

**Tax Measures:  
Supplementary  
Information and  
Notices of Ways  
and Means Motions**

Annex

5

The image features three stylized, upward-pointing arrows of different colors: blue, brown, and green. The brown arrow is the tallest and has the number '5' printed on its shaft. The blue and green arrows are shorter and positioned to the left and right of the brown arrow, respectively. All three arrows have a slight 3D effect with a lighter shade on their right side. The background is plain white.

## **Tax Measures: Supplementary Information**

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Tax Measures:  
Supplementary  
Information



## Overview

This annex provides detailed information on each of the tax measures proposed in the Budget.

Table A5.1 lists these measures and provides estimates of their budgetary impact.

The annex also provides Notices of Ways and Means Motions to amend the *Income Tax Act*, and the regulations thereunder, the *Excise Tax Act*, the *Customs Tariff*, the *Universal Child Care Benefit Act*, the *Excise Act, 2001*, the *Air Travellers Security Charge Act*, the *Canada Pension Plan* and the *Employment Insurance Act*.



Table A5.1

**Cost of Proposed Tax and Tariff Measures<sup>1</sup>**

	2009– 2010	2010– 2011	2011– 2012	2012– 2013	2013– 2014	2014– 2015	Total
Fiscal Costs (millions of dollars)							
<b>Personal Income Tax Measures</b>							
Benefits Entitlement – Shared Custody	–	–	–	–	–	–	–
Universal Child Care Benefit for Single Parents	–	5	5	5	5	5	25
Medical Expense Tax Credit – Purely Cosmetic Procedures	–	-40	-40	-40	-40	-40	-200
Rollover of RRSP Proceeds to an RDSP	–	–	5	5	5	5	20
Carry Forward of RDSP Grants and Bonds <sup>2</sup>	–	20	70	45	30	10	175
Provincial Payments into RESPs and RDSPs	–	–	–	–	–	–	–
Scholarship Exemption and Education Tax Credit	–	–	–	–	–	–	–
Charities: Disbursement Quota Reform	–	–	–	–	–	–	–
Employee Stock Options	-20	-270	-300	-320	-355	-395	-1,660
U.S. Social Security Benefits	–	5	5	5	5	5	25
Mineral Exploration Tax Credit	–	85	-20	–	–	–	65
<b>Business Income Tax Measures</b>							
Accelerated Capital Cost Allowance for Clean Energy Generation	–	–	–	5	5	10	20
Television Set-top Boxes – Capital Cost Allowance	–	5	5	5	5	5	25
Interest on Overpaid Taxes	–	-45	-100	-140	-170	-190	-645
Federal Credit Unions	–	–	–	–	–	–	–
SIFT Conversions and Loss Trading	–	–	–	–	–	–	–

<sup>1</sup> A "-" indicates a nil amount, a small amount (less than \$5 million) or an amount that cannot be determined in respect of a measure that is intended to protect the tax base.

<sup>2</sup> The cost of this measure is attributable to program expenditures.



Table A5.1 (cont'd)

**Cost of Proposed Tax and Tariff Measures**

	2009– 2010	2010– 2011	2011– 2012	2012– 2013	2013– 2014	2014– 2015	Total
Fiscal Costs (millions of dollars)							
<b>International Taxation</b>							
Section 116 and Taxable Canadian Property	–	30	25	25	25	25	130
Refunds under Regulation 105 and Section 116	–	–	–	5	5	5	15
Foreign Tax Credit Generators	–	–	–	–	–	–	–
Foreign Investment Entities and Non-Resident Trusts	–	–	–	–	–	–	–
<b>Sales Tax Measures</b>							
GST/HST and Purely Cosmetic Procedures	–	–	–	–	–	–	–
Simplification of the GST/HST for the Direct Selling Industry	–	–	–	–	–	–	–
<b>Other Tax Measures</b>							
Specified Leasing Property Rules	–	–	–	–	–	–	–
Information Reporting of Tax Avoidance Transactions – Public Consultation	–	–	–	–	–	–	–
Online Notices	–	–	–	–	–	–	–
Tax Evasion and the Proceeds of Crime and Money Laundering Regime	–	–	–	–	–	–	–
Taxation of Corporate Groups	–	–	–	–	–	–	–
Aboriginal Tax Policy	–	–	–	–	–	–	–
<b>Customs Tariff Measures</b>							
Tariff Reductions on Manufacturing Inputs and Machinery and Equipment	17	210	230	252	275	292	1,276



## Personal Income Tax Measures

### Benefits Entitlement – Shared Custody

Under existing rules, only one eligible individual can receive the Canada Child Tax Benefit and Universal Child Care Benefit in respect of a qualified dependant each month. Similarly, the child component of the Goods and Services Tax/Harmonized Sales Tax Credit (GST/HST credit) is payable in respect of a qualified dependant to only one eligible individual each quarter.

