# 2010 Federal Budget Commentary

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Following the resumption of Parliament, the minority Harper government released its fifth Budget on March 4, 2010 (Budget 2010). The focus of Budget 2010 is to continue to support economic growth, jobs, infrastructure and industry. Budget 2010 recognizes the effects of the global recession, but contains a measure of optimism balanced with uncertainty about the strength and depth of the economic recovery.

Unlike certain recent budgets, Budget 2010 includes scores of tax measures, many of which will be welcomed by industry and taxpayers. As contemplated in the Throne Speech, which referred to closing "loopholes," a number of measures are intended to maintain the revenue base for the country and will tighten or eliminate structures which are perceived by the Government to be inconsistent with tax policy.

Highlights of Budget 2010 include significant changes to employee stock option rules, measures to streamline the section 116 withholding and reporting regime, modifications to improve proposals relating to the taxation of non-resident trusts (NRTs) and foreign investment entities (FIEs), as well as a host of capital cost allowance and other measures. The Government has also committed to explore consolidated group reporting or related party loss transfer rules. Budget 2010 also targets perceived aggressive transactions by including proposals to address income fund conversion transactions structured to take advantage of unrelated corporate loss pools and foreign tax credit generator transactions and mandatory information reporting of certain avoidance transactions.

## BUSINESS TAX MEASURES

### SIFT Conversions and Loss Trading

Subsection 256(7) of the *Income Tax Act* (Canada) (the Act) provides certain deeming rules relating to whether there is an acquisition of control of a corporation. The acquisition of control of a corporation by a person or group of persons is an event that triggers a number of tax consequences including the streaming of non-capital losses and the successoring of resource pools. Budget 2010 proposes two amendments to subsection 256(7) in the context of the conversion of a publicly traded income trust or partnership into a corporation.

First, Budget 2010 proposes to introduce a new provision similar to existing paragraph 256(7)(c), which currently provides that, in the context of a reverse takeover of a corporation, subject to certain exceptions, where two or more persons exchange shares of a corporation for shares of another corporation, control of the other corporation will be deemed to have been acquired by a person or group of persons. The budget proposes to broaden this rule to capture reverse takeovers undertaken by

publicly traded income trusts and partnerships. Specifically, where two or more persons dispose of interests in a specified investment flow-through (SIFT) trust, SIFT partnership or a real estate investment trust in exchange for shares of a corporation, control of the corporation and of each corporation controlled by it will be deemed to have been acquired at the time of the exchange by a person or a group of persons. This measure is in response to several conversions of publicly traded income trusts into corporate form which have used corporations with existing tax pools as the continuing publicly traded entity.

Second, Budget 2010 proposes to amend subsection 256(7) to ensure that where (i) a SIFT trust undertakes a transaction to convert into a corporation; (ii) the sole beneficiary of the SIFT trust is a corporation; and (iii) the SIFT trust distributes the shares of a subsidiary corporation which the SIFT trust controls as part of the winding-up of the SIFT trust, the distribution by the SIFT trust of such shares of the subsidiary corporation to the beneficiary corporation will be deemed not to result in an acquisition of control of the subsidiary corporation by the beneficiary corporation. This is a relieving provision.

The two proposed amendments will apply to transactions undertaken after 4:00 p.m. EST on March 4, 2010. However, where taxpayers have entered into an agreement in writing before such time which obligates the parties to undertake a transaction after such time, the proposed amendments will not apply to such a transaction (subject to making the elections described below). For this purpose, where the terms of the agreement allow a party to avoid completing the transaction as a result of amendments to the Act, the party will not be considered to be obligated to undertake the transaction.

In addition, the Budget proposes to allow taxpayers to elect to have these measures apply to transactions that were completed or agreed to in writing before 4:00 p.m. EST on March 4, 2010. It appears that, if the election is made, both measures will apply to the transaction.

Budget 2010 does not assert that transactions that have been completed may be challenged under existing rules. This is in contrast to statements made in relation to the Foreign Tax Credit Generator proposals outlined below. However, there is nothing to prevent the Canada Revenue Agency (CRA) from reassessing conversions implemented under the existing rules and the CRA has indicated at the 2009 Canadian Tax Foundation Annual Conference that it would review such transactions as part of its normal audit function.

### Reporting of Avoidance Transactions

Budget 2010 proposes a compulsory reporting regime for certain tax avoidance transactions. Details of the proposed regime will be released at the earliest opportunity and a consultation process will be announced at that time. Similar proposals have been recently introduced in President Obama’s Green Book and by the Province of Québec in its bulletin no. 2009-5.

Similar to the existing reporting regime applicable to tax shelters, the purpose of these proposals is to enhance the CRA's audit ability. Such proposals are consistent with recent international trends to combat alleged aggressive tax structures.

Mandatory reporting will be required for transactions that constitute an "avoidance transaction" under the existing General Anti-Avoidance Rule (GAAR) and that satisfy any two of the following criteria:

- a promoter or tax advisor is entitled to fees that depend on the realization of, or the amount of, the tax benefit from the transaction or the number of participants in the transaction;
- a promoter or tax advisor requires that confidentiality or non-disclosure arrangements be entered into or otherwise requires "confidential protection" in relation to the transaction; and
- the taxpayer (or a person who enters into the transaction for the benefit of the taxpayer) obtains "contractual protection" in respect of the transaction.

Failure to report a relevant avoidance transaction could result in the denial of the tax benefit and the imposition of penalties. Unlike the Québec proposals, there is no suggestion of penalties being imposed on the promoter.

Such proposals would apply to avoidance transactions entered into after 2010 or that are part of a series of transactions completed after 2010 and will not apply to tax shelters and flow-through share arrangements.

The extent and form of the required disclosure is not outlined in the budget. Clients will need to consider the impact of entering into confidentiality and similar arrangements with tax advisors. The benefit of solicitor-client privilege may become significant in the context of any reportable transactions.

