The 2013 Canadian Federal Budget: Lots of technical tax changes

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Budget Day 2013 finally arrived on March 21, 2013. By now you have likely received dozens of Budget 2013 summaries. After having had the opportunity to absorb the proposed tax changes, we are excited to share our reflective comments on some of the key proposed measures that will affect our clients and friends. This is lengthy so apologies in advance.

For those who do not have the time or energy to read through the entire summary in detail, here is a quick overview of the significant proposed changes:

- The rates for the gross-up and dividend tax credit will be adjusted in regards to non-eligible dividends paid after 2013, effectively increasing the top marginal federal and Alberta combined personal tax rate on such dividends to 29.9% (currently 27.7%);
- The lifetime cumulative amount for the capital gains deduction will be increased from $750,000 to $800,000 for the 2014 taxation year and will be indexed to inflation for subsequent taxation years;
- For amounts assessed in respect of charitable donation tax shelters for 2013 and subsequent taxation years, the Canada Revenue Agency ("CRA") will have the ability to collect 50% of the disputed tax, interest or penalties when an objection is filed;
- Effective March 21, 2013, a taxpayer who enters into an "synthetic disposition arrangement", defined as one or more arrangements that have the effect of eliminating all or substantially all the taxpayer's risk of loss and opportunity for gain or profit in respect of the particular property for a period of more than one year, will be deemed to have immediately disposed of the property;
- Amendments to the *Income Tax Act* (the "Act") will be made to restrict deduction of farming losses to a maximum of $17,500 for taxation years ending on or after March 21, 2013, unless all of the taxpayer's other sources of income are subordinate to farming;
- Effective March 21, 2013, a corporation will be deemed to have underwent an acquisition of control if a person (or group of persons) crosses a 75% ownership threshold (measured by the fair market value ("FMV") of all issued shares) without otherwise acquiring control of the corporation and one of the main reasons for not acquiring control is to avoid limitations that would have been imposed on the corporation's tax pools;
- Form T1135 (Foreign Income Verification Statement) will be revised to obtain detailed information of a taxpayer's "specified foreign property", such as names of specific foreign institutions, countries in which offshore assets are located, and foreign income earned thereon. Further, failure to file Form T1135 will cause a taxpayer's normal reassessment period to be extended;
- The CRA will launch a "Stop International Tax Evasion Program" under which it will pay rewards to individuals providing information on major international tax non-compliance that leads to $100,000 or more of additional federal tax assessments; and

- The Government will consult on measures to possibly eliminate or limit the use of graduated tax rates for testamentary trusts.

Personal Tax Changes

1. Dividend Tax Credit Adjustment for Non-Eligible Dividends

When a Canadian resident individual shareholder receives a dividend from a Canadian corporation, the amount of the dividend is grossed up by a certain percentage (i.e. a proxy for pre-tax profits) and the individual obtains a dividend tax credit ("DTC") that is intended to compensate for the underlying corporate tax presumed to be paid. This mechanism is based on the concept of integration which is intended to ensure that income earned by a corporation and paid out to an individual will be subject to the same amount of tax as if the income was earned directly by that individual.

The amount of gross-up and DTC depends on whether the dividend received is an eligible dividend or a dividend other than an eligible dividend (in other words, a "non-eligible dividend"). Non-eligible dividends are paid from corporate retained earnings that were subject to the lower small business tax rate (or certain other preferential tax rates), whereas eligible dividends are paid from corporate retained earnings that were subject to the general corporate tax rate. Due to reductions in federal corporate tax rates over the last decade, the present gross-up and DTC that applies to non-eligible dividends actually overcompensates shareholders for the amount of underlying corporate tax paid, putting them in a better tax position than if the same amount was earned directly. Accordingly, Budget 2013 proposes to decrease the gross-up factor from 25% to 18% and increase the DTC from 2/3 of the gross-up to 13/18 of the gross-up. This change is effective for non-eligible dividends paid after 2013.

This measure is, in effect, a disguised personal tax increase on shareholders of certain Canadian corporations and is, by far, the most significant revenue generating tax measure in the Budget. The Government expects to raise $2.3 billion of tax revenue over the next five years. This is contrary to our prediction that there would be no increase in personal tax rates. For Alberta residents at the top marginal tax rate, this change increases the combined federal and provincial personal tax rate on non-eligible dividends from 27.7% to 29.9%. Accordingly, *owner-managers of private corporations should consider paying non-eligible dividends in 2013 before the personal tax rate increases in 2014.*

A bit of good news does arise from this new measure. Certain government benefits (such as OAS and Child Tax Benefits) are calculated based on "net income" (which accounts for the impact of the gross-up). Accordingly, certain recipients may see their benefits go up because of the decrease in the dividend gross-up.

2. Lifetime Capital Gains Deduction

The lifetime capital gains deduction ("LCGD") permits an individual to deduct up to a lifetime cumulative amount of $750,000 against capital gains realized on the disposition of "qualified small business corporation shares", "qualified farm property" or "qualified fishing property". The last adjustment to the amount of the LCGD was for taxation years that began after March 19, 2007, and Budget 2013 is now addressing the lack of adjustment for inflation in the past six years.