To improve the allocation of child benefits between parents who share custody of a child, Budget 2010 proposes to allow two eligible individuals to receive Canada Child Tax Benefit and Universal Child Care Benefit amounts in a particular month, and two eligible individuals to receive GST/HST credit amounts in respect of a particular quarter, in respect of a child if the recipients would be eligible to receive amounts under the Canada Revenue Agency's existing shared eligibility policy. This policy applies when a child lives more or less equally with two individuals who live separately. The Canada Child Tax Benefit and Universal Child Care Benefit payments will be equivalent to each eligible individual receiving one-half of the annual entitlement that they would receive if they were the sole eligible individual, paid in monthly instalments over the year. The child component of the GST/HST credit will similarly be equivalent to each eligible individual receiving one-half of the annual entitlement that they would receive if they were the sole eligible individual, paid in quarterly instalments over the year.

Corresponding amendments will be made to the *Universal Child Care Benefit Act*.

This measure will apply to benefits payable commencing July 2011.

### Universal Child Care Benefit for Single Parents

The Universal Child Care Benefit provides families with \$100 a month for each child under the age of six years. In two-parent families, the Universal Child Care Benefit is included in the income of the lower-income spouse or common-law partner. In the case of a single-parent family, the Universal Child Care Benefit is generally included in the single parent's income and taxed at his or her marginal tax rate. As a result, a single parent can pay more tax on Universal Child Care Benefit amounts than a single-earner couple, with the same income, receiving the same Universal Child Care Benefit.

Budget 2010 proposes to allow a single parent the option of including the aggregate Universal Child Care Benefit amount received, in respect of all of his or her children, in the parent's income or in the income of the dependant for whom an Eligible Dependant Credit is claimed. If a single parent is unable to claim an Eligible Dependant Credit, he or she will have the option of including the aggregate Universal Child Care Benefit amount in the income of one of the children for whom the Universal Child Care Benefit is paid.

This measure will apply to the 2010 and subsequent taxation years.

### **Medical Expense Tax Credit – Purely Cosmetic Procedures**

The Medical Expense Tax Credit provides tax recognition for above-average medical and disability-related expenses incurred by individuals. For 2010, the Medical Expense Tax Credit reduces the federal tax of a claimant by 15 per cent of eligible unreimbursed medical expenses in excess of the lesser of \$2,024 and three per cent of net income.

An expense is generally eligible to be claimed under the Medical Expense Tax Credit if it is directly related to a disability or a medical condition. An expense is not generally intended to be eligible if it is ordinarily incurred by persons without a disability or a medical condition or has a substantial element of personal consumption and choice.

To ensure consistency with the intent of the Medical Expense Tax Credit, Budget 2010 proposes that expenses incurred for purely cosmetic procedures (including related services and other expenses such as travel) be ineligible to be claimed under the Medical Expense Tax Credit. This generally includes surgical and non-surgical procedures purely aimed at enhancing one's appearance such as liposuction, hair replacement procedures, botulinum toxin injections, and teeth whitening.

A cosmetic procedure, including those identified above, will continue to qualify for the Medical Expense Tax Credit if it is required for medical or reconstructive purposes, such as surgery to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease.

The proposed changes will make the tax treatment of purely cosmetic procedures consistent with that in other jurisdictions, such as the United States, the United Kingdom and Québec.

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



## **Rollover of RRSP Proceeds to an RDSP**

When the annuitant under a Registered Retirement Savings Plan (RRSP) dies, the existing income tax rules generally provide that the value of the RRSP is included in computing the deceased's income for the year of death. However, preferential tax treatment is provided on RRSP distributions made after death to the deceased's surviving spouse or common-law partner, or to children or grandchildren who were financially dependent on the deceased RRSP annuitant. There are two aspects to this preferential tax treatment.

- Distributions of the RRSP proceeds to the deceased's surviving spouse or common-law partner, or to a financially dependent child or grandchild, reduce the amount of the deceased's income and are included in the income of the recipient (these distributions are referred to as "refunds of premiums").
- If a spouse or common-law partner, or a child or grandchild who was dependent on the deceased annuitant because of physical or mental infirmity, receives a refund of premiums, an offsetting deduction allows the refund of premiums to be transferred on a tax-deferred (or "rollover") basis to the RRSP of the recipient, or used to purchase an immediate life annuity.

Similar rules also apply in respect of Registered Retirement Income Fund (RRIF) proceeds and certain lump-sum amounts paid from Registered Pension Plans (RPPs). For the purposes of this supplementary information, "RRSP proceeds" also refers to RRIF and lump-sum RPP proceeds and "RRSP annuitant" also refers to a RRIF annuitant and an RPP member.

Registered Disability Savings Plans (RDSPs) were introduced in Budget 2007 to help parents and others save for the long-term financial security of a child with a severe disability. An RDSP is a tax-assisted savings vehicle in which investment income accumulates tax-free. Canada Disability Savings Grants and Canada Disability Savings Bonds may also be paid by the government into the RDSP. Canada Disability Savings Grants, Canada Disability Savings Bonds and investment income are included in the beneficiary's income for tax purposes when paid out of the RDSP.

Budget 2010 proposes to extend the existing RRSP rollover rules to allow a rollover of a deceased individual's RRSP proceeds to the RDSP of a financially dependent infirm child or grandchild.