### Mineral Exploration Tax Credit

The flow-through share provisions of the Act allow a corporation that incurs certain expenses, including "Canadian exploration expense" (CEE), to renounce such expenses to an investor who is entitled to deduct such expenses in computing income.

In addition, certain CEE incurred in "grass roots" mineral exploration and renounced to an individual investor (other than a trust) will give rise to a 15 per cent non-refundable tax credit to the investor. The amount of the credit must be deducted from the individual's cumulative CEE account in the following year and, if the investor's cumulative CEE account is negative at the end of that year because the investor did not incur sufficient CEE in that year, the negative amount must be included in income.

Under the current provisions of the Act (as a result of amendments made pursuant to the 2009 federal budget), only expenses incurred pursuant to flow-through share agreements made before April 1, 2010 may qualify for the foregoing treatment. In addition, the expenses must be incurred by the corporation by December 31, 2010.

Budget 2010 extends the provision by one year so that it will apply to flow-through share agreements made after March 2010 and before April 1, 2011 where the expenses are incurred by the corporation, or deemed under the look-back rule to be incurred, by December 31, 2011. The look-back rule will therefore accommodate expenses incurred to the end of 2012.

There is still no proposal to extend a similar credit to resource issuers engaged in oil and gas exploration.

Consistent with the focus on green and clean measures in Budget 2010, the Government reiterates that all activities related to mineral exploration are subject to federal and provincial environmental regulations.

## Employee Stock Options

Budget 2010 proposes a number of measures associated with the taxation of employee stock options.

While one of the measures is relieving in nature, in aggregate the measures are expected to increase federal tax revenues by almost $1.7 billion by the end of the 2015 fiscal period principally through (i) the denial of a deduction to either the employee or the employer where a stock option is "cashed out," and (ii) the elimination of an employee's ability to defer the taxable benefit arising on the exercise of public company stock options.

### *Stock Option Cash-Outs*

If, in the course of employment, an employee acquires a security of his or her employer under a stock option agreement, the difference between the fair market value of the security at the time the option is exercised and the aggregate of the amount paid by the employee to acquire the security and the cost of the option is treated as a taxable employment benefit. Where certain conditions are met, the employee is entitled to a deduction from income equal to one-half of the employment benefit (the stock option deduction), resulting in the taxation of the benefit at capital gains rates.

If securities are issued under such stock option agreements, employers are generally prevented under the Act from claiming a deduction from income in respect of the issuance of the securities. However, currently, where an employee elects to receive cash, which is usually equal to the "in-the-money" amount of the options, and to essentially "cash out" his or her rights under the stock option agreement instead of acquiring securities of the employer, the employer is normally able to deduct the amount of the cash payment even though the employee is still entitled to the stock option deduction.

Budget 2010 proposes that the ability of both the employer and the employee to claim deductions on a "cash out" be eliminated in respect of employee stock options disposed of after 4:00 p.m. EST on March 4, 2010. Employees will be entitled to the stock option deduction (under paragraph 110(1)(d) or (d.1) of the Act) on exercise of employee stock options only where:

- they exercise their options by acquiring shares of their employer; or
- they exercise a right to cash out their options *and* the employer makes an election to forego the deduction for the cash payment made by it.

### *Non-Arm's Length Disposition of Employee Stock Options*

While the Government believes that the disposition of rights under a stock option agreement to a non-arm's length person results in an employment benefit under the Act at the time of disposition (including where the rights are cashed-out), Budget 2010 proposes to amend the Act (effective at 4:00 p.m. EST on March 4, 2010) to expressly provide for this result.

### *Tax Election Deferral and Remittance Requirement*

The taxable benefit arising when an employee acquires securities under a stock option agreement is treated as employment income under the Act. Changes in value of the securities after their acquisition generally give rise to capital gains or losses on the disposition of the securities.

Where certain conditions are met, the Act permits an employee of a publicly traded company to elect to defer the recognition of the employment benefit for tax purposes until the disposition of the securities. Budget 2010 proposes to repeal the tax deferral election in respect of publicly traded securities (but not the somewhat similar deferral available in respect of employee-stock options for employers that are Canadian-controlled private corporations). The repeal will apply to employee stock options exercised after 4:00 p.m. EST on March 4, 2010.

Budget 2010 also proposes to clarify withholding requirements to ensure that an amount in respect of the employment benefit associated with the issuance of a security is required to be remitted to the CRA by the employer. The employer will be required to remit tax in respect of the benefit, together with other employer remittances in respect of salaries and benefits, for the period that includes the date on which the security was issued or sold as if the benefit were a cash bonus. Where the stock option deduction is available, it will be taken into account in computing the amount of taxable benefit that is subject to withholding. This withholding measure will not apply, however, to options granted prior to 2011 pursuant to an agreement entered in writing prior to 4:00 p.m. EST on March 4, 2010 where the agreement included restrictions on the disposition of the optioned securities. Budget 2010 does not address whether the administrative relief for undue hardship will continue to be available.

### *Special Relief for Tax Deferral Elections*

Some employees who took advantage of the tax deferral election in respect of securities of a publicly-traded company have experienced financial difficulties where the optioned securities have declined in value, in some cases to the point that the value of the securities is less than the deferred tax liability on the underlying stock option benefit.

Budget 2010 proposes to introduce a special elective tax for affected taxpayers who made the tax deferral election. This special election is intended to ensure that the tax liability on the deferred stock option benefit does not exceed the proceeds of disposition of the optioned securities, taking into account tax relief resulting from the use of capital losses on the optioned securities against capital gains from other sources.

