changes to personal income tax rules

Budget 2013 proposes a number of changes to the provisions of the *Income Tax Act* (Canada) (the "**Tax Act**") governing the taxation of individuals, including (i) an increase in the lifetime capital gains exemption and the indexing of same to inflation, (ii) a reduction in the dividend tax credit rate for "non-eligible" dividends, (iii) an extension of the reassessment period for participants in certain tax shelter arrangements and tax avoidance transactions, and (iv) measures enabling the Canada Revenue Agency (the "**CRA**") to collect 50% of disputed taxes arising from charitable donation tax shelters.

increase in the lifetime capital gains exemption

The Tax Act currently provides for a lifetime capital gains exemption (the "**Lifetime Exemption**") on gains of up to $750,000 realized by an individual who disposes of "qualified small business corporation" shares (i.e., shares of a "small business corporation" which satisfy a series of activity, ownership and asset tests), "qualified fishing property", and "qualified farm property" (collectively, "**Eligible Property**"). Any resulting capital gain from the disposition of Eligible Property up to a lifetime maximum of $750,000 is currently exempt from taxation.

Budget 2013 proposes to increase the Lifetime Exemption from $750,000 to $800,000 starting in the 2014 taxation year. After 2014, the Lifetime Exemption will be indexed to inflation. The increased Lifetime Exemption limit will apply to all individuals, even individuals who have previously used the Lifetime Exemption. The Government's stated intent in making this change is to assist small business owners, farmers and fishermen.

Although the immediate effect of indexing the Lifetime Exemption limit to inflation is not significant, it should ensure that the Lifetime Exemption limit continues to reflect current economic realities, while reducing uncertainty as to the future value of the Lifetime Exemption limit.

reduction in the dividend tax credit for non-eligible dividends

While corporations are generally required to pay tax on their earnings, shareholders also pay tax when such earnings are distributed to them as dividends. In order to avoid the double-taxation of corporate income, the Tax Act contains a dividend gross-up and tax credit mechanism intended to ensure that the combined tax rate for corporations and shareholders on a dollar of corporate income is approximately the same as it would be if that income had been earned directly by the shareholders.[1] More specifically (i) a dividend received by a Canadian-resident shareholder from a Canadian-resident corporation is "grossed up" to reflect the tax presumed to have been paid by the corporation on its underlying income, and (ii) the shareholder is then entitled to a dividend tax credit ("**DTC**") which reduces the shareholder's tax payable.

The gross-up and DTC rates differ depending on whether the underlying corporate income is taxed at the general corporate rate or at a reduced corporate rate (for example, where the corporation claimed the small business deduction). Generally, dividends paid out of corporate income that is taxed at reduced rate (a "**non-eligible dividend**") is not entitled to the enhanced gross-up and DTC that applies to "eligible dividends". Instead, a shareholder that receives a non-eligible dividend may claim the standard gross-up (currently 25%) and DTC (currently 2/3 of the gross-up).

The Government has taken the view that the current gross-up and DTC rates applicable to non-eligible dividends does not accurately reflect the actual corporate tax rate on underlying corporate income. Therefore, Budget 2013 proposes to reduce the gross-up factor applicable to non-eligible dividends from 25% to 18% and to increase the corresponding DTC from 2/3 of the grossed-up amount to 13/18 thereof. As a result, the effective DTC rate will decline from approximately 13.3% of the grossed-up amount of the non-eligible dividend to 11%. This reduction in the DTC rate will particularly affect taxpayers who own shares in corporations which claim the small business deduction. The amendment will apply to non-eligible dividends paid after 2013.

extension of the reassessment period for tax shelters and reportable transactions

Generally, the CRA is permitted to reassess individuals for a particular taxation year within three years of the date of their initial notice of assessment (the "normal reassessment period"), subject to certain exceptions, such as situations involving certain misrepresentations or fraud.

However, in order to assist the CRA in combating aggressive tax planning, Budget 2013 proposes to extend the normal reassessment period for taxpayers who participate in tax shelter arrangements and certain reportable tax avoidance transactions (collectively, "**Prescribed Transactions**"). Under the Tax Act, where persons engage in a Prescribed Transaction, the promoter, the taxpayer and/or their advisors are required to file an information return in respect of the Prescribed Transaction.

Under the existing rules, if the information return is not filed in a timely manner in respect of the Prescribed Transaction, the CRA may not be able to reassess participating taxpayers before the end of their normal reassessment period. Therefore, Budget 2013 proposes to extend the normal reassessment period for taxpayers participating in Prescribed Transactions, to allow the CRA to reassess such taxpayers within three years following the filing of the relevant information return.

This change applies to taxation years that end as at or after March 21, 2013.

CRA permitted to collect 50% of disputed taxes in relation to charitable donation tax shelters

In recent years, the CRA has been aggressive in challenging charitable donation tax shelters. For example, in October 2012, the CRA announced it would delay the assessments of taxpayers who claim tax credits from participation in a gifting tax shelter scheme until the completion of the audit of the tax shelter.

Budget 2013 proposes to arm the CRA with another weapon to discourage the use of "questionable" charitable donation tax shelters. Generally, where an individual has objected to the CRA's assessment of tax, penalties or interest, the CRA is not permitted to take collection action on the amount in controversy. However, Budget 2013 proposes to enable the CRA to collect 50% of the tax, penalties and interest in dispute pending final determination of the taxpayer's liability in connection with the tax shelter investment.

Some promoters obtain a tax shelter identification number out of an abundance of caution if there is any doubt that the arrangement is a tax shelter. To the extent that the arrangement is not in fact a tax shelter, taxpayers may be able to dispute the proposed collection measure on that basis.

While the Budget Papers suggest that the proposed collection measure is targeted at "questionable" charitable donation tax shelters, the new collection mechanism would appear to capture all tax shelters under which a donation tax credit or deduction may be claimed. The over-inclusive nature of the measure may serve as a significant deterrent to entering into any charitable donation tax shelter and could unnecessarily reduce charitable giving.

The measure is proposed to apply to the 2013 and later taxation years.

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[1] The provinces generally provide a comparable mechanism with respect to provincial income taxes.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.