An individual who qualifies to be an RDSP beneficiary and who meets the age and residency requirements for RDSP contributions will be eligible to roll over RRSP proceeds received as a result of the death of their parent or grandparent to their RDSP if the requirements under the existing RRSP rollover rules are satisfied (that is, if the RDSP beneficiary was financially dependent on the deceased individual by reason of physical or mental infirmity). An infirm child or grandchild is generally considered to be financially dependent if the child's income for the year preceding the year of death did not exceed a specified threshold (\$17,621 for 2010). An infirm child with income above this amount may also be considered to be financially dependent, but only if the dependency can be demonstrated based on the particular facts.

The amount of RRSP proceeds rolled over into an RDSP will not be permitted to exceed the beneficiary's available RDSP contribution room. The lifetime contribution limit for RDSPs is \$200,000. The rolled-over proceeds will reduce the beneficiary's RDSP contribution room, but will not attract Canada Disability Savings Grants. These proceeds will be considered private contributions for the purpose of determining whether an RDSP is a primarily government-assisted plan (a plan where Canada Disability Savings Grants and Canada Disability Savings Bonds paid to the plan exceed private contributions made to the plan, and which is consequentially subject to a number of additional requirements). Since the amount of RRSP proceeds rolled over to an RDSP will not have been subject to income tax, the amount will form part of the portion of a disability assistance payment that is included in the beneficiary's income when withdrawn from the RDSP.

The RDSP beneficiary or his or her legal representative will be required to make an election in prescribed form to transfer the RRSP proceeds to the RDSP on a rollover basis. The election would be made at the time of the RDSP contribution and filed with both the Canada Revenue Agency and Human Resources and Skills Development Canada by the RDSP issuer.

These measures will be effective for deaths occurring on or after March 4, 2010.

### **Transitional Rules**

Where the death of an RRSP annuitant occurs after 2007 and before 2011, special transitional rules will allow a contribution to be made to the RDSP of a financially dependent infirm child or grandchild of the annuitant that would provide a result that is generally equivalent to the proposed measures.



As with the general measures, the transitional rules will be available in respect of RDSP contributions by or for an individual who qualifies to be an RDSP beneficiary and who meets the age and residency requirements for RDSP contributions. This will effectively allow the proposed measure to apply as of January 1, 2008 – the date that RDSPs were first permitted to be established under the income tax rules. In cases of deaths after March 3, 2010 and before 2011, taxpayers may use either the general measures or the transitional rules. This will accommodate situations where taxpayers may not have had an opportunity to adjust their estate planning to take advantage of the general measures.

The transitional rules will allow an eligible individual to make an election to contribute up to the amount of a deceased annuitant's RRSP proceeds to the RDSP of a child who is an infirm child or grandchild of the deceased annuitant and who was financially dependent on the deceased annuitant, subject to available RDSP contribution room. For these purposes, an "eligible individual" will be a beneficiary of the deceased RRSP annuitant's estate or a person who received an amount of the deceased's RRSP proceeds directly on the death of the annuitant. An offsetting deduction will be provided either on the deceased annuitant's terminal tax return or on that of the eligible individual making the contribution, as the case may be, provided the contribution is made before 2012. As with the general measures, an election would be required to be made in prescribed form at the time of the RDSP contribution and filed with both the Canada Revenue Agency and Human Resources and Skills Development Canada by the RDSP issuer.

To allow time for financial institutions and Human Resources and Skills Development Canada to adjust their RDSP systems, RDSP contributions benefiting from the proposed rollover measure cannot be made before July 2011.

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

The Registered Disability Savings Plan (RDSP) was introduced in Budget 2007 to better enable parents and others to ensure the long-term financial security of a child with a severe disability. The Government of Canada supports these plans by providing Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs).

Annual RDSP contributions attract CDSGs of up to \$3,500, depending on the beneficiary's family income and the amount contributed, up to a lifetime limit of \$70,000. The family income ranges and the corresponding maximum annual CDSGs are set out in Table A5.2.<sup>1</sup>

In addition, CDSBs of up to \$1,000 annually are provided to RDSPs established by low- and modest-income families, based on a beneficiary's family income, up to a lifetime limit of \$20,000. The amount of the CDSB begins to be phased out for incomes above \$23,855 and is fully phased-out at \$40,970 (for 2010). Beneficiaries are currently unable to carry forward unused CDSG and CDSB entitlements to future years.

Table A5.2

**Maximum Annual Canada Disability Savings Grants**

Family Income <sup>1</sup> (\$)	
Up to 81,941	Over 81,941
300% on the first \$500	100% on the first \$1,000
200% on the next \$1,000	

<sup>1</sup> Family net income thresholds are in 2010 dollars. These income thresholds are indexed to inflation.

In recognition of the fact that families of children with disabilities may not be able to contribute regularly to their plans, Budget 2010 proposes to amend the *Canada Disability Savings Act* to allow a 10-year carry forward of CDSG and CDSB entitlements.