In any year in which a taxpayer is required to include in income a qualifying deferred stock option benefit (i.e., where some of the optioned shares are disposed of), the taxpayer may elect to pay a special tax equal to the taxpayer's proceeds of disposition (or two-thirds of such proceeds for residents of Québec, given the separate tax regime applicable to individuals resident in Québec) from the disposition of the optioned securities. Where this election is made:

- the taxpayer will be able to claim a deduction equal to the amount of the stock option benefit; and
- an amount equal to one-half of the lesser of the stock option benefit and the capital loss on the optioned securities will be included in the taxpayer's income as a taxable capital gain. That gain may be offset by the allowable capital loss arising on the disposition of the optioned securities (provided that the loss has not otherwise been used).

To qualify for this elective special tax treatment:

- where the optioned securities were disposed of before 2010, the election must be made on or before the filing-due date for the 2010 taxation year (typically, April 30, 2011); and
- where the optioned securities were not disposed of before 2010, the securities must be disposed of before 2015, and the election must be made before the filing–due date for the taxation year of the disposition.

This measure should provide welcome relief to taxpayers who elected to defer the stock option benefit on publicly traded securities where the securities declined significantly such that on disposition their value was less than the tax liability deferred.

## Capital Cost Allowance (CCA)

### *Clean Energy Generation*

Under the CCA regime in the Act, Class 43.2 of Schedule II to the Income Tax Regulations (Regulations) provides accelerated CCA (i.e., a 50 per cent rate, on a declining balance basis) for specified clean energy generation and conservation equipment.

Budget 2010 proposes to expand Class 43.2 to include unused assets acquired on or after March 4, 2010 that are:

- heat recovery equipment used in a broader range of applications than currently contemplated; and
- distribution equipment used in district energy systems that rely primarily on ground source heat pumps, active solar systems or heat recovery equipment.

### *Set-Top Boxes*

Budget 2010 proposes that new satellite set-top boxes (used to decode digital television signals) and cable set-top boxes that are acquired after March 4, 2010 be eligible for CCA at a 40 per cent rate, on a declining-balance basis. This is an increase in the rates currently applicable of 20 per cent for satellite set-top boxes (Class 8 assets) and of 30 per cent for cable set-top boxes (Class 10 assets). This proposed increase is intended to better reflect the useful life of these assets.

## Canadian Renewable and Conservation Expenses — Principal-Business Corporations

Where most of the tangible property in a project qualifies for inclusion in Class 43.2 (referred to above), then certain project start-up expenses (e.g., feasibility and design studies) qualify as Canadian renewable and conservation expenses (CRCE). CRCE can be fully deducted in the year incurred or transferred by a "principal-business corporation" to investors purchasing flow-through shares of the corporation.

Budget 2010 proposes to amend the definition of "principal-business corporation" to clarify that a corporation will qualify as a "principal-business corporation" where the principal business of the corporation is one or any combination of:

- producing fuel;
- producing energy; or
- distributing energy,

using Class 43.2 property or Class 43.1 property.

As this change is said to be consistent with the original policy intent of recent changes to Class 43.2, it is proposed that it apply in respect of taxation years ending after 2004.

### Interest on Overpayment of Taxes

Budget 2010 proposes to reduce by 2 per cent the interest payable by the Minister of National Revenue to corporate taxpayers on overpayments of most tax and levies, effective July 1, 2010. Interest payable to non-corporate taxpayers will not be reduced.

This measure stems from concerns raised by the Auditor General in her spring 2009 report that when the tax authorities “unnecessarily hold large amounts [of tax dollars] on deposit,” they are effectively borrowing such sums from the taxpayers at a 2 per cent premium above the T-bill rate.

### Federal Credit Unions

As one of the measures to support Canada’s strong financial sector, Budget 2010 announces that a new legislative framework will be introduced to enable credit unions to incorporate and continue their operations as federal entities. Consequential amendments to the Act may be made to allow such new federal credit unions to qualify as a “credit union” under the Act and to be subject to the same rules as existing credit unions.

### Specified Leasing Property

The Act contains restrictions on CCA that may be claimed in respect of specified leasing property (SLP). Numerous properties are exempt from the SLP rules, including exempt property and leases having a term of less than a year or where the leased assets have an aggregate fair market value of less than $25,000.

Budget 2010 proposes to extend the application of the SLP rules to property that would otherwise be exempt property if the lessee is a government, a tax-exempt entity or a non-resident person. A safe harbour will be retained for property the total value of which is less than $1 million (subject to a specific anti-avoidance rule preventing taxpayers from dividing property among separate leases to meet the $1 million safe-harbour).

## INTERNATIONAL TAX MEASURES

### Section 116 Relief

Subject to the provisions of applicable tax treaties, Canada currently taxes non-residents on their income and gains from the disposition of “taxable Canadian property.” The Act also imposes an obligation on a purchaser acquiring such property from a non-resident to withhold part of the purchase

price and remit such funds to the government on account of the non-resident's potential Canadian tax liability, unless the non-resident vendor obtains a "clearance certificate" from the CRA. To obtain a clearance certificate, a non-resident must remit an amount to the CRA on account of the non-resident's potential Canadian tax liability, post security or satisfy the CRA that no tax will be due.

Budget 2010 proposes an important relieving measure to exclude from the definition of taxable Canadian property shares of corporations, and certain other interests, that do not at any time during the 60-month period prior to the determination time derive their value principally from real or immovable property situated in Canada, Canadian resource property or timber resource property. These measures will apply in determining after March 4, 2010 whether a property is taxable Canadian property of a taxpayer.

This measure will align the provisions of the Act more closely with Canada's tax treaties and the domestic rules of various OECD countries including the United States. The measure also builds upon recent changes to the Act that eased compliance requirements on the disposition by a non-resident of taxable Canadian property where treaty exemptions were applicable.

The Act deems certain property to be taxable Canadian property in certain circumstances (e.g., under the provisions of paragraph 85(1)(i) and other reorganization provisions where the exchanged property was taxable Canadian property). Such provisions are generally to be amended such that the deeming rule will apply only for 60 months after the relevant disposition.