Effective for the 2014 taxation year, the LCGD will be $800,000 and will be indexed for inflation for subsequent taxation years.

Our firm certainly welcomes this unexpected measure.

3. First-Time Donor's Super Charitable Credit

We predicted in our March 4, 2013 blog that there would be charitable tax amendments in Budget 2013 and there was. As a temporary measure to encourage charitable giving by new donors, the Government proposes to introduce the First-Time Donor's Super Credit ("FDSC"). Presently, the Charitable Donations Tax Credit ("CDTD") (found in section 118.1 of the Act) provides an individual with a 15% non-refundable tax credit on the first $200 of annual charitable donations and 29% of the portion in excess of $200.

The FDSC will supplement the CDTD with an additional 25% tax credit to a maximum of $1,000 of annual donations made by a first-time donor. An individual will be a first-time donor if neither the individual nor his or her spouse or common-law partner has claimed either the CDTC or the FDSC in a preceding taxation year that is after 2007. The credit can be shared by first-time donor couples and can only be claimed once in the 2013 or subsequent taxation years before 2018.

While this proposed measure is certainly welcome, it is very narrow in scope. We doubt that this proposal will encourage charitable giving for people who have not been recently philanthropic.

4. Adoption Expense Tax Credit

The Adoption Expense Tax Credit ("AETC") is a non-refundable 15% tax credit provided for in subsection 118.01(2) of the Act. Currently, the AETC allows adoptive parents to claim eligible adoption expenses (to a maximum of $11,440 for 2012) incurred over a specified period (called the "adoption period") in the taxation year that the adoption of a child under age 18 is finalized.

In recognition of the fact that many adoptive parents incur significant adoption related expenses prior to being matched with a child, Budget 2013 proposes to amend the meaning of "adoption period" to begin at the earlier of the time that an application is made for registration with a provincial ministry responsible for adoption (or with an adoption agency licensed by a provincial government) and the time, if any, that an application related to the adoption is made to a Canadian court.

This measure will apply to adoptions finalized in 2013 and later. While this is welcome, it will likely have limited application.

5. Deduction for Safety Deposit Boxes

The Act currently permits deductions of expenses incurred for the purpose of earning income from a business or property to the extent that it is reasonable in the circumstances. In recognition of the increased use of electronic storage of documents related to a taxpayer's investment portfolio and the dwindling use of physical safety deposits for this purpose, Budget 2013 proposes to disallow any deduction for the use of a safety deposit box at a financial institution. This measure will apply to taxation years that begin on or after March 21, 2013.

Measures Targeting Certain "Tax Products" and Other Perceived Abuses

1. "10/8" Life Insurance and Leveraged Life Insurance Arrangements

Budget 2013 targets certain benefits enjoyed by taxpayers in respect of "10/8 life insurance arrangements" ("10/8") and "leveraged insured annuities" ("LIAs"). Currently, a taxpayer can earn tax-exempt income within an exempt life insurance policy and concurrently receive an interest expense

deduction for funds borrowed to earn income. When a private corporation is the recipient of the life insurance proceeds, an additional tax benefit may accrue. The beneficial tax treatment afforded to life insurance policies is now being restricted to curtail perceived abuses.

Under a 10/8, a taxpayer invests funds in the tax exempt account of a life insurance policy (typically earning, say, an 8% return) and borrows an equal amount (say, at 10% interest) using the policy or an investment account in respect of the policy as collateral. The taxpayer invests the borrowed money in income producing assets to ensure that the interest costs are deductible. The income earned in the investment fund of the policy is tax exempt, yet a taxpayer can still claim deductions for the premiums paid under the policy and the interest costs on the borrowed funds. The life insurance policy names a private corporation as beneficiary so that the corporation will receive the proceeds in its capital dividend account ("CDA"). Upon receipt of the proceeds, the corporation can pay a tax-free capital dividend to the shareholder.

LIAs typically involve utilizing borrowed funds to acquire an investment product that includes a lifetime annuity and a life insurance policy. During the investor's lifetime, the annuity provides a regular payment stream to the investor and a portion of the cash-flow is used to pay the life insurance premiums. At death, the life insurance policy pays out a death benefit equal to the capital invested in the annuity to the estate (or the named beneficiary) to replace the capital originally invested. Although these arrangements are sold as integrated investment products, the annuity and the insurance policy are treated separately for tax purposes. Investment income on the portion of funds invested in the life insurance policy is treated as tax-free income, while the policy premiums and the interest costs on the borrowed funds are generally deductible. Upon death, the capital invested in the annuity is returned in the form of a tax-free death benefit and if the policy is owned by a private corporation, the proceeds will increase its CDA.

In order to limit availability of income tax benefits for 10/8s and LIAs, the government has proposed a number of changes. If a life insurance policy, or an investment account under the policy, is assigned as security on a borrowing, and either the interest rate payable on an investment account under the policy is determined by reference to the interest rate payable on the borrowing or the maximum value of an investment account under the policy is determined by reference to the amount of the borrowing, then the following income tax benefits will be denied:

- the deductibility of interest paid or payable on the borrowing that relates to a period after 2013;
- the deductibility of a premium that is paid or payable under the policy that relates to a period after 2013; and
- the increase in the capital dividend account by the amount of the death benefit that becomes payable after 2013 under the policy and that is associated with the borrowing.