Upon opening an RDSP, CDSB entitlements will be determined and paid into the plan for the preceding 10 years (not before 2008, the year RDSPs became available), based on the beneficiary's family income in those years. Balances of unused CDSG entitlements will also be determined and maintained for the same period. CDSGs will be paid on unused entitlements, up to an annual maximum of \$10,500.

<sup>1</sup> Budget 2009 increased the two lowest personal income tax brackets above their indexed values. Consequential changes will be made to the family income thresholds used to determine eligibility for Canada Education Savings Grants, Canada Disability Savings Grants, and Canada Disability Savings Bonds to ensure that these thresholds correspond to the income tax brackets. These changes will apply to the 2009 and subsequent contribution years.



The matching rate on unused CDSG entitlements will be the same as that which would have applied had the contribution been made in the year in which the entitlement was earned. Matching rates on RDSP contributions will be paid in descending order, with contributions using up any grant entitlements at the highest available matching rate first, followed by any grant entitlements at lower rates. Plan holders will receive annual statements of CDSG entitlements.

The carry forward will be available starting in 2011.

## Benefits of the RDSP Carry Forward: An Example

Roger, who is a low-income adult who has been eligible for the Disability Tax Credit his whole life, opens an RDSP in 2011.

In each of 2008 (the year RDSPs became available), 2009, 2010 and 2011, Roger will have accumulated \$500 in grant entitlements at a 300-per-cent matching rate, \$1,000 in grant entitlements at a 200-per-cent matching rate, and \$1,000 in CDSB entitlements based on his family income.

When Roger opens an RDSP in 2011, his RDSP will automatically receive \$4,000 in CDSBs.

After the RDSP is opened, Roger's family contributes \$400 to his plan in 2011, for which his RDSP receives \$1,200 in CDSGs. Roger carries forward \$1,600 in unused grant entitlements at the 300-per-cent rate and \$4,000 in unused grant entitlements at the 200 per-cent-rate. When these unused entitlements are added to his grant entitlements for 2012, Roger has \$2,100 in grant entitlements at the 300-per-cent matching rate and \$5,000 in grant entitlements at the 200-per-cent matching rate.

In 2012, Roger's family contributes \$3,000 to his RDSP. The first \$2,100 of this contribution uses up Roger's grant entitlements at the 300-per-cent matching rate. The next \$900 is matched at the 200-per-cent matching rate. In total, Roger's RDSP receives \$8,100 in CDSGs in 2012. In addition, his RDSP receives a CDSB of \$1,000 based on his bond entitlements for 2012.

### Grant and Bond Entitlements Example

Year	Contributions	Accumulated grant entitlements			CDSGs paid	Accumulated bond entitlements	CDSBs paid
		300%	200%	100%			
(\$)							
2008	–	500	1,000	0	–	1,000	–
2009	–	1,000	2,000	0	–	2,000	–
2010	–	1,500	3,000	0	–	3,000	–
RDSP opened							
2011	400	1,600	4,000	0	1,200	0	4,000
2012	3,000	0	4,100	0	8,100	0	1,000
<b>Total</b>	<b>3,400</b>				<b>9,300</b>		<b>5,000</b>



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

The Government of Canada provides financial assistance to Canadian families saving for their children's education through Registered Education Savings Plans and the associated Canada Education Savings Grants and Canada Learning Bond. It also helps families with severely disabled children save for their children's long-term financial security through Registered Disability Savings Plans and the associated Canada Disability Savings Grants and Canada Disability Savings Bonds.

Provincial and territorial governments may also support the efforts of parents to save by making payments into Registered Education Savings Plans and Registered Disability Savings Plans. These provincial programs receive the same treatment as federal grants and bonds paid into these plans – they do not use up a beneficiary's Registered Education Savings Plan or Registered Disability Savings Plan contribution room and they do not attract federal grants. Under the current rules, provincial initiatives that are not administered by the federal government have to be prescribed in order to be treated as provincial programs, which can create uncertainty about the status of payments from these programs.

Budget 2010 proposes to clarify that all payments made to a Registered Education Savings Plan or a Registered Disability Savings Plan through a program funded, directly or indirectly, by a province or administered by a province will be treated the same way as federal grants and bonds and will therefore not themselves attract or reduce federal grants and bonds.

In the case of programs that are administered by a province, this measure will apply to payments made after 2006. In the case of programs that are not administered by a province, this measure will apply to payments made after 2008.

## **Scholarship Exemption and Education Tax Credit**

Budget 2006 introduced a full tax exemption for post-secondary scholarships, fellowships and bursaries to help foster academic excellence by providing tax relief to post-secondary students. The scholarship exemption applies to amounts received in connection with the student's enrolment in an educational program that entitles the student to the Education Tax Credit. The Education Tax Credit is generally available in respect of programs at the post-secondary level, and programs at educational institutions that are certified by the Minister of Human Resources and Skills Development as providing skills in an occupation.

Budget 2010 proposes to clarify that a post-secondary program that consists principally of research will be eligible for the Education Tax Credit, and the scholarship exemption, only if it leads to a college or CEGEP diploma, or a bachelor, masters or doctoral degree (or an equivalent degree). Accordingly, post-doctoral fellowships will be taxable.

