STEP Canada

Federal Budget 2012: STEP Canada Summary

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The Conservative government introduced its second federal Budget, Economic Action Plan 2012, as a majority government. Much like its first Budget released last June, many of the tax measures related to personal, business and international taxation, proposed on March 29, 2012 are largely technical and aimed at ensuring long-term economic stability and increasing the Canada Revenue Agency's powers to ensure Ottawa's coffers are not leaking — a notable exception being improvements suggested for Registered Disability Savings Plans. Following are the principal highlights of interest to Trust and Estate Practitioners:

Registered Disability Savings Plans

Following a recent review of Registered Disability Savings Plans (RDSPs), Ottawa is proposing in the 2012 Budget to make a number of changes to improve the effectiveness of these plans. Additional information can be found in an information bulletin released by the Canada Revenue Agency on March 30, 2012: http://www.cra-arc.gc.ca/gncy/bdgt/2012/qa08-eng.html

Introduction

An RDSP is a trust arrangement between a holder and an issuer (i.e., a trust company) to provide for the long-term financial security of a beneficiary who has a prolonged and severe physical or mental impairment. Any individual who is eligible for the Disability Tax Credit ("DTC") can be the beneficiary of an RDSP.

The planholder opening the RDSP makes decisions regarding contributions, investments, and withdrawals. If the plan is opened for a minor child, the planholder can be a parent or legal representative of the beneficiary. Parents, beneficiaries and others wishing to save on behalf of the beneficiary are allowed to contribute to an RDSP. Contributions are limited to a lifetime maximum of $200,000. Contributions are permitted until the end of the year in which a beneficiary reaches 59.

Annual RDSP contributions attract Canada Disability Saving Grants ("CDSGs") at matching rates of 100, 200, or 300%, depending on the beneficiary's family income, and the amount contributed up to a lifetime maximum of $70,000. The Government also provides up to $1,000 in Canada Disability Savings Bonds ("CDSBs") annually to RDSPs established by low- and modest-income families, up to a lifetime maximum of $20,000. An RDSP is eligible to receive

CDSGs, and CDSBs are paid into RDSPs, until the end of the year in which the beneficiary attains 49 years of age.

Contributions to an RDSP are not deductible and are not included in the beneficiary's income when withdrawn. Investment income earned in an RDSP grows tax-free. CDSGs, CDSBs and investment income earned in an RDSP are included in the beneficiary's income for tax purposes when withdrawn from the RDSP.

Each withdrawal from an RDSP comprises a taxable portion and a non-taxable portion based on the relative proportion of taxable assets (including CDSGs, CDSBs, and investment income) and non-taxable assets (private contributions) in the RDSP. RDSP withdrawals must commence by the end of the year in which the beneficiary attains 60 years of age.

Dealing with Planholder Capacity

A number of adults with disabilities have experienced difficulty in establishing a plan because their capacity to enter into a contract is in doubt. In many provinces and territories, the only way that an RDSP can be opened in these cases is for the individual to be declared legally incompetent and have someone named as their legal guardian – a drawn-out and expensive process.

Ottawa is proposing an interim solution while the provinces and territories develop long-term solutions to address RDSP legal representation issues. Specifically, where, in the opinion of an RDSP issuer, an individual's ability to enter into a contract is in doubt, the spouse, common-law partner, or parent of the individual will be considered a "qualifying family member" and will be eligible to establish an RDSP for the individual.

Ottawa is also proposing, as a result, that no legal action will be able to be brought against an RDSP issuer who allows a qualifying family member to establish and become the holder of an RDSP for the beneficiary. RDSP issuers will be required to notify an individual when a qualifying family member establishes an RDSP for which the individual is the beneficiary.

Subsequently, if the issuer no longer doubts the individual's contractual competence, or the individual is determined to be contractually competent by a public agency or tribunal authorized to make such a determination, the individual may replace the qualifying family member as planholder. After a qualifying family member opens an RDSP and a legal representative is formally named in respect of an individual, the legal representative will replace the qualifying family member as the planholder.