These new rules come into effect on March 21, 2013, but the Government will grant taxpayers relief from these provisions if they withdraw funds from a 10/8 arrangement before January 1, 2014. The Government announced that it will continue to monitor developments in this area and respond to structures or measures that attempt to undermine the effectiveness of the LIA and 10/8 proposals.

For the life insurance industry, this will certainly be a big blow.

2. Taxes in Dispute and Charitable Donation Tax Shelters

The CRA has warned Canadians numerous times to avoid tax shelter donation arrangements (see the CRA's website stating that they will audit all gifting arrangements). Despite these warnings and billions of dollars in reassessments, claims in respect of questionable charitable donation tax shelters continue to

tie up scarce Government resources (like those of the CRA's and the courts'). Current legislation generally prohibits the CRA from taking collection actions in respect of assessed income taxes and related interest and penalties where a taxpayer has objected to an assessment. Excluded from this general rule are large corporations, from whom the CRA can collect 50% of any disputed assessments. Budget 2013 proposes to give the CRA a similar ability to collect 50% of the disputed tax, interest or penalties where a taxpayer files an objection to an assessment relating to credits claimed for charitable donation tax shelters. This proposed legislation may also reduce the risk of the unpaid amounts becoming uncollectable during the long objection and appeals process.

We view this measure as a "pay to play" mechanism for the appeal process. Our firm has been very vocal about its dislike of charitable donation tax shelters. From that perspective, this is a welcome measure in light of the number of people who continue to believe that their facts are unique from those of the precedential court cases when in reality their facts and issues are likely not different.

This provision will apply in respect of amounts assessed for the 2013 and subsequent taxation years.

3. Synthetic Disposition Arrangement

It is a general rule in Canadian taxation that a disposition of property leads to tax implications, whether that be an income amount, a gain or a loss. A disposition usually does not occur unless there is a change in beneficial ownership of a property (which generally means that the risks, rewards and use of the property have passed to the new owner). Therefore, provided that beneficial ownership has not changed, a transaction that, economically, would be a disposition would not constitute a disposition for tax purposes. This may allow a taxpayer to defer recognition of income or gain, as well as to meet certain holding period tests under the Act.

Proposed section 80.6, announced in Budget 2013, will apply to an agreement or arrangement that is a "synthetic disposition arrangement" entered into on or after March 21, 2013, or that was entered into before that date but is extended on or after March 21, 2013. As proposed, a "synthetic disposition arrangement" will mean one or more agreements or arrangements entered into by the taxpayer (or a non-arm's length person) in respect of a property owned by the taxpayer that:

- have the effect of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the particular property for a period of more than one year;
- can, in respect of those agreements or arrangements entered into by a non-arm's length person, reasonably be considered to have been entered into for purpose of obtaining the above effect; and
- do not cause a disposition within one year.

The Government explains in Budget 2013 that this definition is intended to cover transactions such as a forward sale of property (whether or not combined with a secured loan), a put-call collar in respect of an underlying property, an issuance of certain indebtedness that is exchangeable for property, a total return swap in respect of property, or a securities borrowing to facilitate a short sale of property that is identical or economically similar to a property of the taxpayer.

By referring to a period of more than one year, most ordinary commercial agreements should be carved out from the definition of synthetic disposition arrangements. However, taxpayers should be aware of the potential application of this proposed measure before undertaking transactions. For example, an owner of a share may enter into a put-call collar that has a term of more than one year in order to lock in the gain on that share. Since such put-call agreements eliminate all or substantially all the owner's risk of

loss or opportunity for gain for more than one year, they will likely constitute a synthetic disposition arrangement.

Where a synthetic disposition arrangement is entered into (other than an arrangement that is an exchange of a convertible share or debt for another share of the issuer), the taxpayer is deemed to have disposed of the subject property immediately before the arrangement for FMV and to have reacquired it at FMV, thus forcing the taxpayer to recognize any income, gain or loss accrued up to that point. Also, the taxpayer will be considered not to own the subject property for purposes of determining whether the taxpayer meets the holding-period tests contained in the dividend stop-loss rules and the foreign tax credit rules.

It is interesting to note that a synthetic disposition arrangement may include transactions commonly known as a "commodity straddle", whereby an investor enters into long and short futures contracts of a commodity for delivery in different months but the investor does not actually own or take delivery of the commodity. By closing the 'loss' leg and the 'profit' leg of the contracts in different taxation years, a taxpayer may be able to deduct a loss in one year while delaying recognition of the offsetting gain in the next. Although such transactions may be considered a synthetic disposition arrangement, proposed section 80.6 may not have an actual impact if the taxpayer enters into the two legs simultaneously. This is because there should be no accrued gain or loss immediately before the arrangement on any subject property at the time the contracts are entered into. Also, since the taxpayer is deemed to have reacquired those contracts, the taxpayer is free to close each leg in different taxation years.