Occupational training programs certified by the Minister of Human Resources and Skills Development will continue to qualify for the Education Tax Credit.

Budget 2010 also proposes that an amount will be eligible for the scholarship exemption only to the extent it can reasonably be considered to be received in connection with enrolment in an eligible educational program for the duration of the period of study related to the scholarship.

If a scholarship, fellowship or bursary amount is provided in connection with a part-time program, it is proposed that the scholarship exemption be limited to the amount of tuition paid for the program plus the costs of program-related materials, except if the part-time program is undertaken by 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.

The proposed measures will help ensure that the scholarship exemption for post-secondary scholarships, fellowships and bursaries remains targeted to its original purpose. The measures will apply to the 2010 and subsequent taxation years.

## **Charities: Disbursement Quota Reform**

### **Background**

It is estimated that Canadian individuals will receive \$2.4 billion in federal tax relief on charitable donations of \$8.8 billion in 2009. In addition, corporations benefit from a deduction with respect to charitable donations.

Charitable activities are not defined in the *Income Tax Act*; instead, the meaning of charitable purposes and charitable activities in Canada is largely determined by jurisprudence. Charities must devote their resources to charitable purposes. The *Income Tax Act* specifies requirements for registration as a charity as well as grounds for revocation of that status. The Canada Revenue Agency determines the eligibility of an organization to be a registered charity for federal income tax purposes, based on an examination of the organization's purposes and activities. In addition, charities are subject to corporate and trust law.



The disbursement quota was introduced in 1976 to help curtail fundraising costs and limit capital accumulation. The disbursement quota is intended to ensure that a significant portion of a registered charity’s resources are devoted to charitable purposes.

In general terms, the disbursement quota requires that the amount a charity spends each year on charitable activities (including gifts to qualified donees) be at least the sum of:

- 80 per cent of the previous year’s tax-receipted donations plus other amounts relating to enduring property and transfers between charities (in other words, a “charitable expenditure rule”); and
- 3.5 per cent of all assets not currently used in charitable programs or administration, if these assets exceed \$25,000 (in other words, a “capital accumulation rule”).

Some have observed that the impact of the charitable expenditure rule can vary considerably, for reasons unrelated to the manner in which a charity conducts its charitable activities. For example, some charities have a wide range of revenue sources from which to fund their charitable activities, such as grants received from governments and revenues from related business activities. Since all charitable expenditures count toward meeting the disbursement quota, these charities have little difficulty satisfying it even if they do not spend their tax-receipted donations on charitable activities. In contrast, the rule is much more constraining on many small and rural charities that rely mainly on tax-receipted donations.

Stakeholders such as Imagine Canada have called for the elimination of the disbursement quota because it imposes “an unduly complex and costly administrative burden on charities - particularly small and rural charities” and it constrains the flexibility of charities, without achieving its core purpose of limiting spending on fundraising and non-charitable activities.

Recent legislative and administrative initiatives have strengthened the Canada Revenue Agency’s ability to ensure that a charity’s fundraising and other practices are appropriate. For example, the Canada Revenue Agency publication “Fundraising by Registered Charities” provides guidance for charities on acceptable fundraising practices.

The Canada Revenue Agency may impose sanctions or revoke the registration of a charity in situations where charities use their funds inappropriately, such as in cases where there is undue private benefit. These tools provide a more effective and direct means to fulfill the objectives of the charitable expenditure rule of the disbursement quota.

Budget 2010 proposes to reform the disbursement quota for fiscal years that end on or after March 4, 2010. Specifically, Budget 2010 proposes to:

- repeal the charitable expenditure rule;
- modify the capital accumulation rule; and
- strengthen related anti-avoidance rules for charities.

The Government will monitor the effectiveness of the Canada Revenue Agency's guidance on "Fundraising by Registered Charities", and take action if needed to ensure its stated objectives are achieved.

## **Repeal of Charitable Expenditure Rule**

Budget 2010 proposes to repeal the charitable expenditure rule. Consequently, provisions relating to a number of concepts will no longer be required to calculate the disbursement quota:

- enduring property (gifts to a charity for endowments or multi-year charitable projects which are not subject to the charitable expenditure rule);
- the capital gains reduction and the capital gains pool (provisions that ensure that capital gains realized from the disposition of enduring property are not subject to the charitable expenditure rule and the capital accumulation rule);
- specified gifts (a provision that allows charities with disbursement excesses to help charities with disbursement shortfalls to meet their disbursement quota requirements); and
- exclusions from the calculation of the base to which the 3.5-per-cent disbursement rate is applied (provisions that ensure that funds subject to the charitable expenditure rule are not also subject to the capital accumulation rule).



Budget 2010 also proposes to amend the existing rule that provides the Canada Revenue Agency with the discretion to allow charities to accumulate property for a particular purpose, such as a building project. The existing provision states that property accumulated after approval from the Canada Revenue Agency and any income earned in respect of that property is deemed to have been spent on charitable activities. This rule will require amendment in the absence of the charitable expenditure rule. In order to allow a charity to accumulate property for a particular project, the Canada Revenue Agency will be given the discretion to exclude the accumulated property from the capital accumulation rule calculation.