This measure is temporary and will apply from the date of Royal Assent to the enacting legislation until the end of 2016, when it is hoped that provincial legislation will have been enacted to address this issue. A qualifying family member who becomes a planholder under this measure will be able to remain the planholder after 2016.

Proportional Repayment Rule

Under current rules, any CDSGs and CDSBs paid into an RDSP in the preceding 10 years generally must be repaid to the Government on any of the following events:

- any amount is withdrawn from the RDSP;
- the RDSP is terminated or deregistered; or
- the RDSP beneficiary ceases to be eligible for the DTC or dies.

This is the "10-year repayment rule". RDSP issuers must set aside an "assistance holdback amount" equal to the total CDSGs and CDSBs paid into the RDSP in the preceding 10 years less any CDSGs and CDSBs already repaid in respect of that 10-year period.

In the 2012 Budget, Ottawa is proposing to provide greater access to RDSP savings for small withdrawals by introducing a "proportional repayment rule" that will apply when a withdrawal is made from an RDSP. This rule will replace the 10-year repayment rule only in respect of RDSP withdrawals. The existing 10-year repayment rule will continue to apply where the RDSP is terminated or deregistered, or the RDSP beneficiary ceases to be eligible for the DTC or dies.

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

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

Maximum and Minimum Withdrawals

Changes have been proposed to the rules governing maximum and minimum withdrawals from RDSPs. There are two types of withdrawals that may be made from an RDSP: a discretionary disability assistance payment, which may be made at any time, subject to the plan terms and certain restrictions under the tax rules; and a lifetime disability assistance payment ("LDAP"), which provides an ongoing stream of payments from the RDSP for a beneficiary.

LDAPs may commence at any time. Once begun, they must be paid at least annually until either the RDSP is terminated or the beneficiary dies. LDAPs must begin no later than the end of the year in which the beneficiary attains 60 years of age. The maximum LDAP that can be withdrawn from the RDSP each year is determined by a formula ("the LDAP formula") that is based on the age of the beneficiary and the fair market value of the assets held in the RDSP.

Specific rules limit the maximum amount that may be withdrawn annually from RDSPs where CDSGs and CDSBs paid into the plan exceed private contributions made to the plan. Such RDSPs are known as primarily government-assisted plans ("PGAPs"). Under the 2012 Budget, Ottawa is proposing to increase the maximum annual limit for withdrawals from PGAPs to the greater of the amount determined by the LDAP formula and 10 percent of the fair market value of plan assets at the beginning of the calendar year.

PGAPs are also subject to a minimum annual withdrawal requirement commencing with the calendar year in which the beneficiary attains 60 years of age. The 2012 Budget proposes to extend the minimum annual withdrawal requirement that currently applies only to PGAPs to all RDSPs. Accordingly, once an RDSP beneficiary attains 60 years of age, the total withdrawals from the RDSP in a calendar year must be at least equal to the amount determined by the LDAP formula for the year.

These measures will apply after 2013.

Rollover of RESP Investment Income

To provide greater flexibility for parents who save in a Registered Education Savings Plan ("RESP") for a child with a severe disability, Ottawa is proposing to allow investment income earned in an RESP to be transferred on a tax-free rollover basis to an RDSP if the plans share a common beneficiary. In order to qualify for this measure, the beneficiary must meet the existing age and residency requirements in relation to RDSP contributions. As well, one of the following conditions must be met:

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

Under this proposal, when RESP investment income is rolled over to an RDSP, contributions in the RESP will be returned to the RESP subscriber on a tax-free basis. The amount of RESP investment income rolled over to an RDSP may not exceed, and will reduce, the beneficiary's available RDSP contribution room. The rollover amount will be included in the taxable portion of RDSP withdrawals.

This measure will apply to rollovers of RESP investment income made after 2013.

Termination of an RDSP following Cessation of Eligibility for the DTC

If a beneficiary's condition factually improves such that the beneficiary does not qualify for the DTC for a taxation year, the RDSP must currently be terminated by the end of the following year. Where a beneficiary's condition is such that he or she may become eligible for the DTC in the near future, this requirement can cause undue hardship. To reduce the administrative burden on these beneficiaries and ensure greater continuity in their long-term saving, it is proposed in certain circumstances that the period for which an RDSP may remain open, when a beneficiary becomes DTC-ineligible, be extended.