As practitioners in the estate planning profession, we have also taken a close look at whether proposed section 80.6 may potentially affect taxpayers' ability to undertake transactions commonly known as "estate freezes". Generally speaking, an estate freeze is an estate planning technique used to lock in the current value of a business by exchanging the owner's common shares for preferred shares with a fixed redemption value, while attributing the value of the future growth of the business to another person, usually family members of the owner or a trust for their benefit. If done correctly, an estate freeze should not trigger tax implications upon the exchange of the shares. However, the question remains whether this constitutes an arrangement that has the effect of eliminating all or substantially all the owner's risk of loss and opportunity for gain or profit. We think not. Firstly, even though the preferred shares have a fixed redemption value, the value of these shares is not protected from downside risk since it will be dependent upon the underlying corporate asset values of the company, which is certainly not protected as a result of the share exchange. Secondly, the preferred shares issued on the exchange usually carry some right to receive dividends in the future. Therefore, we think an estate freeze done in this manner generally should not be affected by proposed section 80.6.

Overall, these proposed new rules appear to be very expansive and taxpayers will need to consider and monitor them closely.

4. Restricted Farm Losses

As foreshadowed in our March 4, 2013 blog, Budget 2013 revised the chief source of income test in section 31 of the Act in response to the Supreme Court of Canada's ("SCC") decision in, *Canada v. Craig.*

In *Craig,* the taxpayer was a lawyer and his primary source of income was from his law practice. The taxpayer was also in the business of buying and selling horses, the losses from which he deducted against his other income. In response, the CRA reassessed the taxpayer under section 31 and limited his deductions to $8,750 per year.

Currently, subsection 31(1) of the Act reads as follows:

> 31(1) Where a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income, for the purposes of sections 3 and 111 the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be the total of …[a maximum of $8,750]

The SCC agreed with the taxpayer that section 31 did not apply because a combination of farming and some other source of income constitute a "chief source of income", despite the fact that the farming income was subordinate to the other source of income. This decision clearly did not sit well with the Department of Finance. Therefore, Budget 2013 proposes a legislative "fix" to the SCC's decision in Craig by amending subsection 31(1) to read:

> 31. (1) If a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that is a subordinate source of income for the taxpayer, then for the purposes of sections 3 and 111 the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be the total of
>
> (a) the lesser of
>
> (i) the amount by which the total of the taxpayer's losses for the year, determined without reference to this section and before making any deduction under section 37 or 37.1, from all farming businesses carried on by the taxpayer exceeds the total of the taxpayer's incomes for the year, so determined from all such businesses, and
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> (ii) $2,500 plus the lesser of
>
> (A) 1/2 of the amount by which the amount determined under subparagraph (i) exceeds $2,500, and
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> (B) $15,000, and
>
> (b) the amount, if any, by which
>
> (i) the amount that would be determined under subparagraph (a)(i) if it were read as though the words "and before making any deduction under section 37 or 37.1" were deleted,
> exceeds
>
> (ii) the amount determined under subparagraph (a)(i).

The proposed addition of the phrase "subordinate source of income" should restore the principles of *Moldowan,* which provided that the ability to deduct farm losses would be restricted unless all of the other sources of the taxpayer's income are subordinate to farming. The proposed amendment to subsection 31(1) will apply to taxation years ending on or after March 21, 2013.

Overall, this proposed amendment is disappointing but not surprising. One positive outcome is that the maximum restricted farm loss will now be $17,500 as compared to the previous limit of $8,750. Fundamentally, from a general policy perspective, we do not see why someone engaging in farming as a

bona fide side business should be singled out and penalized in comparison to someone engaging in other types of bona fide side businesses.

5. Trust Loss Trading

The Act contains provisions to prevent companies from undertaking arm's length loss trading, which occurs when a profitable company acquires an arm's length entity solely for the acquiree's history of losses without any intention to continue the acquiree's business. Under existing law, a corporation's tax attributes are subject to various constraints where *de jure* control (generally meaning shares constituting more than 50% of the votes) is acquired by a person or a group of persons. However, no such regime applies in respect of a trust where there is a significant change in the beneficiaries of the trust.

It is reasonable that the Department of Finance sees this as a potential "loophole" that can be exploited since trusts are now widely used in a commercial context. For example, mutual fund trusts, real estate investment trusts, and business trusts may all issue transferrable beneficial units and can theoretically be used as loss trading vehicles. Therefore, Budget 2013 proposes new provisions applicable to trusts that are similar to the corporate acquisition of control rules. Proposed section 251.2 will apply to a trust where there is a "loss restriction event", which will occur when a person becomes a majority-interest beneficiary (that is, a beneficiary who, together with affiliated persons or partnerships, has more than 50% of the beneficial interest in the trust's income or capital measured by the FMV of all beneficial interests in income or capital respectively) or a group becomes a majority-interest group of beneficiaries in the trust.