### **Modify the capital accumulation component**

There is currently an exemption from the capital accumulation rule for charities having \$25,000 or less in assets not used in charitable programs or administration. Budget 2010 proposes to increase this threshold to \$100,000 for charitable organizations. This increase will reduce the compliance burden on small charitable organizations and provide them with greater ability to maintain reserves to deal with contingencies. The threshold for charitable foundations will remain at \$25,000.

The amount of all assets not currently used in charitable programs or administration, for the purpose of the capital accumulation rule in the disbursement quota, is subject to a calculation provided for in the *Income Tax Regulations*. This calculation requires a technical amendment to clarify that it applies both to charitable foundations and charitable organizations.

### **Strengthen anti-avoidance rules**

Budget 2010 proposes to extend existing anti-avoidance rules to situations where it can reasonably be considered that a purpose of a transaction was to delay unduly or avoid the application of the disbursement quota.

Budget 2010 proposes provisions to ensure that amounts transferred between non-arm's length charities will be used to satisfy the disbursement quota of only one charity. It is proposed that a recipient charity, in such circumstances, be required to spend the full amount transferred on its own charitable activities, or to transfer the amount to a qualified donee with which it deals at arm's length, in the current or subsequent taxation year. Alternatively, the transferring charity will be able to elect that the amount transferred will not count towards satisfying its disbursement quota, in which case the recipient charity would not be subject to the immediate disbursement requirement under the anti-avoidance rules.

## Employee Stock Options

Budget 2010 proposes the following measures associated with the tax treatment of employee stock options.

### Stock Option Cash Outs

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

The stock option deduction results in the taxation of stock option benefits at capital gains tax rates, and as such provides Canadian businesses with a valuable tool to attract and retain highly-skilled workers. In 2007, about 78,000 employees took advantage of the deduction, claiming an average amount of \$53,000; three-quarters of the aggregate value of the deduction was claimed by individuals earning more than \$500,000.

Table A5.3

### Distribution of stock option deduction by income (2007)

Individual's total income <sup>1</sup> (\$)	Number of individuals claiming a stock option deduction	Stock option deduction claimed		
		Average amount (\$)	Aggregate amount (\$ millions)	% of total
Under 100,000	32,483	3,000	100	2%
100,000 to 500,000	38,034	23,000	890	22%
Over 500,000	7,985	393,000	3,140	75%
Total	78,502	53,000	4,130	100%

<sup>1</sup> Including stock option benefits

Source: Tax filer data for the 2007 taxation year.  
Numbers may not add due to rounding.

Given the considerable tax benefits provided by the stock option deduction, particularly to high-income individuals, it is important to ensure that it is used in a manner consistent with its intended policy objectives.

The tax rules currently ensure that, when an employee acquires securities under a stock option agreement, only one deduction (at the employee level) is provided. This is because employers are, in this context, prevented from claiming a tax deduction for the issuance of a security.



It is possible, however, to structure employee stock option agreements so that, if employees dispose of (“cash out”) their stock option rights for a cash payment from the employer (or other in-kind benefit), the employment benefit is eligible for the stock option deduction while the cash payment is fully deductible by the employer.

Budget 2010 proposes to prevent both the stock option deduction and a deduction by the employer from being claimed for the same employment benefit. To this effect, the stock option deduction will generally be available to employees only in situations where they exercise their options by acquiring securities of their employer. An employer may continue to allow employees to cash out their stock option rights to the corporation without affecting their eligibility for the stock option deduction provided the employer makes an election to forgo the deduction for the cash payment. This will ensure a comparable tax rate with that available on other compensation, when considered on a total employer-employee basis.

Table A5.4

**Federal tax collected on \$100 of employment benefit (\$)**

	Type of benefit				
	Bonus/ Salary	Stock option exercise	Stock option cash out		
			Current	Proposed	
			With election	Without election	
Employee <sup>1</sup>	29	14.5	14.5	14.5	29
Employer <sup>2</sup>	0	18	0	18	0
<b>Total</b>	<b>29</b>	<b>32.5</b>	<b>14.5</b>	<b>32.5</b>	<b>29</b>

<sup>1</sup> Assumed to be taxed at 29 per cent (the highest federal personal income tax rate).

<sup>2</sup> Assumed to be taxed at 18 per cent (the general federal corporate income tax rate for 2010).

The proposed measure will also help preserve symmetry in the tax treatment of stock-based compensation: that is, where preferential tax treatment is provided to the employee on stock-based benefits, the employer is generally not allowed a tax deduction for the cost of such benefits.