A medical practitioner must certify in writing that the nature of the beneficiary's condition makes it likely that the beneficiary will, because of the condition, be eligible for the DTC in the foreseeable future. The sole purpose of the certification and election is to allow an RDSP to remain open for the years under election.

Election
If an RDSP plan holder decides to take advantage of this measure, the planholder will be required to elect in prescribed form and submit the election, along with the written certification, to the RDSP issuer. The RDSP issuer will then be required to notify Human Resources and Skills Development Canada that the election has been made. The election must be made on or before December 31st of the year following the first full calendar year for which the beneficiary is DTC-ineligible.

Results of an Election
Where an election is made, the following rules will apply commencing with the first full calendar year for which the beneficiary is DTC-ineligible:

- No contributions to the RDSP will be permitted, including under the proposed rule for the rollover of RESP investment income. However, a rollover of proceeds from a deceased individual's Registered Retirement Savings Plan or Registered Retirement Income Fund to the RDSP of a financially dependent infirm child or grandchild will still be permitted.
- No new CDSGs or CDSBs will be paid into the RDSP.
- No new entitlements will be generated for the purpose of the carry-forward of CDSGs and CDSBs for years for which the beneficiary is DTC-ineligible.
- Withdrawals from the RDSP will be permitted, and will be subject to the proposed proportional repayment rule and the proposed maximum and minimum withdrawal rules as applicable.

An election will generally be valid until the end of the fourth calendar year following the first full calendar year for which a beneficiary is DTC-ineligible. The RDSP must be terminated by the end of the first year during which there is no longer a valid election.

This measure will apply to elections made after 2013.

Eligible Dividends – Split-Dividend Designation and Late Designation

In the 2012 Budget, Ottawa is introducing two new rules to alleviate some of the strictness in the application of the rules governing eligible dividends. In general terms, under current law, a corporation may pay an eligible dividend out of corporate income that has been subject to tax at the general corporate rate (and not the small business rate). Taxpayers in receipt of an eligible dividend are entitled to an enhanced dividend tax credit. The purpose of the eligible dividend/enhanced dividend tax credit mechanism is to provide for better integration of the corporate level and shareholder level taxes.

Under current rules, a corporation paying a dividend may designate the dividend as an eligible dividend by notifying each shareholder in writing, at the time the eligible dividend is paid, that the dividend is designated as an eligible dividend. It is not possible, under the current rules, for a corporation make a late designation.

The Budget introduces two alleviating rules. First, it is proposed that the Minister of National Revenue will have discretion to accept a late designation of an eligible dividend if the late-filed designation is filed within three years following the date on which the designation should have been made. The Minister must be of the opinion that accepting the late~~-filed~~ designation is just and equitable in the circumstances, including to affected shareholders. The proposed rules will deem the late designation to have been made at the time the dividend was paid.

Second, it is proposed that a designation may be made in respect of a portion of a dividend, instead of the whole dividend, as currently required.

The two rules together will improve tax fairness in situations where a corporation could have designated a dividend as an eligible dividend, but did not. The second rule will also simplify the mechanics of declaring, paying and designating eligible dividends. The Canada Revenue Agency released an information bulletin on March 30, 2012 providing additional information about these rules. These rules apply to dividends paid after March 28, 2012.

Group Sickness or Accident Insurance Plans

Generally, if an employer contributes to a group insurance plan in respect of an employee, an amount is included in the employee's income either when the employer contributions are made to the plan or when benefits are received under the plan.

Currently wage-loss replacement benefits that are payable on a periodic basis under a group sickness or accident insurance plan to which an employer has contributed are included in an employee's income for tax purposes when those benefits are received. However, no amount is included in an employee's income when the employer contributions are made, or the benefits are received, if:

- benefits are not payable on a periodic basis; or
- benefits are payable in respect of a sickness or accident when there is no loss of employment income.