In order to ensure that typical transactions or events involving changes in the beneficiaries of a personal or family trust will not trigger loss restriction events, proposed section 251.2 contains numerous exceptions for transfers within an affiliated group. For example, acquisition of beneficial interests from an affiliated person or as a consequence of death of an affiliated person will not cause a trust to undergo a loss restriction event. The affiliation rules are modified as they apply to this proposed section. For example, blood relationships will be considered affiliated and the concept of control will mean only de jure control.

The tax consequences for a trust subject to a loss restriction event is expected to be similar to those of a corporation, which may include a mandatory write-down of assets, an immediate expiry of net capital loss carryforwards, a restriction on the use of non-capital loss and investment tax credit carryforwards, among other consequences.

As intended, commercial trusts will be affected by proposed section 251.2 and these trusts will have to actively monitor their investors' ownership level in order to avoid the application of these new rules. Although the exceptions in the proposed section are intended to carve out most transactions in the context of personal or family trusts, these proposed rules are technical and complex. *Families with ownership structures that involve trusts are well advised to consider and monitor these rules to avoid inadvertently triggering loss restriction events.*

The proposed rules apply to transactions occurring on or after March 21, 2013. Limited grandfathering is provided for transactions undertaken by persons who are obligated to complete a transaction pursuant to an agreement in writing entered into before that date.

6. Corporate Loss Trading

The current scheme of the Act prevents transfer of tax attributes between arm's length parties mainly by

the use of the acquisition of control provisions, which are generally triggered when a person or a group of persons acquires *de jure* control of a corporation. The determination of *de jure* control involves a bright-line test based on who holds the majority voting interest in the election of the board of directors and this concept is derived from a large body of jurisprudence. Over the years, many have tried to circumvent the acquisition of control provisions by designing transactions that cause ownership of the economic interest of a corporation to transfer to unrelated parties but without acquiring voting control (commonly known as “tech wreck” planning).

Up to now, the CRA has largely relied on the general anti-avoidance rule (“GAAR”) to combat such transactions. Budget 2013 proposes a specific anti-avoidance rule that will deem an acquisition of control to occur where a person or group of persons crosses a 75% ownership threshold (measured by the FMV value of all issued shares) without otherwise acquiring control of the corporation. It must also be reasonable to conclude that one of the main reasons for not acquiring control is to avoid any of the restrictions that would have been imposed on the corporation’s tax attributes. These specific legislative measures are expected to be more effective in targeting arm’s length loss trading transactions than merely relying on GAAR.

Since the proposed rule applies without regard to whether the crossing of the 75% threshold is by virtue of an acquisition, a holder of non-voting shares in a corporation with multiple share classes may cross the threshold due solely to market price fluctuations or redemption of other classes of shares. Once that threshold is crossed (and assuming the various exceptions for affiliation do not apply), the taxpayer will need to argue that avoiding the acquisition of control rules is not “one of the main reasons” for crossing the threshold. This will add considerable ambiguity to the rules, particularly when compared to the current regime which relies on a bright-line acquisition of *de jure* control test. Further, there may be bona fide commercial reasons behind changes in economic ownership by a non-controlling person or group, but it will be up to the taxpayer to prove that avoiding the consequences of an acquisition of control is not among the “main reasons”.

The proposed rules apply to transactions occurring on or after March 21, 2013. Limited grandfathering is provided for transactions undertaken by persons who are obligated to complete a transaction pursuant to an agreement in writing entered into before that date.

7. Character Conversion Transactions

Under the existing provisions of the Act, a taxpayer can re-characterize income that would ordinarily be treated as business or property income as capital gains through the use of a derivative forward agreement.

One of the most common types of such arrangements is in the context of investment vehicles, such as mutual funds or publicly traded trusts. These vehicles typically offer a taxpayer a security with a return linked to the performance of a portfolio of investments that would otherwise generate business or property income, but through the use of forward contracts, the return is taxed as a capital gain.

For example, a Canadian mutual fund would offer investors a return in reference to a bond portfolio. However, instead of purchasing a bond portfolio that pays fully taxable interest income, the mutual fund may acquire a portfolio of Canadian securities. The fund would then enter into arrangements with other financial institutions to sell those Canadian securities for a price based on the performance of the bond portfolio. As a result, the fund would earn the same return as if it had acquired the bond portfolio directly but it would earn it in the form of a capital gain only half of which is taxable. The Government has taken the position that such transactions inappropriately convert the tax ‘character’ of income.

As a result of this perceived abuse, Budget 2013 proposes measures to address these types of character conversion structures. These measures will apply to taxpayers who acquire or dispose of property under a "derivative forward agreement". A "derivative forward agreement" will include an agreement relating to the purchase and sale of capital property the term of which exceeds 180 days (or that is part of a series of agreements with a term that exceeds 180 days) and the value of the property is determined in whole or in part by reference to an underlying interest unrelated to the value, income or gain of the property. Any gain derived from a property purchased or sold under a derivative forward agreement will be treated as ordinary income rather than capital gain. Conversely, any loss on a property purchased or sold under such an agreement will be deductible as an ordinary loss. However, where an agreement is settled incrementally over time, the net loss cannot be recognized until the final settlement.