Table A5.5

**Tax treatment of stock-based compensation at the employer and employee level - Canada and United States**

Type of Plan	Tax treatment of benefit	
	Employer	Employee
<b>Canada</b>		
Employee stock option plans	No deduction	50-per-cent deduction <sup>1</sup>
Cash incentive plans (e.g. phantom stock option plan)	Deduction	Full income inclusion
Share purchase plans	Deduction	Full income inclusion
Stock option cash outs		
Current	Deduction	50-per-cent deduction
Proposed (without election)	Deduction	Full income inclusion
Proposed (with election)	No deduction	50-per-cent deduction
<b>U.S.</b>		
Statutory (incentive) stock option plans <sup>2</sup>	No deduction	Capital gains treatment
Non-qualifying stock option plans	Deduction	Full income inclusion
Stock option plan cash outs	Deduction	Full income inclusion

<sup>1</sup> To qualify for the 50-per-cent deduction stock options have to meet certain general eligibility conditions (i.e. the option has to provide a right to purchase common shares, at a price that is no less than the fair market value of these shares at the time the option is granted, and the employee has to deal at arm's length with the employer).

<sup>2</sup> There are a number of eligibility conditions and limitations associated with the use of these plans including a two-year minimum combined holding period for the option and acquired shares (with a one-year minimum holding period specifically applicable to the acquired shares), and annual vesting limits (\$25,000 for qualifying share purchase plans and \$100,000 for qualifying stock option plans). These restrictions significantly reduce the attractiveness of statutory plans and their use. As a result, non-qualifying plans are the most commonly used type of employee stock option plan in the U.S.

Budget 2010 also proposes to amend the income tax rules to clarify that the disposition of rights under a stock option agreement to a non-arm's length person results in an employment benefit at the time of disposition (including cash out). Although the Government considers that these benefits are taxable in these circumstances under existing tax rules, the Government also believes that clarification of these rules is warranted.

These measures will apply to dispositions of employee stock options that occur after 4:00 p.m. Eastern Standard Time on March 4, 2010.



## **Tax Deferral Election and Remittance Requirement**

The benefit arising when an employee acquires securities under a stock option agreement is treated as employment income for tax purposes. Any subsequent change in the value of the optioned securities is treated separately as a capital gain or loss upon disposition of securities. This treatment recognizes that once employees acquire securities through a stock option they are in a position similar to that of other individuals who acquire securities directly in the market.

Under certain conditions, an employee of a publicly-traded company may elect to defer the recognition of the employment benefit for tax purposes until the disposition of the optioned securities. This election is available for benefits in respect of up to \$100,000 of an employee's qualifying stock options vesting in a particular year. Gains or losses realized on the optioned securities continue to be treated separately from the employment benefit as capital income.

If an employee elects to defer recognition of the employment benefit and the value of the optioned securities subsequently decreases, the employee may not have sufficient proceeds from the disposition of the securities to satisfy his or her tax obligation on the employment benefit, which can create financial difficulties for some individuals.

Budget 2010 proposes to repeal the tax deferral election and to clarify existing withholding requirements to ensure that an amount in respect of tax on the value of the employment benefit associated with the issuance of a security is required to be remitted to the government by the employer. This amount will be added to the employer's remittances of tax withheld at source in respect of all employee salary and benefits, including other in-kind benefits, for the period that includes the date on which the security was issued or sold. These measures will prevent situations in which an employee is unable to meet his or her tax obligation as a result of a decrease in the value of these securities.

The repeal of the tax deferral election will apply to employee stock options exercised after 4:00 p.m. Eastern Standard Time on March 4, 2010.

The clarifications to remittance requirements will apply to benefits arising on the issuance of securities after 2010, to provide time for businesses to adjust their compensation arrangements and payroll systems.

The proposed tax remittance measure will not apply in respect of options granted before 2011 pursuant to an agreement in writing entered into before 4:00 p.m. Eastern Standard Time on March 4, 2010 where the agreement included, at that time, restrictions on the disposition of the optioned securities.

## Special Relief for Tax Deferral Elections

Some taxpayers who took advantage of the tax deferral election on stock options introduced in Budget 2000 have experienced financial difficulties as a result of a decline in the value of the optioned securities to the point that the value of the securities is less than the deferred tax liability on the underlying stock option benefit.

To provide relief for taxpayers in these situations, Budget 2010 proposes to introduce a special elective tax treatment for affected taxpayers who elected under the current rules to defer taxation of their stock option benefits until the disposition of the optioned securities. In effect, the special elective treatment will ensure that the tax liability on a 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, the taxpayer may elect to pay a special tax for the year equal to the taxpayer's proceeds of disposition<sup>2</sup>, if any, from the sale or other disposition of the optioned securities. Where such an election is made:

- the taxpayer will be able to claim an offsetting deduction equal to the amount of the stock option benefit; and
- an amount equal to 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 on the optioned securities, provided this loss has not been otherwise used.

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<sup>2</sup> The special tax will be equal to two-thirds of such proceeds for residents of Québec.



Only stock option benefits for which an election to defer taxation has been made will qualify for this special elective tax treatment. In addition:

- individuals who disposed of their optioned securities before 2010 will have to make an election for this special treatment on or before their filing-due date for the 2010 taxation year (generally April 30, 2011); and
- individuals who have not disposed of their optioned securities before 2010 must do so before 2015. They will then have until their filing-due date for the taxation year of disposition to make an election for this special treatment.

This special tax treatment will provide relief for federal income tax liabilities on qualifying deferred stock option benefits, and provincial and territorial income tax on those benefits for residents of provinces and territories participating in a Tax Collection Agreement. Amendments will be made to allow for the sharing of the special tax with provinces and territories.