Ottawa is proposing to include the amount of an employer's contributions to a group sickness or accident insurance plan in an employee's income for the year in which the contributions are made to the extent that the contributions are not in respect of a wage-loss replacement benefit payable on a periodic basis. It appears the target is accidental death and dismemberment benefits and critical illness insurance. While the benefits paid to employees under these plans will not be taxable to the employee, the employee will receive a taxable benefit on the employers contributions (i.e., the premiums paid) to provide the coverage. This is similar to the treatment of employer paid life insurance.

This measure will not affect the tax treatment of private health services plans or similar plans described in paragraph 6(1)(*a*) of the *Income Tax Act*.

This measure will apply in respect of employer contributions made on or after Budget Day — March 29, 2012 — to the extent that the contributions relate to coverage after 2012, except that such contributions made on or after Budget Day and before 2013 will be included in the employee's income for 2013.

Addressing perceived abuses of Retirement Compensation Arrangements

A retirement compensation arrangement ("RCA") is an employer-sponsored funded retirement savings plan that is typically used to fund retirement benefits for higher-income employees in excess of the maximum pension benefits permitted by registered pension plans contribution limits. Under the current rules, employer contributions to an RCA are deductible to the employer, but subject to tax in the RCA trust, at the rate of 50%. This 50% tax is refunded on a proportionate basis when the employee draws down the plan in retirement. Income and capital gains in the RCA trust are similarly subject to a 50% refundable tax (and therefore not subject to tax under Part I). There is a special rule that permits a refund of the 50% tax even where the RCA investments have lost some or all of their value.

For a number of years, the Federal Government has been concerned that a number of arrangements have been developed to take advantage of the RCA rules. To date RCAs have not been subject to any restrictions as to the investments they can hold. In the 2012 Budget, Ottawa is proposing to change this by introducing new "prohibited investment" rules for RCAs. Further, new "advantage" and "strip" rules are also being introduced. No definitions of these new terms are provided; rather the Budget simply indicates that they will be similar to the existing definitions of corresponding terms in the registered retirement savings plan ("RRSP") context.

The new rules are anti-avoidance in nature, their intent being to prevent RCAs from engaging in certain tax-motivated non-arm's length transactions. The Budget document specifically identified two areas of concern:

- deductions of large contributions that are indirectly returned to the contributors such that the RCA ends up with little or no assets but being entitled to claim refundable tax using the impaired asset exception, and;
- arrangements using insurance products to allocate costs to the arrangement for benefits that arise outside of the RCA, such as where the RCA owns the surrender value of the policy and another person holds the death benefit.

These rules will apply where the RCA has a "specified beneficiary". An RCA beneficiary will be a "specified beneficiary" if he/she has a "significant interest" in the employer (generally defined to mean a 10% or greater interest). Analogizing to the current prohibited investment rules for RRSPs, it can be anticipated that prohibited investments for an RCA will likely include debt of the specified beneficiary and shares or debt of any corporation in which the specified beneficiary has a 10% or greater interest. "Advantage" will include benefits attributable to a prohibited investment and strip transactions whereby value is intentionally eroded from the RCA without adequate consideration.

The consequences of the RCA holding a prohibited investment or extending an advantage will be onerous:

- a 50% tax on the fair market value of the prohibited investment
- a tax equal to 100% of the fair market value of the advantage obtained by the specified beneficiary
- the special election normally available where there has been a decline in value of RCA property (which allows RCA tax to be refunded despite insufficient distributions from the RCA) will not be available where the decline in value is attributable to a prohibited investment or advantage, with the result that the ability to obtain a refund of RCA tax will be jeopardized.

A new restriction on tax refunds where the RCA investments have lost value has also been proposed. Transitional rules will address advantage arrangements already in place. On March 30, 2012, the Canada Revenue Agency released a bulletin on the RCA proposals containing additional information: http://www.cra-arc.gc.ca/gncy/bdgt/2012/qa09-eng.html

These rules apply in respect of RCA tax on RCA contributions made on or after Budget Day.

“Specified employees” and Employee Profit Sharing Plans

Employee Profit Sharing Plans (“EPSPs”) are trusts that facilitate the sharing of profits with employees. An employer’s contribution to an EPSP is deductible in the year it is made. An EPSP is required to make allocations of all employer contributions, as well as income and capital gains from trust property, to beneficiaries each year and the beneficiaries are required to include such allocations in income.