### Foreign Tax Credit Generators

Budget 2010 includes measures to address transactions that the Budget refers to as "foreign tax credit generators," and which the Budget describes as transactions "designed to shelter tax otherwise payable in respect of interest income on loans made, indirectly, to foreign corporations." The budget suggests that underlying these transactions is different treatment of the transaction in Canada (which focuses on the form of the transaction) and a foreign jurisdiction ("that taxes on the basis of the substantive effect of the transaction"). We presume the Government had the US in mind.

The Canadian regime taxes Canadian residents on worldwide income but provides tax recognition for the foreign tax burden associated with foreign source income (in the form of foreign tax credit (FTC) relief or, in the case of a foreign affiliate, through the foreign accrual tax (FAT) and underlying foreign tax (UFT) mechanisms). The Budget 2010 proposals would limit FTC claims (and deductions for FAT and UFT of foreign affiliates) in respect of these "foreign tax credit generator" structures.

Budget 2010 describes these transactions as involving a Canadian corporation making a loan to a corporation resident in a foreign jurisdiction. The Canadian corporation invests in a "special purpose entity" (SPV) that pays full tax in the foreign jurisdiction on its income, but "an offsetting tax reduction is generated in respect of that return within the foreign corporation's group." "If the Canadian corporation had instead made a simple loan to the foreign corporation … full Canadian tax

would be levied on the interest income in respect of that loan." "By using these foreign tax credit generator schemes … the Canadian corporation is able to … partly or fully offset its Canadian tax otherwise payable in respect of its interest income."

Budget 2010 would exclude from a taxpayer's business-income tax or non-business income tax for purposes of computing a taxpayer's FTC for a taxation year any income or profits tax paid to a foreign government where the tax is paid in respect of income of a partnership and, under the foreign tax law, the taxpayer's share of the income of the partnership is less than its share for Canadian federal income tax purposes. In other words, the Canadian tax law and the foreign tax law have different perspectives on the taxpayer's share of the partnership income, and the foreign tax law regards the taxpayer as having a lesser share of the income than does Canada. Similar rules are applicable for purposes of determining FAT and UFT of a foreign affiliate in respect of a taxpayer resident in Canada, except these rules also include circumstances where the SPV is a corporation. They provide that FAT and UFT does not include income or profits tax paid to a foreign government in respect of the earnings of a corporation where the Canadian tax law and the foreign tax law have different perspectives on the taxpayer's ownership of shares of the corporation, and the foreign tax law regards the taxpayer as owning less shares than does Canada.

Comments in Budget 2010 suggest taxpayers that have undertaken these structures may be challenged by CRA. In fact, a procedural skirmish in one case has already been dealt with by the Tax Court. Similar structures have withstood challenge in the U.K. courts, but have been successfully challenged in a couple of New Zealand cases.

The proposals are intended to take effect for foreign taxes incurred in taxation years ending after March 4, 2010. This would have retroactive effect on existing structures. The government is taking comments on such proposals until May 4, 2010.

**Foreign Investment Entities (FIE)/Non-Resident Trusts (NRT)**

***Current Rules***

The Act currently imposes tax on Canadian residents that hold interests in foreign corporations, trusts and other entities. In brief:

1. A Canadian resident that owns a share of a non-resident corporation that is a "controlled foreign affiliate" (CFA) of the taxpayer is required to include in income a share of the "foreign accrual property income" (FAPI) of the corporation equal to the share's participating percentage.

2. A Canadian resident that holds a share, interest in or debt of a non-resident entity (other than a CFA) that may reasonably be considered to derive its value, directly or indirectly, from "portfolio investments" of that or any other non-resident entity in listed properties (including

shares, indebtedness, annuities, commodities, interests in other entities, real estate and foreign currency) may be required by section 94.1 to include a prescribed amount in income on an annual basis regardless of the return from the investment. In order for the inclusion to be required, a tax avoidance motive test must be satisfied. Specifically, it must be reasonable to conclude, having regard to all the circumstances (including the extent to which income, profits and gains (earnings) are distributed by the non-resident entity and the tax burden borne by the non-resident entity relative to the tax burden that would be borne by the taxpayer under Part I of the Act if the earnings were earned directly by the taxpayer), that one of the main reasons for the taxpayer acquiring, holding or having the interest in such property was to derive a benefit from such portfolio investments in such a manner that the taxes on such earnings from such property for a particular year are "significantly less" than the tax applicable under Part I if such earnings had been earned directly by the taxpayer. If the tax avoidance motive test is satisfied, the taxpayer must include in income each month an amount equal to the "designated cost" of the property (referred to as an "offshore investment fund property") multiplied by 1/12 of the prescribed rate of interest for the period reduced by the amount included in income for the year from the property (i.e., distributions) but excluding a capital gain from the disposition of the property.

3. A non-resident trust may be treated as resident in Canada or treated as a CFA of certain beneficiaries under current section 94. In order for the rule to apply, a beneficiary of the trust must be a person resident in Canada, a corporation or trust with which a person resident in Canada does not deal at arm's length or a CFA of a person resident in Canada. In addition, the trust or a corporation that would, if the trust were resident in Canada, be a CFA of the trust, must have acquired property, directly or indirectly, from certain persons including a resident of Canada related to a beneficiary. If the trust is "non-discretionary" (i.e., the amount of income or capital of the trust to be distributed at any time to a beneficiary does not depend on the exercise, or failure by any person to exercise, a discretionary power), the trust will, in respect of a beneficiary that owns an interest in the trust with a fair market value of 10 per cent or more of the interests in the trust, be treated as a CFA of the beneficiary such that the rules in the first point above will apply. In any other case, the trust is deemed for the purposes of Part I of the Act and certain other provisions to be a person resident in Canada and liable to tax on its taxable income earned in Canada (i.e., the amount that it would be liable to tax on even if section 94 did not apply) and its FAPI (with certain adjustments).