Income inclusions and deductions under these proposed measures will be considered in determining the adjusted cost bases of property acquired or disposed of so that there will be no double taxation or deduction.
The definition of a derivative forward agreement is drafted very broadly and may potentially include ordinary commercial transactions that are not the intended target of these proposed measures. It is not unusual for purchase and sale agreements to contain purchase price adjustments that take into account changes or events occurring between the signing date and the closing date such as changes in working capital, inventory valuation, etc. It is unclear whether such purchase price adjustments are related to the property subject to acquisition or disposition. If any part of the purchase or sale price is considered to be determined by reference to an underlying interest unrelated to the property, the entire agreement is caught and the entire gain will be treated as ordinary income. Moreover, in the case of a disposal of property under a derivative forward agreement, the gain re-characterized as ordinary income will include any unrealized gain accrued prior to the vendor entering into the derivative forward agreement. Fortunately, the exception provided for agreements under 180 days should exclude most ordinary transactions from the definition of a derivative forward agreement (provided that they are not part of a series of agreements with a term that extends over 180 days).

These proposed measures will apply to arrangements entered into on or after March 21, 2013 and to arrangements entered into before that date if their term is extended on or after March 21, 2013. We highly encourage these proposed measures be taken into account when structuring purchase and sale agreements, particularly those with long closing periods.

8. Non-Resident Trusts

The Act contains a well-known, often discussed, albeit generally poorly understood attribution rule in subsection 75(2). The seemingly simple wording of the provision acts to re-direct or attribute the income earned by a trust on certain property if the property is held by a trust on condition that (i) it or property substituted therefor may revert to the person from whom the property or property for which it was substituted was received, or pass to persons to be determined by that person after the creation of the trust, or (ii) during the existence of that person, the property shall not be disposed of by the trust except with that person's consent or in accordance with that person's direction. The rule is designed to follow the effective ownership of the property in question by looking to the *de facto* owner of the property: easier said than done. A related rule, subsection 107(4.1), prevents a tax-deferred distribution or rollout of property from a trust where property of the trust is, or has been, subject to the attribution rule.

Subsection 75(2) currently applies to all trusts regardless of the residency of the trust.

In a recent decision of the Federal Court of Appeal ("FCA") (*The Queen v. Sommerer*) that we discussed in our July 20, 2012 blog, the FCA affirmed the decision of the Tax Court of Canada in concluding that

subsection 75(2) was not applicable where a taxpayer transferred property to a non-resident trust in exchange for FMV consideration. It is important to note that in the *Sommerer* case, the vendor of the property was also a beneficiary of the trust and hence, the property may revert to the vendor/beneficiary at some future point. As pointed out in Budget 2013, the Government feels that the decision in *Sommerer* is “not in accordance with the intended tax policy” of the attribution rule, thus necessitating legislative intervention.

In order to address the intended tax policy purpose of the attribution rule, Budget 2013 proposes that the non-resident trust rules contained in Bill C-48 again be amended to ensure that a transfer of property to a non-resident trust that would otherwise result in the application of the subsection 75(2) attribution rule fall within the defined term “contribution”, thus deeming the non-resident to be resident in Canada for certain purposes of the Act. It is perplexing as to why the current proposed definition of “contribution” contained in Bill C-48, which is incredibly broad, would not already capture this scenario. Perhaps the Department of Finance was concerned with other perceived mischief not solely related to the decision in *Sommerer*. Even if further amendment is necessary to the definition of “contribution”, we are concerned that such an amendment may lead to perverse results when a truly arm’s length transfer is completed with no malicious intent or tax motivated purpose. For example, assume an individual sells a residential property to a non-resident trust and in completing the transaction takes back a mortgage as security. It would seem on its face that this fact scenario would fit within the broad wording of subsection 75(2), in that the vendor may ultimately get the property back, which would seem to indicate that the sale would actually be defined as a “contribution” to the trust.
This, one would think, would clearly be a bizarre and unintended result.

In an interesting twist, to avoid potential double taxation, Budget 2013 further proposes to restrict the application of the current attribution provision only to trusts that are actually resident in Canada and not merely deemed to be resident in Canada. Budget 2013 does not address the double taxation issue where an otherwise foreign trust is also deemed to be resident in Canada and subject to tax in both jurisdictions.

This measure will apply to taxation years that end on or after March 21, 2013.

9. Thin Capitalization Rules

The thin capitalization rules in section 18 limit the deductibility of interest expense of a Canadian resident corporation in circumstances where the amount of debt owing to specified non-residents exceeds a debt-to-equity ratio of 1.5-to-1. These rules protect against erosion of the Canadian tax base by preventing Canadian corporations from deducting excessive amounts of interest paid to non-residents. The current rules only apply to Canadian resident corporations and partnerships with a Canadian resident corporate member. Budget 2013 proposes to extend the scope of the thin capitalization rules to (i) Canadian resident trusts, and (ii) non-resident corporations and trusts with branch operations in Canada. This proposed extension of the thin capitalization rules will be effective for taxation years that begin after 2013.

