2012 FEDERAL BUDGET

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Tax highlights from the 2012 federal budget

Finance Minister James Flaherty tabled the 2012 federal budget on March 29, 2012. This is the first budget presented in the House of Commons since the Conservative party won a majority of the seats in Parliament in the last election. This budget projects a deficit of $24.9 billion for the soon-to-end 2011-2012 fiscal year, which is significantly lower than last year's forecast of a $32.3 billion deficit for that period. The budget projects deficits of $21.1 billion for the 2012-2013 fiscal year, $10.2 billion for the 2013-2014 fiscal year, and $1.3 billion for the 2014-2015 fiscal year. The government expects to be back to a surplus of $3.4 billion by the 2015-2016 fiscal year.

These projections are based on various economic assumptions with respect to growth in overall gross domestic product (GDP), increasing tax revenues and spending control. Over the past year the government conducted a comprehensive review of approximately $75 billion of program spending. The result is a plan to achieve ongoing annual savings of $5.2 billion by 2016. While this is a large number, it represents less than 2% of spending in that year, and under 0.2% of GDP. The spending reductions will impact all government departments and agencies to some extent, with a projected reduction in the government work force of 19,200 positions over three years. In addition to spending cuts, the government projects revenue increases of almost $3.5 billion over the next five years.

There were no tax rate increases in the budget, nor were there any changes to previously announced tax rate reductions. As expected, the prime minister's musings regarding the future sustainability of Canada's retirement income system at the Davos World Economic Forum in January translated into the budget proposal to increase the Old Age Security eligibility age from 65 to 67.

The following pages are a summary of the changes announced in the budget. Please note that these changes are still proposals until passed into law by the federal government.

PERSONAL TAX MATTERS

Personal income tax rates

There were no changes announced with respect to personal income tax rates in this budget, although tax brackets have been indexed by 2.8% to reflect the impact of inflation. The effective rates for 2012 and corresponding tax bracket thresholds are shown in the following table.

Taxable income range	2012 tax rates
$10,823 - $42,707	15%
$42,708 - $85,414	22%
$85,415 - $132,406	26%
$132,407 or more	29%

Medical expense tax credit

The budget proposes an addition to the list of expenses eligible for the 15% non-refundable medical expense tax credit. The cost of medically prescribed blood coagulation monitors, including associated disposable items such as pricking devices, lancets, and test strips, will be eligible for the credit, effective January 1, 2012.

Group sickness or accident insurance plans

The budget proposes to include contributions made to group sickness and accident plans as a taxable benefit for the year in which the contributions are made, to the extent that the contributions are not for a wage-loss replacement benefit payable on a periodic basis. This measure will apply to contributions made on or after March 29, 2012 for coverage after 2012. Contributions made between budget day and the end of 2012 will be included in the employee's income for 2013.

Registered disability savings plans

After government consultation with the public, the budget proposes a number of changes to the rules governing registered disability savings plans (RDSPs).

- **Plan holders –** Currently, an RDSP for an adult beneficiary can only be established by the beneficiary or a legal representative of a beneficiary who is incapable of entering into a contract. The budget proposes a temporary measure that will allow for the establishment of an RDSP by a qualifying family member (spouse, common-law partner, or parent), in cases where there is a question as to the capacity of the beneficiary. This measure will apply from the date of royal assent until December 31, 2016.
- **Proportional repayment –** Currently, any government assistance received by an RDSP must be repaid if a withdrawal is made within the following 10 years. The budget proposes to allow for small withdrawals by requiring $3 of assistance received within the previous 10 years to be repaid for every $1 withdrawn from the plan. This change will apply to withdrawals made after 2013. The existing 10-year repayment rule will continue to apply when the RDSP is terminated, deregistered, of if the beneficiary no longer qualifies for the disability tax credit (DTC) or dies.
- **Maximum and minimum withdrawals –** The budget proposes to change the maximum and minimum withdraw provisions for primarily government assisted plans (where government assistance exceeds private contributions), effective for withdrawals after 2013.
- **Rollover of RESP investment income –** In certain circumstances, an RESP beneficiary who is not able to pursue post-secondary education due to his or her disability, could have the subscriber of the plan transfer the accumulated investment income earned in the RESP to an RDSP for the same beneficiary on a tax-free basis. This is effective after 2013, and the transfer is limited by the beneficiary's available RDSP contribution room.
- **Termination of an RDSP where the beneficiary becomes ineligible for the DTC –** Currently the plan must be terminated by the end of the following year. The budget proposes an election to allow for the plan to continue in circumstances where a medical practitioner certifies in writing that the beneficiary will likely become DTC eligible again in the foreseeable future. This measure applies to elections made after 2013.

Employee profit sharing plans

The government has recently concluded a consultation process described in the 2011 budget. To ensure that employee profit sharing plans (EPSPs) are used for their intended purpose, the budget proposes a special tax to be payable by "specified" employees who do not deal at arm's length with the employer.