***The Government's Concerns and Responses to Date***

In the 1999 Budget, the Government indicated that it was concerned that the current provisions of the Act were inadequate to deal with perceived tax avoidance by way of investment in non-resident entities. The response was the proposed replacement of sections 94 and 94.1 with new rules applicable to non-resident trusts (the NRT Rules) and "foreign investment entities" (the FIE Rules). Despite several versions of the proposed rules, the closest the rules came to being enacted was in the

39th Parliament, which was dissolved in 2008. In the 2009 Budget, the Government announced that it would review the NRT and FIE proposals in light of the recommendations of the Advisory Panel on Canada's System of International Taxation.

That review is now complete: it is now proposed that current section 94.1 live on, that the NRT Rules be significantly narrowed and that the FIE Rules be abandoned. The proposals are to be subject to a consultation process before being tabled in Parliament. Comments from the public are requested by May 4, 2010 and a panel of tax practitioners is to be struck to work with the Department of Finance to review issues identified in comments received and to make recommendations for the draft legislation to implement the proposals, following which draft legislation is to be released for public comment. The proposal to strike a panel of practitioners is particularly welcome.

#### *Amendments to Section 94.1*

Budget 2010 proposes that the prescribed rate to be used in determining the income inclusion in respect of an interest in an offshore investment fund property be increased to the three month T-Bill rate plus 2 per cent to "better reflect actual long-term investment returns."

Of note, there is no change to the definition of "offshore investment fund property" and, in particular, the tax avoidance motive test.

The measure is to apply for taxation years ending after March 4, 2010. If a taxpayer had treated an investment as being subject to the FIE Rules in prior years on the basis that the FIE Rules would be enacted (and which mandated a prescribed income inclusion), the taxpayer will be entitled to have the relevant years reassessed or to deduct in the current year any excess income inclusion for such years.

It is also proposed that the relevant reassessment period in respect of interests in an offshore investment fund property be extended by three years and that the existing reporting requirements with respect to "specified foreign property" be expanded so that more detailed information is available for audit use by the CRA.

#### *Amendments to the NRT Rules*

The NRT Rules as proposed prior to Budget 2010 would have applied to non-resident trusts (other than "exempt foreign trusts") where, at the end of a taxation year, there was a "resident contributor" to the trust (being a person resident in Canada and a contributor to the trust), whether or not there was also a Canadian beneficiary. They would have also have applied if the non-resident trust had a "resident beneficiary" (i.e., a Canadian beneficiary if a contribution had been made by a contributor that had been resident in Canada within 60 months of having made the contribution to the trust).
If these conditions were satisfied, the trust would be deemed to be resident in Canada for certain purposes and, in particular, would be liable to be taxed on its worldwide income, regardless of who contributed the property upon which the income was earned or the source of the income. Deductions

would be permitted in respect of certain income distributed to beneficiaries. Resident contributors and resident beneficiaries would be jointly and severally liable for all of the tax payable by the trust, subject to certain limits.

Extensive changes to the most recent version of the NRT Rules, referred to below, are proposed with respect to the circumstances in which they will apply and the manner of their application.

*Additional Exemptions from the NRT Rules*

Under the NRT Rules, a resident beneficiary or resident contributor could be jointly and severally liable for the trust's income tax liability even though such beneficiary or contributor is a tax-exempt entity. It is proposed that an exemption from resident contributor and resident beneficiary status be provided for all persons exempt from tax under section 149 of the Act (e.g., pension funds, Crown corporations and registered charities). However, if a tax-exempt entity were to be used as a conduit to allow a Canadian resident to make an indirect contribution to a non-resident trust, there are provisions in the NRT Rules that would ensure that the Canadian resident making the indirect contribution is a resident contributor to the trust.

It has been the Government's policy that *bona fide* investments in commercial trusts are not to be caught by the NRT Rules. The difficulty has been in describing a *bona fide* investment in a commercial trust. The attempt to do so has been in paragraph (h) of the definition of "exempt foreign trust." In certain cases, eligibility under paragraph (h) required that the trust not hold "restricted property." This requirement is to be deleted. In addition, pursuant to Budget 2010 a commercial trust will not be deemed resident in Canada if the trust satisfies all of the following conditions:

- Each beneficiary is entitled to both income and capital of the trust.

- Any transfer of an interest by a beneficiary results in a disposition for the purposes of the Act and interests in the trust cannot cease to exist otherwise than as a consequence of a redemption or cancellation under which the beneficiary is entitled to receive the fair market value of the interest. As there may be legitimate circumstances in which non-resident beneficiaries may disclaim an interest in a commercial trust for non-tax reasons, a safe harbour will be provided where the interest being disclaimed is below a *de minimis* threshold. This requirement may be problematic in the case of certain trusts which may mandate the redemption of a beneficiary's interest in the trust for other than fair market value if the beneficiary is not permitted to hold an interest by applicable (e.g., securities) law.

- The amount of income and capital payable to a beneficiary does not depend on the exercise of, or failure to exercise, discretion by any person (other than discretion with respect to the timing of distributions). This requirement may be problematic where, for example, the trustee has the discretion to allocate expenses to different classes of interests.

- Interests in the trust (i) are listed and regularly traded on a designated stock exchange, (ii) were issued by the trust for fair market value or (iii) where the trust has at least 150 investors, are available to the public in an open market.

- The terms of the trust cannot be varied without the consent of all of the beneficiaries or, in the case of a widely held trust, a majority of the beneficiaries. This requirement is problematic as most trust agreements for commercial trusts permit amendments without consent where the amendment is of a non-material nature or is necessary to comply with applicable law.

- The trust is not a personal trust.

A new rule will provide that loans made by a Canadian financial institution to a non-resident trust will not result in the financial institution being a resident contributor to the trust as long as the loan is made in the ordinary course of the financial institution's business.

The definition of "restricted property" will be "narrowed and better targeted." It will be limited to shares or rights (or property that derives its value from such shares or rights) acquired, held, loaned or transferred by a taxpayer as part of a series of transactions or events in which "specified shares" (generally, shares with fixed entitlement rights) of a closely-held corporation were issued at a tax cost less than their fair market value.