For a number of years, the Government has been concerned that EPSPs have been used by business owners to direct profits to the members of their families in order to reduce or defer the payment of income tax on profits. In the 2012 Budget, Ottawa is proposing to impose special tax payable by “specified employees” on “excess EPSP amounts. “Specified employees” are employees who have a significant equity interest in the employer or who are not at arm’s length with employer. A contribution will be an “excess EPSP amount” if it is in excess of 20% of the employee’s salary for that year.

Life Insurance Policy Exemption Test

The income earned on the savings component of a life insurance policy that is an exempt policy, as determined under the *Income Tax Regulations*, is not subject to accrual taxation in the hands of the policyholder. The exemption test that determines whether a life insurance policy is an exempt policy was implemented in the early 1980s and is intended to differentiate protection-oriented life insurance policies from investment-oriented life insurance policies.

Because the exemption test was implemented almost 30 years ago, the Federal Government has reviewed it to ensure that it continues to serve the intended purpose. This review has shown that technical improvements are required to update and simplify the test. Over the coming months, Ottawa will undertake consultations with key stakeholders on the proposed technical improvements. Amendments to the tax provisions arising from these consultations will apply to life insurance policies issued after 2013.

At present, a life insurance policy is an exempt policy when the savings accumulating in the policy does not exceed the savings in a benchmark policy. The benchmark policy is generally defined as a policy where the death benefit is payable on the earlier of death and the age of 85 years ("the endowment time"), and premiums are payable 20 years after the issuance of the policy ("the pay period"). Depending on the type of coverage, the savings in the benchmark policy are calculated using prescribed mortality and interest rates, the rates used in determining the premiums, or the cash surrender value of the actual policy. The savings in an actual policy are measured using an amount that is equal to the greater of the cash surrender value of the policy and the modified net premium reserve in respect of the policy.

In the 2012 Budget, Ottawa is proposing to implement the following changes to the exemption test:

- measuring the savings in an actual policy and the benchmark policy using the Canadian Institute of Actuaries 1986-1992 mortality tables and an interest rate of 3.5 percent to better reflect mortality rates and investment returns while improving consistency between the measurement of the savings in an actual policy and the measurement of the savings in the benchmark policy;
- increasing the endowment time of the benchmark policy from age 85 years to age 90 years to reflect increased life expectancy;
- measuring the savings in an actual policy using the greater of the cash surrender value of the policy before the application of surrender charges, and the net premium reserve in respect of the policy to capture all savings in an actual policy while improving consistency between the measurement of the savings in the policy and the measurement of the savings in the benchmark policy; and
- reducing the pay period of the benchmark policy to eight years from 20 years to better reflect current industry practices and the pay period used in other countries.

It is anticipated that these rules will apply to life insurance policies issued after 2013.

Overseas Employment Tax Credit

Employees who are residents of Canada and qualify for the Overseas Employment Tax Credit ("OETC") are entitled to a tax credit equal to the federal income tax otherwise payable on 80% of their qualifying foreign employment income, up to a maximum foreign employment income of $100,000. The OETC is deductible in determining the employee's tax payable.

The OETC was originally introduced in Budget 1979 as a targeted measure to maintain the competitiveness of Canadian firms in certain sectors in bidding for overseas contracts. At the time, the tax legislation of many of Canada's foreign competitors provided some degree of similar tax relief. Since then the Government has implemented broad-based tax reductions that support investment and growth in all sectors of the economy and most of Canada's foreign competitors (for example, the United States, United Kingdom and France) do not have analogous tax preferences. In addition, recent court decisions have expanded the application of the OETC beyond its original intent.

In the 2012 Budget, the Federal Government proposes to phase out the OETC over four taxation years, beginning with the 2013 taxation year. During the phase-out period, the factor applied to an employee's qualifying foreign employment income in determining the employee's OETC will be reduced to 60% for the 2013 taxation year, 40% for the 2014 taxation year and 20% for the 2015 taxation year. The OETC will be eliminated for the 2016 and subsequent taxation years.