In respect of the proposed rules as they apply to a Canadian branch of a non-resident corporation or trust, the Government recognizes that the branch is not a distinct entity apart from the non-resident. Hence, the Canadian branch does not have shareholders or equity amounts upon which the traditional thin capitalization rules can be based. Therefore, a 3-to-5 debt-to-asset ratio will be used in applying the thin capitalization rules to Canadian branches in place of the traditional 1.5-to-1 debt-to-equity ratio. Also, these rules will apply to a non-resident corporation or trust earning rental income in Canada that makes the election under section 216 of the Act to be taxed on its net income (rather than being subject

to tax under Part XIII on its gross rental income).

We applaud the Government for extending the thin-capitalization regime as there are no sound policy reasons for excluding trusts and Canadian branches from these rules. The proposal will have a significant impact on non-residents operating directly in Canada through a branch rather than through a Canadian corporate subsidiary. Although the proposed legislation takes effect for taxation years after 2013, there is no grandfathering for existing debts owed to specified non-residents. *As such, non-residents with branch operations in Canada should review their situation before the end of this year to assess how this proposal impacts them. This proposed measure also reduces the incentive for a non-resident to use a Canadian branch instead of a Canadian resident corporate subsidiary when investing in Canada.*

10. Extended Reassessment Period: Tax Shelters and Reportable Transactions

For taxpayers other than certain corporations and mutual fund trusts, the CRA may reassess a taxation year within three years after the day of sending of a notice of assessment (the “normal reassessment period”) unless special circumstances, such as misrepresentation or fraud, apply.

To assist the CRA in combating aggressive tax planning, the Act imposes various requirements to file information returns in respect of tax shelters and “reportable transactions”. A promoter of a tax shelter is required to file information returns listing each participant in the shelter and a taxpayer who undertakes “reportable transactions” is required to file information returns disclosing such transactions (the latter is under the legislative proposals included in Bill C-48). Generally speaking, a “reportable transaction” is a transaction that results in a tax benefit and to which two of the following applies:

- an advisor or promoter is entitled to a fee based on the amount of tax benefit or the number of participants (or the number of people who have been given advice on the transaction);
- an advisor or promoter has ‘confidential protection’ in respect of the transaction; or
- a participant, advisor or promoter has ‘contractual protection’ in respect of the transaction.

Where such information returns are not timely filed, or not filed at all, the CRA would be delayed in obtaining the information necessary to conduct proper audits of the tax shelter or reportable transaction. As a result, the CRA may not be able to reassess a participant in a tax shelter or a reportable transaction before the end of the relevant normal reassessment period. Therefore, Budget 2013 proposes to extend the normal reassessment period in respect of a participant in a tax shelter or a reportable transaction where the relevant information return is not filed on time. In particular, the normal reassessment period will be extended to three years after the relevant information return is filed.

Our firm believes that tax planning should be done in a way that is consistent with the intent of the Act. In that light, we agree with strengthening the CRA’s ability to police tax products that are abusive to or inconsistent with the spirit and intent of the law.

Strengthening Compliance And Other Measures

1. Stop International Tax Evasion Program (“Whistleblower Awards”)

Following the United States’ lead, the Government announced the creation of the “Stop International Tax Evasion Program”, which will pay rewards to individuals with knowledge of major international tax non-compliance. The CRA will pay an individual who provides information to the CRA if the information leads to assessments or reassessments resulting in additional federal taxes in excess of $100,000. The

CRA will enter into contracts with individuals that provide such information and will pay, upon collection of the tax, up to 15% of the federal tax collected but only where the non-compliant activity involves foreign property or property located or transferred outside Canada, or transactions conducted partially or entirely outside of Canada.

Individuals who have been convicted of tax evasion about which they have information will not be eligible for a payment under the program. Interestingly, the Government clarified that all reward payments will be taxable in the hands of the individual (similar to the US whistleblower payment program that we discussed in our September 12, 2012 blog).

2. Form T1135

Extended Reassessment Period

A taxpayer must file Form T1135 (Foreign Income Verification Statement) if the taxpayer owns “specified foreign property” with aggregate costs exceeding Cdn$100,000. Specified foreign property generally includes income-earning property outside of Canada but specifically excludes personal use property (e.g. a personal use cottage) and property used in carrying on an active business. This form helps the CRA assess the accuracy and completeness of foreign-sourced income reported on a taxpayer’s tax return.

As discussed above, the CRA’s normal reassessment period under normal circumstances is three years after the day a notice of assessment is sent to the taxpayer. If a taxpayer files the Form T1135 late, the CRA may only have a small window of time within which it can verify the foreign income reported by the taxpayer.

Budget 2013 proposes to add a three-year extension to the normal reassessment period if the taxpayer has not complied with the filing requirements for Form T1135. The extended reassessment will only apply where the taxpayer failed to report income from a specified foreign property and Form T1135 was improperly completed or late-filed. This measure will be effective for the 2013 and subsequent taxation years.

The provisions of subsection 152(4.01) generally limits the scope of a reassessment in an extended reassessment period to a specific area or transaction. For example, under existing legislation, the normal reassessment period is extended by three years in relation to transactions between a taxpayer and a non-arm’s length non-resident, but any reassessment under this extended period is limited only to those transactions. Conversely, the proposed amendment appears to intentionally leave out from subsection 152(4.01) the reassessment period extension as it applies to Form T1135 non-compliance. This means that the CRA will have the ability to reassess a taxpayer’s entire tax return within the extended reassessment period if the taxpayer does not comply with Form T1135 requirements.