***Calculation of the Trust's Income***

If a non-resident trust, other than an exempt foreign trust, has a resident beneficiary or a resident contributor, the NRT Rules as proposed prior to Budget 2010 would impose tax on all of the trust's income, generally with a deduction for income made payable to beneficiaries.

Budget 2010 proposes a number of changes. The trust's property is to be divided into a resident portion and a non-resident portion. The resident portion will consist of property acquired by the trust by way of contributions from residents and certain former residents, and any property substituted for such property. The non-resident portion will consist of the remaining property. It appears that it will be necessary for trustees to trace property and income to, and distributions from, each "bucket."

The income of the trust will be reduced by the following amounts (presumably without duplication):

- income attributable to the non-resident portion (other than income from Canadian sources that are subject to non-resident taxation);

- income allocated to resident contributors in proportion to their relative contributions (see below); and

- income distributed to beneficiaries.

As a result, the trust itself will ordinarily pay tax in Canada only on income derived from contributions of certain former resident contributors.

If income of the trust for a year is not distributed to beneficiaries, the income that is accumulated will be deemed to be a contribution by the trust's connected contributors and will form part of the resident portion for the next taxation year. There will be an exception to this deeming rule; accumulated income that arises from property that is part of the non-resident portion will not be subject to the deeming rule if it is kept separate and apart from all the property of the resident portion.

Ordering rules will be introduced with respect to distributions to beneficiaries. Distributions to resident beneficiaries will be deemed to be made first out of the resident portion of the trust's income while distributions to non-resident beneficiaries will be deemed to be made first out of the non-resident portion. Distributions to non-resident beneficiaries out of the non-resident portion of the trust will not be subject to Part XIII tax, but distributions to non-resident beneficiaries out of the resident portion of the trust will be subject to Part XIII tax.

A further change is to permit the trust to claim a foreign tax credit for income taxes paid to another country that treats the trust as a resident of that country for income tax purposes, without regard to the limits under subsection 20(11) of the Act but up to the Canadian tax rate.

The *Income Tax Conventions Interpretation Act* will be amended to clarify that a trust that is deemed to be resident in Canada under these rules is a resident of Canada and subject to tax under the Act for tax treaty purposes.

#### *Liability of Resident Contributors and Resident Beneficiaries*

The NRT Rules generally make both resident contributors and resident beneficiaries jointly and severally liable for tax payable by a trust deemed resident. As a result, resident contributors could be held liable for tax on income that has no connection with the property they contributed to the trust.

Budget 2010 proposes that resident contributors be attributed, and taxed on, their proportionate share of the trust's income for Canadian tax purposes. They will not be jointly and severally liable for the trust's own income tax obligations (but no change will be made to a resident beneficiary's liability).

The income attributed to a resident contributor will generally be based on the proportion of the fair market value of its contributions to the trust (at the times the contributions were made) to the fair market value of all contributions received by the trust from connected contributors. Income distributions from the trust will reduce the amount of income that is attributed to resident contributors. Adjustments will be made to deal with losses of other years claimed by the trust.

The NRT Rules, in their most recent formulation, were to apply to non-resident trusts for the 2007 and subsequent taxation years. No change to the date of application is proposed. There will be an election

allowing a trust to elect to be deemed resident for 2001 and subsequent taxation years, which it is expected would be made by those trusts that were structured to be deemed resident under the original proposals. The attribution of trust income to resident contributors will apply to taxation years that end after March 4, 2010.

#### *Trusts to which the NRT Rules Do Not Apply*

If the NRT Rules do not apply to a non-resident trust and the conditions of current section 94 were met, the trust would be treated as a CFA of a beneficiary if the beneficiary owns interests in the trust with a fair market value of 10 per cent or more of the interests in the trust. This rule will be broadened to apply if a beneficiary, together will persons not dealing at arm's length with the beneficiary, owns interests in the trust with a fair market value of 10 per cent or more of any class of interests in the trust.

### Refunds of Withheld Funds

Section 105 of the Regulations and section 116 of the Act impose requirements on payers of funds to non-resident service providers and purchasers of taxable Canadian property from non-residents, respectively, to withhold and remit to the CRA a portion of the amount paid to the non-resident person in certain circumstances. The amounts are required to be deducted and remitted on account of the non-resident's potential Canadian tax liability. Such amounts deducted and remitted will often exceed the amount of the non-resident's liability for Canadian tax (e.g., the non-resident may be exempt from such tax under an applicable tax treaty).

Budget 2010 proposes an amendment to the Act to permit the issuance of a refund of an overpayment of tax if the overpayment is related to an assessment of the payer or purchaser in respect of a required withholding under section 105 of the Regulations or section 116 of the Act, provided that the taxpayer files a return no more than two years after the date of that assessment.

This measure will be effective for applications for refunds claimed in returns filed after March 4, 2010. The measure is said to correct a possible interpretation of provisions under the Act which together could result in a non-resident in certain circumstances being unable to recoup overpayments of such taxes.

## PERSONAL TAX MEASURES

### Child Benefit Entitlements — Shared Custody

Budget 2010 proposes to allow the Canada Child Tax Benefit and the Universal Child Care Benefit payable in respect of a dependant to be shared on an equal basis between two eligible individuals where the two eligible individuals live separately, share custody of the dependant on an equal or near equal basis and both individuals are primarily responsible for the care of the dependant. The budget

also includes measures to allow the two eligible individuals to share on an equal basis the GST/HST credit amounts in respect of the dependant.

These measures will apply to benefits payable commencing July 2011.