These phase-out rules will not apply with respect to qualifying foreign employment income earned by an employee in connection with a project or activity to which the employee's employer had committed in writing before Budget Day. In such instances, the factor applied to an employee's qualifying foreign employment income in determining the employee's OETC will remain at 80 per cent for the 2013, 2014 and 2015 taxation years. The OETC will be eliminated for the 2016 and subsequent taxation years.

Gifts to Foreign Charitable Organizations

Generally, donations made by Canadians to foreign charities are not eligible for the Charitable Donations Tax Credit or Deduction. However, a foreign charitable organization that receives a gift from the Government of Canada may register as a qualified donee under the *Income Tax Act*. As a qualified donee, a foreign charitable organization may issue an official donation receipt for a gift received from a Canadian donor, entitling the donor to a credit or deduction in computing Canadian income or tax.

In the 2012 Budget, Ottawa is proposing to modify the rules for registering certain foreign charitable organizations as qualified donees. Foreign charitable organizations that receive a gift from the Government may apply for qualified donee status if they pursue activities:

- related to disaster relief or urgent humanitarian aid; or
- in the national interest of Canada.

After consultation with the Minister of Finance, the Minister of National Revenue will have the discretionary power to grant qualified donee status to a foreign charitable organization that meets these criteria. Qualified donee status will be made public, and will be granted for a 24-month period that begins on the date chosen by the Minister of National Revenue, which normally would be no later than the date of the gift from the Government.

Foreign charitable organizations that have received qualified donee status under the existing rules will continue to be qualified donees until the expiration of the period of their current status. This measure will apply to applications made by foreign charitable organizations on or after the later of January 1, 2013 and Royal Assent to the enacting legislation.

Charities: Enhancing Accountability for Engaging in Political Activity

Under the *Income Tax Act*, registered charities are required to operate exclusively for charitable purposes and devote their resources exclusively to charitable activities. A charity is allowed to engage in political activity, as long as the activities represent a limited portion of its resources, are non-partisan as well as ancillary and incidental to its charitable purposes and activities.

As reported extensively in the media, concerns have been raised that some charities may be exceeding these limitations. Also, there is no requirement for a charity to disclose the extent to which it receives funding from foreign sources for political activities. To enhance compliance and increase disclosure by charities regarding political activities, Ottawa is also proposing to provide additional enforcement tools to the Canada Revenue Agency. These measures will apply on Royal Assent to the enacting legislation.

At present, when a charity makes a gift to another qualified donee, the *Income Tax Act* currently treats the amount of the gift to have been devoted to its charitable purposes and activities, even if the gift is earmarked for political activities. This treatment allows a charity to indirectly pursue political activities beyond what would be permitted if it engaged in those activities directly.

In the 2012 Budget, it is proposed that when a gift is made by a charity can be reasonably considered a gift for the purpose of supporting the political activities of a qualified donee, the gift will be considered to be an expenditure made by the charity on political activities.

Changes made to Scientific Research and Experimental Development Program

In 2010, the Government mandated the Expert Review Panel on Research and Development to review all federal support for business research and development with the goal of maximizing the impact of federal programs contributing to innovation and creating economic opportunities for business. The panel submitted its report (the "Jenkins Report") to the Government in October 2011. It makes a series of recommendations that call for a simplified and more focused approach to the Government's support for business research and development, including the Scientific Research and Experimental Development (SR&ED) tax incentive program. To support the key objectives identified in the Jenkins Report, the 2012 Budget ~~is~~ proposes several changes to the SR&ED tax incentive program to make it simpler, and more cost effective and predictable.

Under the current SR&ED program, allowable current and capital expenditures are fully deductible. In addition, qualified SR&ED expenditures incurred in Canada are included in computing a taxpayer's SR&ED qualified expenditure pool at the end of each taxation year. In general, the amount of this pool at the end of a taxation year is equal to all the qualified expenditures incurred by the taxpayer in the year, plus any amount transferred to the taxpayer in respect of certain non-arm's length SR&ED contracts less any amount transferred by the taxpayer in respect of such contracts to another person. The balance in the SR&ED qualified expenditure pool at the end of a taxation year is generally eligible for an investment tax credit. There are two investment tax credit rates for SR&ED qualified expenditure pool balances. The general rate is 20% and there is an enhanced rate of 35%for eligible Canadian-controlled private corporations ("CCPCs").

