *Excise Tax Act* will apply to combat the use, possession or acquisition, manufacture, development, sale, possession for sale, offer for sale or otherwise making available of electronic suppression of sales (ESS) software. Penalties will range from $5,000 or $10,000 for the first infraction to $50,000 of $100,000 for subsequent infractions.

Criminal offences can also arise that can result in fines up to $1 million and imprisonment for up to five years.

These measures will apply on the later of January 1, 2014, and royal assent to the enacting legislation.

Aboriginal Tax Policy

The federal government reiterates its willingness to discuss and put into effect direct taxation arrangements with interested Aboriginal governments.

Customs Tariff Measures

The budget:

- eliminates all tariffs on baby clothes and sports and athletic equipment (excluding bicycles), for goods imported into Canada after March 31, 2013; and
- proposes changes to Canada's General Preferential Tariff (GPT) regime under the Customs Tariff to ensure that the development assistance is appropriately aligned with the global economic landscape, effective for goods imported into Canada after December 31, 2014, and will be extended for ten years, until December 31, 2024.

Previously Announced Measures

The budget confirms that the government will proceed with the following previously announced measures:

- proposed changes to certain GST/HST rules relating to financial institutions released on January 28, 2011;
- automobile expense amounts for 2012 announced on December 29, 2011, and for 2013 announced on December 28, 2012;
- legislative proposals implementing the proposed changes to the life insurance policyholder exemption test announced in the March 29, 2012 budget;
- legislative proposals released on June 8, 2012 relating to improving the caseload management of the Tax Court of Canada;
- legislative proposals released on July 25, 2012 relating to specified investment flow-through entities, real estate investment trusts and publicly-traded corporations;
- legislative proposals released on November 27, 2012 relating to income tax rules applicable to Canadian banks with foreign affiliates; and
- legislative proposals released on December 21, 2012 relating to income tax technical amendments.

The government also reaffirms the government's commitment to move ahead with technical amendments to improve the certainty of the tax system.

For More Help

For more help on how the budget changes affect you or your business, please contact:

- your PricewaterhouseCoopers LLP tax adviser;
- any of the individuals listed at **www.pwc.com/ca/taxcontacts**; or
- a member of PwC's Canadian National Tax Services (CNTS). For more on CNTS and its members, go to: **www.pwc.com/ca/cnts**.

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