### Universal Child Care Benefit for Single Parents

For 2010 and subsequent taxation years, a single parent will be permitted to elect to include the $100 per month Universal Child Care Benefit in his or her income or the income of the dependant for whom the Eligible Dependant Credit is claimed or if the Eligible Dependant Credit is not available, elect to include the aggregate amount of the Universal Child Care Benefit in the income of one of the children for whom the benefit is paid. This measure is intended to permit a single parent to take advantage of the potentially lower marginal tax rate of his or her child or children so that the single parent will be in a similar position to a two-parent family that is currently permitted to include the benefit amount in the income of the lower-income spouse.

### Medical Expense Tax Credit — Purely Cosmetic Procedures

Expenses incurred by a taxpayer in respect of cosmetic procedures purely aimed at enhancing a taxpayer’s appearance (including related services and expenses) will no longer qualify for the medical expense tax credit under subsection 118.2(1) of the Act. However, cosmetic procedures will continue to qualify for the credit to the extent they are required for medical or reconstructive purposes.

This measure will apply to expenses incurred after March 4, 2010.

### RDSPs and RESPs

Budget 2010 includes certain relieving measures relating to Registered Disability Savings Plans (RDSPs) and Registered Education Savings Plans (RESPs).

#### *Rollover of RRSP, RRIF and RPP Proceeds to an RDSP*

Generally speaking, upon the death of a taxpayer, the value of the deceased’s Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF) and Registered Pension Plan (RPP) is included in the deceased’s income for the year of death. However, preferential tax treatment is provided where the proceeds of the RRSP, RRIF or RPP are distributed to the deceased’s surviving spouse or common-law partner or to a financially dependent child or grandchild. In such cases, the amount so distributed is not included in the deceased’s income for the year of death, but is included in the income of the recipient. However, if the recipient is financially dependent on the deceased annuitant because of a mental or physical infirmity, such infirm recipient may claim an offsetting deduction where the amount is transferred to the RRSP of the recipient or is used to purchase an

immediate life annuity, thereby allowing for a rollover of the proceeds of the deceased's registered plan.

Budget 2010 proposes to allow such proceeds also to be transferred to an RDSP of a financially dependent infirm child or grandchild of the deceased. The amount that may be transferred in this manner is limited to the beneficiary's available RDSP contribution room. The contribution of the proceeds from a RRSP, RRIF or RPP of the deceased to the RDSP in this manner will reduce the beneficiary's $200,000 lifetime contribution limit, will not attract any matching Canada Disability Savings Grants and will be included in the beneficiary's income when it is withdrawn from the RDSP.

The foregoing measures will apply to deaths occurring after March 3, 2010. There are transitional rules for deaths occurring after 2007 and before 2011 to permit similar preferential tax treatment.

#### *Carry Forward of RDSP Grants and Bonds*

Currently, contributions to an RDSP attract matching Canada Disability Savings Grants (CDSGs) of up to $3,500 depending on the beneficiary's family income and the amount contributed. In addition, Canada Disability Savings Bonds (CDSBs) of up to $1,000 annually are provided to RDSPs that are established by low and modest income families, even if no contribution is made to the RDSP. Currently, disabled beneficiaries are not entitled to carry forward unused CDSG and CDSB entitlements to future years.

Budget 2010 proposes to amend the *Canada Disability Savings Act* to allow a 10-year carry forward of the CDSG and CDSB entitlements commencing in 2011. Upon the settlement of an RDSP, CDSB entitlements will be determined and paid into the plan in respect of the preceding 10 years (not including any year prior to 2008), based on the beneficiary's family income in those years. Balances of unused CDSG entitlements will also be determined and maintained for that period.

#### *Provincial Payments into RESPs and RDSPs*

Budget 2010 proposes to clarify that all payments to RESPs and RDSPs through a program funded directly or indirectly by a province or administered by a province will be treated in the same way as assistance provided by the Government of Canada through Canada Education Savings Grants, Canada Learning Bonds, CDSGs and CDSBs. Accordingly, such payments will neither attract nor reduce federal grants and bonds. This measure will apply to payments made after 2006 for programs administered by a province and to payments made after 2008 for programs that are not administered by a province.

### Scholarship Exemption and Education Tax Credit

Budget 2010 clarifies that the education tax credit in subsection 118.6(2) of the Act and the scholarship exemption in paragraph 56(3)(a) of the Act in respect of the enrolment in a post-secondary program consisting principally of research will only be available if it leads to a college or CEGEP diploma, or a

bachelor, masters or doctoral degree (or equivalent degree) — that is, post-doctoral fellowships will not qualify.

The budget also proposes to limit the availability of the scholarship exemption to the extent it is reasonable to conclude that the scholarship, fellowship or bursary was received to support the taxpayer's enrolment in the post-secondary program having regard to all the circumstances, including any terms and conditions that apply in respect of the award, the duration of the program and the period for which support is intended to be provided by the award.

Finally, the budget also proposes to limit the availability of the scholarship exemption in respect of a scholarship, fellowship or bursary amount received by a taxpayer (other than a student entitled to the disability tax credit or a student who cannot be enrolled on a full time basis because of a mental or physical impairment) enrolled in a part-time program to the amount of the tuition paid plus costs of program-related materials.

These measures will apply to amounts received in 2010 and subsequent taxation years.

### US Social Security Benefits

Pursuant to the *Canada-United States Tax Convention* (1980), benefits arising under certain social security legislation in the U.S. (excluding unemployment benefits) are included in income of a Canadian resident recipient at an 85 per cent inclusion rate. Budget 2010 provides that, in computing taxable income for taxation years ending after 2009, the inclusion rate for such benefits for certain Canadian resident recipients will be decreased from 85 per cent to 50 per cent through the availability of a 35 per cent deduction.

This deduction applies to Canadian residents who have been in receipt of such benefits since before January 1, 1996 and for their spouses and common-law partners who are eligible to receive survivor benefits. This measure applies to social benefits received on or after January 1, 2010.