The tax will be payable on the portion of the EPSP contribution allocated by the trustee to the employee that exceeds 20% of the employee's salary for the year from that employer. The rate of tax will be equal to the highest combined federal and provincial marginal tax rate for the province where the employee lives. Quebec residents will only be subject to tax at the highest federal marginal rate.

A corresponding new deduction will be introduced to ensure that the excess amount is not also taxed as regular income. A specified employee will not be able to claim any other deductions or credits in respect of an excess EPSP amount. These measures generally apply to EPSP contributions made on or after March 29, 2012.

Retirement compensation arrangements

To prevent the use of retirement compensation arrangements (RCAs) to receive unintended tax benefits, the budget proposes new prohibited investment and advantage rules that are similar to those recently introduced with respect to TFSAs and RRSPs. These new rules will impose significant penalties where an RCA engages in non-arm's length transactions. In addition, there are new rules that may restrict RCA tax refunds in certain circumstances where there has been a significant decline in value of the RCA due to prohibited investments or advantages. Both of these measures will apply on or after March 29, 2012.

Mineral exploration tax-credit for flow-through share investors

The budget extends this credit for flow-through share arrangements that was scheduled to expire on March 31, 2012. The credit will continue to be available for flow-through share arrangements entered into on or before March 31, 2013.

Overseas employment tax credit

The budget proposes to phase out the overseas employment tax credit (OETC) over a four-year period beginning in 2013. During the phase-out period, the current 80% rate applied to an employee's qualifying foreign employment income will be reduced to 60% for 2013, 40% for 2014, and 20% for 2015. The OETC will be eliminated for 2016 and subsequent years.

The phase-out rules will not apply to qualifying foreign employment income earned by an employee under a contract committed to in writing before March 29, 2012. In this case, the factor will remain at 80% until the end of the 2015 taxation year, at which time it will become 0%.

Life insurance policy exemption test

The budget proposes technical changes to update and simplify the test to determine if a life insurance policy is an exempt policy. The government also intends to consult with stakeholders on proposed changes to the investment income tax levied on insurance companies. The changes will apply to life insurance policies issued after 2013.

Salary of the Governor General

The budget proposes to end the tax exemption on the salary of the Governor General, effective for 2013 and subsequent taxation years.

CORPORATE TAX MATTERS

Corporate income tax rates

There were no changes proposed to any corporate income tax rates. The table below shows federal tax rates and the small business limit for 2012.

Category	2012 tax rates
General rate	15%
Manufacturing & processing rate	15%
Small business rate	11%
Small business limit	$500,000

Temporary incentive for manufacturing and processing equipment

Eligible dividends

The budget proposes new administrative rules that would allow a corporation to designate, at the time it pays a taxable dividend, any portion of the dividend to be an eligible dividend, the remaining portion of which would be an ineligible dividend. This simplifies compliance and eliminates the need to pay two separate dividends. In addition, corporations will now be able to make late eligible dividend designations, if the late designation is made within three years following the day on which the original designation was required to be filed. These proposals are effective on or after March 29, 2012.

Hiring credit for small business

The budget proposes a one-year extension of the temporary hiring credit for small business introduced in the 2011 budget. The credit offers up to $1,000 to offset a small business's increase in 2012 Employment Insurance (EI) premiums over those paid in 2011. This credit will be available to employers whose EI premiums were $10,000 or less in 2011.

Scientific research and experimental development tax credit

The budget proposes making several changes to research and development (R&D) tax incentives, to make the program more cost effective as well as to simplify compliance and administrative efforts.

- The general investment tax credit rate will be reduced from 20% to 15%, effective January 1, 2014. The 5% reduction will be pro-rated for taxation years that straddle that date.
- Capital expenditures will no longer be included in the calculation of eligible expenditures in 2014 and subsequent years. This includes payments made for the right to use property through capital leases.
- The prescribed proxy amount will be reduced from 65% of direct labour costs to 60% for 2013, and to 55% for 2014.
- Contract amounts paid to arm's length parties will be reduced to 80% of the amount paid for the purpose of determining the amount of eligible expenditures, effective for expenditures incurred on or after January 1, 2013.
- Capital expenditures incurred by a contractor will also be excluded from the determination of eligible expenditures, effective January 1, 2014.

Corporate mineral exploration and development tax credit

The budget phases out the 10% tax credit for pre-production mining expenditures over several years.

- Exploration expenses will be eligible for a 10% credit in 2012 and a 5% credit in 2013, with no further tax credits after 2013.
- Pre-production development costs will be eligible for a 10% credit in 2012 and 2013, a 7% credit in 2014 and a 4% credit in 2015, with no further credits after 2015.