It appears that Canada intends to get tough on non-reporting or under-reporting of foreign-sourced income.

Revised Form T1135 and Improvements to Filing Process

Form T1135 currently requires only general information regarding location of the specified foreign property and the income it generates. The CRA will revise the form to require more detailed information on each specified foreign property, including:

1. the name of the specific foreign institution or entity holding funds outside Canada;
2. the specific country to which the property relates; and
3. the foreign income generated from the property.

The level of detail requested in the revised form is significantly more than the current one, and suggests that the Government is moving towards a more intrusive foreign reporting system similar to the United States (case in point, see the notorious FBAR form that US citizens with foreign bank and financial accounts are required to file).

Budget 2013 also announced that the CRA will make the following improvements to the T1135 filing process:

- Reminder of Form T1135 requirement on notice of assessments;
- Clarifying the filing instructions printed on Form T1135; and
- Working towards electronic filing of Form T1135 (to date, Form T1135 must be paper-filed separately from a taxpayer's income tax return).

3. International Electronic Funds Transfers

The government is concerned about taxpayers who engage in foreign financial transactions to obfuscate their tax reporting and avoid domestic taxation. Banks, credit unions, caisse populaires, trust and loan companies, money services business and casinos are currently required to report electronic funds transfers ("EFTs") in excess of $10,000 to the Financial Transactions and Reports Analysis Centre of Canada. Beginning in 2015, these same organizations will be required to report international EFTs to the CRA.

4. Registered Pension Plan Contribution Deduction

Currently, contributions made to Registered Pension Plans ("RPPs") can be refunded to plan members or employers only when the contribution limit for the year has been exceeded and the registration of the plan is at risk of revocation as a result. Additionally, refunds are only permitted at the discretion of the CRA. Budget 2013 proposes to enable administrators of RPPs to make refunds of contribution in order to correct reasonable errors without first obtaining CRA's approval. The refund will be reported as income in that year and no adjustment will be made to the employee's prior year. This change is proposed to be effective for contributions made on or after the later of January 1, 2014 and the day of Royal Assent.

This is a welcome change for RPPs' administrators.

Consultation Initiatives

1. Treaty Shopping

Canada enters into bilateral tax treaties with other countries for the purposes of supporting cross-border trade and investment, and preventing international tax evasion and avoidance. The treaties achieve the first objective, in part, by offering reduced rates of withholding taxes on certain types of cross border payments. The Government states in Budget 2013 that it is concerned about "treaty shopping", and it cites an example of a non-resident of a third country (a country not party to a particular bilateral tax treaty) obtaining the benefits of the treaty by using an intermediary entity resident in the treaty partner country. The Government announced that it intends to consult with stakeholders regarding potential

measures that will “protect the integrity of Canada’s tax treaties”.

In our view, the problem of treaty shopping is moderately under control in Canada due to judicial development on concepts such as beneficial ownership and residency. Ending treaty shopping completely remains an elusive goal for governments around the world, so it will be interesting to follow this development and see what potential solutions the consultation initiative will recommend.

2. Consultation on Graduated Rate Taxation of Trusts and Estates

Currently, the taxable income of testamentary and post-June 18, 1971 *inter vivos* trusts is computed at the graduated rates applicable to individuals whereas ordinary *inter vivos* trusts pay federal tax at a flat rate of 29%.

Some taxpayers have taken advantage of the resulting tax benefit by establishing a multiplicity of testamentary trusts for individual beneficiaries which can assist in accessing multiple progressive tax rates (after considering the risks under subsection 104(2) that may deem such multiple trusts to be one trust). For provinces that have the Rule Against Perpetuities (which limits the duration of legal instruments that attempt to split property rights in perpetuity), there is the possibility that property will never vest within the required period in violation of this rule. Subsection 104(4) of the Act requires a deemed disposition of the property of a trust after 21 years and still apply to such testamentary trusts, but there is still significant and mismatching tax benefit from having graduated rates apply to multiple testamentary trusts.

The Government intends to consult on possible measures to eliminate these tax benefits and produce a paper that will be released for public comment.

It is interesting that the Department of Finance is reviewing whether progressive tax rates should apply to testamentary trusts. We know that the Department has been concerned about access to progressive tax rates vis-à-vis testamentary trusts for some time now. Approximately ten years ago, a proposed amendment (currently in Bill C-48) to the definition of “testamentary trust” in subsection 108(1) was made to deem a testamentary trust to be an *inter vivos* trust in certain situations where beneficiaries loaned monies to the trust. This was a targeted measure to try to combat certain pervasive planning that attempted to extend the access of the progressive tax rates of testamentary trusts.

We await further developments in this area.

3. Taxation of Corporate Groups

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

Phew! That’s it for now. As always, our team is ready to help you navigate through these changes so please do not hesitate to contact any one of us for further information.