## MISCELLANEOUS

### Charities

Budget 2010 proposes several improvements to the regime governing charities. Mandatory expenditure requirements are currently imposed on charities in an effort to prohibit the undue accumulation of funds and to ensure funds are used for charitable purposes. Existing rules require charities to disburse on charitable activities (including to qualified donees) at least 80 per cent of the prior year's receipted donations and 3.5 per cent of assets in excess of $25,000 and which are not used in charitable programs or administration.

Budget 2010 proposes to eliminate the 80 per cent disbursement quota for fiscal years ending on or after March 4, 2010. The *de minimis* threshold of $25,000 under the capital appreciation rule will be increased to $100,000, which should streamline the compliance burden for smaller charities. With the consent of the CRA, charities may accumulate property for a particular purpose (e.g., building project) without regard to the capital appreciation rule. As a corollary to these relieving rules, Budget 2010 will strengthen certain anti-avoidance rules relevant to charities.

### Electronic Notices

Budget 2010 proposes to allow taxpayers to elect to receive various statutory notices (e.g., assessment notices) electronically. Notices specifically required under legislation to be delivered personally or by registered or certified mail will not be affected.

### Tax Evasion

Canada has enhanced search and seizure powers and the ability to retain proceeds of crime in respect of certain criminal or terrorist activities. Budget 2010 proposes to ensure that indictable tax offences (whether prosecuted under the *Criminal Code* (Canada) or taxing statutes) are subject to the proceeds of crime and money laundering rules.

## GST & CUSTOMS

### Goods and Services Tax

Basic health care services are exempt from the GST/HST. Budget 2010 proposes to clarify that GST/HST applies to all purely cosmetic procedures (such as liposuction, hair replacement procedures, botulinum toxin injections and teeth whitening), to devices or other goods used or provided with cosmetic procedures, and to services related to cosmetic procedures. Cosmetic procedures required for medical or reconstructive purposes and cosmetic procedures paid for by a provincial health insurance plan will continue to be exempt.

Budget 2010 confirms the Government's intention to implement the 2009 Budget proposals, with certain enhancements and clarifications to the previously announced measures, to allow certain network sellers who are not already entitled to use a simplified GST/HST accounting method to elect jointly with their sales representatives to use such a method.

### Tariff Reductions on Machinery and Equipment

Budget 2010 proposes to eliminate remaining tariffs on manufacturing inputs and machinery and equipment; currently, tariffs on such goods range from 2.5 per cent to 15.5 per cent. The elimination is proposed to apply to 1,541 tariff items that are currently listed in the schedule to the Customs Tariff. In certain instances, the proposed reductions will lead to consequential reductions to the rates of duty

under other tariff treatments, including the General Preferential Tariff, the Costa Rica Tariff, the Peru Tariff, the Australia Tariff and the New Zealand Tariff.

## PREVIOUSLY ANNOUNCED MEASURES

Budget 2010 confirms the Government's commitment to certain previously announced tax measures, as modified to take into account consultations and deliberations since their release. Specifically, the budget references the following:

- the paperwork burden reduction initiative for small excise taxpayers announced by the Minister of National Revenue on March 31, 2009;
- the enhanced tobacco stamping regime to deter contraband tobacco released on August 6, 2009;
- improvements to the application of GST/HST to the financial services sector released on September 23, 2009;
- additional measures proposed in relation to the Canada-U.S. Softwood Lumber Agreement contained in the *Notice of Ways and Means Motion to amend the Softwood Lumber Products Export Charge Act, 2006*, tabled by the House of Commons on September 30, 2009;
- modifications to the rules governing tax-free savings accounts announced on October 16, 2009;
- increased flexibility for employer funding of registered pension plans by increasing the pension surplus threshold for employer contributions to 25 per cent from its previous 10 per cent limit announced October 27, 2009;
- technical legislative proposals addressing recent court decisions on the GST/HST and financial services, announced on December 14, 2009;
- measures released in draft from on December 18, 2009 relating to the income taxation of shareholders of foreign affiliates, as well as the remaining measures released in a previous draft relating to foreign affiliates;
- increases to air travellers security charge rates announced on February 25, 2010;
- rules to facilitate the implementation of employee life and health trusts released in draft form on February 26, 2010; and
- the income tax technical and bijuralism amendments that were previously released but not yet implemented.

## OUTSTANDING MATTERS

While Budget 2010 addresses a host of relieving and targeted measures, several other measures, most of which should not involve a net cost to the Government, are not addressed in Budget 2010:

- Implement the proposals made by the Advisory Panel on Canada's System of International Taxation to simplify Canada's international tax system and improve the international competitiveness of Canadian businesses.
- Encourage investment by passive investors in renewable energy projects by repealing the "specified energy property" rules which restrict the ability of such investors to generate a loss from claiming capital cost allowance on the cost of certain assets, including wind turbines, photovoltaic solar projects and small scale hydro-electric facilities.
- Make further improvements to the definition of Scientific Research and Experimental Development (SR&ED) for income tax purposes, as well as certain other key elements of the SR&ED program, to reduce uncertainty as to whether a particular R&D program will be eligible for SR&ED treatment.
- Improve fairness for private savings by permitting contributions to RRSPs that would allow the purchase of a retirement income comparable to public sector pension plans and make the dividend tax credit refundable so that RRSPs and other tax-exempt entities can receive a benefit from the dividend tax credit.
- Encourage investment by clarifying rules that reallocate partnership income in certain situations to minimize uncertainty relating to when these rules may be applied.
- Narrow the application of the overly broad proposed rules relating to restrictive covenants.
- Amend the definition of "specified financial institution" so that it does not include a corporation solely because it is related to a captive insurer.
- Amend the affiliated person rules to clarify that a widely held mutual fund corporation is not affiliated with any shareholder thereof and deals at arm's length with each shareholder to ensure that suspended loss and dividend stop loss rules do not apply in an inappropriate manner.
- Clarify whether the Government intends to proceed with legislation to enact the "reasonable expectation of profit" rules first announced in October, 2003 that evoked a storm of protest and have languished since then.