Notwithstanding that the tax credits are being phased out, the expenses will continue to be fully deductible in the year incurred.

Atlantic investment tax credit

The budget phases out the 10% Atlantic investment tax credit (AITC) over a four-year period.

- Oil and gas and mining activities will be eligible for a 10% credit for assets acquired before 2014 and a 5% credit for assets acquired in 2014 and 2015, with no further credit for assets acquired after 2015.
- Certain equipment is eligible for the AITC if the equipment is "qualified property," which includes certain electricity generation equipment and clean energy generation equipment used primarily in an eligible activity in the Atlantic region.

These measures will generally apply to assets acquired on or after March 29, 2012, except for assets acquired before 2017 pursuant to a written agreement entered into before March 29, 2012, which will still be eligible for the 10% credit.

Various other tax measures

The budget proposes various other measures that are applicable to specific industry sectors, large business enterprises, and international transactions. These proposed measures include:

- accelerated capital cost allowance provisions for clean energy generation;
- characterization of secondary transfer pricing adjustments as deemed dividends, which are subject to withholding taxes;
- reduction of the debt-to-equity ratio for the purpose of the thin capitalization rules;
- limitations on the use of partnerships as tax avoidance vehicles in structuring Canadian corporate takeover transactions;
- significant limitations with respect to foreign affiliate dumping transactions; and
- changes to the "base erosion test" of the foreign accrual property income regime as it applies to Canadian banks.

OTHER PROPOSALS

Old age security and guaranteed income supplement

As expected, the budget proposes changes to Old Age Security (OAS) and Guaranteed Income Supplement (GIS) benefits that will assist in keeping the program on a sound economic footing given the changing demographics of the country. There will be an 11-year notification period, followed by a six-year phase-in period, to ensure that individuals have ample time to make adjustments to their retirement plans.

The first proposal gradually increases the eligibility age from 65 to 67 starting in April 2023. The change will be fully phased in by January 2029. This measure will not affect anyone who is 54 years of age or older as of March 31, 2012, and will fully impact everyone born on or after February 1, 1962. Those born between April 1, 1958 and January 31, 1962 will have an eligibility age between 65 and 67.

These changes will apply equally to the allowance and survivor's allowance that are currently paid to qualifying individuals between the ages of 60 and 64. These benefits will be subject to the same notification and phase-in periods, with eligibility increasing by two years, to ages 62 to 66.

The government will also ensure that other federal programs that provide income support until age 65 are aligned with the new OAS program rules and do not cause an income gap at ages 65 and 66.

The budget also proposes a new OAS deferral option, effective July 1, 2013, that will allow for the deferral of receipt of OAS for up to five years. Similar to the Canada Pension Plan, deferring receipt of OAS will result in a higher actuarially determined benefit. The budget papers provide an example that assumes an annual OAS benefit of $6,481. Deferral by one year would result in an annual benefit of $6,948, while a five-year deferral would result in an annual benefit of $8,814. It should be noted that this actuarial adjustment would not apply to GIS benefits.

Also contemplated is proactive automatic enrollment for both OAS and GIS recipients, which should eliminate the need for having to complete application forms for these benefits in the future. Proactive enrollment will be phased in from 2013 to 2015.

Travellers' duty and tax exemptions

The budget proposes to increase the exemption available to Canadian residents who have been out of the country.

- The exemption for those away for at least 24 hours increases from $50 to $200.
- The exemption for those away for at least 48 hours increases from $400 to $800. This limit will replace both the old 48-hour exemption and the seven-day exemption of $750.
- There will continue to be no exemption for absences of less than 24 hours.
- Volume and quantity limits on alcohol and tobacco products remain unchanged.

Charitable organizations

The budget proposes to modify the rules for registering certain foreign charitable organizations as qualified donees. Such organizations may qualify if they receive a gift from the government of Canada and they pursue activities related to disaster relief or urgent humanitarian aid; or in the national interest of Canada. This measure will apply to applications made by foreign charities on or after the later of January 1, 2013 and royal assent to the legislation.

Legislation will be introduced to enhance compliance with the limitations imposed on charities with respect to political activities. New rules deem that a charity that makes a donation to another charity that supports a political activity will be deemed to have supported that activity itself.

Tax shelters

The budget proposes increasing certain penalties imposed on promoters of charitable donation tax shelters, as well as on promoters who fail to file tax shelter information returns.

The budget also proposes that tax shelter identification numbers only be valid for the calendar year identified in the application filed with the Canada Revenue Agency.

Although this material has been compiled from sources believed to be reliable, we cannot guarantee its accuracy or completeness. All opinions expressed and data provided herein are subject to change without notice. The information is provided solely for informational and educational purposes and is not intended to provide, and should not be construed as providing individual financial, investment, tax, legal or accounting advice. Professional advisors should be consulted prior to acting on the basis of the information contained in this publication.

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