CCPCs are eligible to claim the enhanced investment tax credit at the rate of 35% on up to $3 million of qualified SR&ED expenditures annually. For these taxpayers, unused investment tax credits are refundable in respect of the first $3 million of expenditures each year; current expenditures are eligible for a 100% refund and capital expenditures are eligible for a 40-per-cent refund. All expenditures above the $3 million limit are eligible for an investment tax credit at the rate of 20%and qualify for a 40% refund. The $3 million expenditure limit is phased out for CCPCs whose taxable income for the previous taxation year is between $500,000 and $800,000 or whose taxable capital employed in Canada for the previous taxation year is between $10 million and $50 million.

SR&ED Investment Tax Credit Rate

The 2012 Budget proposes to reduce the general 20% SR&ED investment tax credit rate applicable to SR&ED qualified expenditure pool balances at the end of a taxation year to 15%. The 15% investment tax credit rate will apply in respect of taxation years that end after 2013, except that, for a taxation year that includes January 1, 2014, the 5% point reduction in the investment tax credit rate will be pro-rated based on the number of days in the taxation year that are after 2013. The enhanced 35% SR&ED investment tax credit rate applicable in respect of eligible CCPCs will remain unchanged on up to $3 million of qualified SR&ED expenditures annually.

SR&ED Capital Expenditures

As indicated above, allowable current and capital expenditures in respect of SR&ED are fully deductible, and qualifying SR&ED expenditures are eligible for an investment tax credit. Ottawa is proposing to exclude expenditures of a capital nature from eligibility for SR&ED deductions and investment tax credits. This measure will apply to property acquired on or after January 1, 2014, and to amounts paid or payable in respect of the use of, or the right to use, property during any period that is after 2013.

This measure will also apply to exclude otherwise eligible contract payments made by a taxpayer from benefiting from SR&ED tax incentives to the extent that the payment is in respect of a capital expenditure made in fulfillment of the contract. Expenditures that have been excluded because of this measure from the SR&ED tax incentives will be accorded the treatment otherwise applicable to such expenditures under the *Income Tax Act*.

SR&ED Overhead Expenditures

Itemized overhead expenditures directly attributable to the conduct of SR&ED are currently eligible for the SR&ED tax incentives. In lieu of itemizing such overhead expenditures, taxpayers can elect to use a simplified proxy method for the calculation of these expenditures. Under the proxy method, a taxpayer can generally include in the taxpayer's SR&ED qualified expenditure pool for a taxation year, which is eligible for SR&ED investment tax credits, an amount equal to 65 per cent of the total of the eligible portion of salaries and wages of the taxpayer's employees directly engaged in the conduct of SR&ED in Canada in the taxation year.

Ottawa is proposing to reduce the rate at which the prescribed proxy amount is calculated to 60% (from 65%) for 2013 and to 55 per cent after 2013. The proxy rate that will apply for taxation years that include days in 2012, 2013 or 2014 will be pro-rated based on the number of days in the taxation year that are in each of those calendar years.

SR&ED Contract Payments

Where a taxpayer contracts to have SR&ED performed by a non-arm's length person, the total qualified expenditures on which either the performer or the payer can claim SR&ED investment tax credits are currently restricted to the amount of the qualified SR&ED expenditures incurred by the performer in fulfillment of the contract.

In the case of arm's length SR&ED contract payments, however, the payer is currently entitled to SR&ED investment tax credits in respect of the entire amount of the contract payment, while the amount of the contract payment is netted against the qualifying SR&ED expenditures of the performer.

Ottawa is proposing to disallow from the expenditure base for investment tax credits the profit element of arm's length SR&ED contracts. For simplicity, it is proposed that this be achieved by way of a proxy, under which only 80% of the cost to a payer of arm's length SR&ED contracts will be eligible for SR&ED investment tax credits.

This measure will apply to expenditures incurred on or after January 1, 2013.