## **U.S. Social Security Benefits**

Prior to 1996, pursuant to the Canada-United States Tax Convention (1980), Canadian residents receiving benefits under the social security legislation in the United States, including tier 1 railroad retirement benefits but not including unemployment benefits (“U.S. Social Security benefits”), were required to include only 50 per cent of those benefits in computing income. Changes made to the Canada-U.S. Tax Convention effective beginning in 1996 increased the inclusion rate for U.S. Social Security benefits to 85 per cent from 50 per cent.

Budget 2010 proposes to reinstate the 50-per-cent inclusion rate for Canadian residents who have been in receipt of U.S. Social Security benefits since before January 1, 1996 and for their spouses and common-law partners who are eligible to receive survivor benefits.

This measure will apply to U.S. Social Security benefits received on or after January 1, 2010.

## Mineral Exploration Tax Credit

Flow-through shares allow companies to renounce or “flow through” tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income. This facilitates the raising of equity to fund exploration by enabling companies to sell their shares at a premium. The mineral exploration tax credit is an additional benefit, available to individuals who invest in flow-through shares, equal to 15 per cent of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

Budget 2010 proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2011. Under the existing “look-back” rule, funds raised in one calendar year with the benefit of the credit can be spent on eligible exploration up to the end of the following calendar year. Therefore, for example, funds raised with the credit during the first three months of 2011 can support eligible exploration until the end of 2012.

Mineral exploration, as well as new mining and related processing activity that could follow from successful exploration efforts, can be associated with a variety of environmental impacts to soil, water and air. All such activity, however, is subject to applicable federal and provincial environmental regulations, including project-specific environmental assessments where required.

## Business Income Tax Measures

### Accelerated Capital Cost Allowance for Clean Energy Generation

Under the capital cost allowance (CCA) regime in the income tax system, Class 43.2 of Schedule II to the *Income Tax Regulations* provides accelerated CCA (50 per cent per year on a declining balance basis) for specified clean energy generation and conservation equipment. The class incorporates by reference a detailed list of eligible equipment that generates or conserves energy by:

- using a renewable energy source (for example, wind, solar, small hydro);
- using fuels from waste (for example, landfill gas, wood waste, manure); or
- making efficient use of fossil fuels (for example, high efficiency cogeneration systems, which simultaneously produce electricity and useful heat).



Providing accelerated CCA in this context is an explicit exception to the general practice of setting CCA rates based on the useful life of assets. Accelerated CCA provides a financial benefit by deferring taxation. This incentive for investment is premised on the environmental benefits of low-emission or no-emission energy generation equipment.

## Accelerated CCA for Clean Energy Generation

Class 43.2 was introduced in 2005 and is currently available for assets acquired on or after February 23, 2005 and before 2020. For assets acquired before February 23, 2005, accelerated CCA is provided under Class 43.1 (30 per cent). The eligibility criteria for these two classes are generally the same, except that cogeneration systems that use fossil fuels must meet a higher efficiency standard for Class 43.2 than for Class 43.1. Systems that only meet the lower efficiency standard are eligible for Class 43.1.

Class 43.2 includes a variety of stationary clean energy generation or conservation equipment that is used to produce electricity or thermal energy, or used to produce certain fuels from waste that are in turn used to produce electricity or thermal energy. Subject to detailed rules in the regulations, eligible equipment includes:

### Electricity

- High efficiency cogeneration equipment;
- Wind turbines;
- Small hydroelectric facilities;
- Fuel cells;
- Photovoltaic equipment;
- Wave and tidal power equipment;
- Equipment that generates electricity using geothermal energy; and
- Equipment that generates electricity using an eligible waste fuel.

## Accelerated CCA for Clean Energy Generation *(cont'd)*

### **Thermal Energy**

- Active solar equipment;
- Ground source heat pump equipment;
- District energy equipment that distributes thermal energy from cogeneration;
- Equipment that generates heat for an industrial process or a greenhouse using an eligible waste fuel; and
- Heat recovery equipment used in electricity generation and industrial processes.

### **Fuels from Waste**

- Equipment that recovers landfill gas or digester gas;
- Equipment used to convert biomass into bio-oil; and
- Equipment used to produce biogas through anaerobic digestion.

If the majority of tangible property in a project is eligible for inclusion in Class 43.2, then certain intangible project start-up expenses (for example, engineering and design work and feasibility studies) are treated as Canadian Renewable and Conservation Expenses. These expenses may be deducted in full in the year incurred, carried forward indefinitely for use in future years, or transferred to investors using flow-through shares.

Budget 2010 proposes to expand Class 43.2 to include: (a) heat recovery equipment used in a broader range of applications; and (b) distribution equipment used in district energy systems that rely primarily on ground source heat pumps, active solar systems or heat recovery equipment.

### **Heat Recovery Equipment**

Heat recovery equipment recovers thermal waste for re-use in order to conserve energy or reduce energy requirements. For example, heat generated in the course of an industrial process can be recovered and then recycled into that process or used for space heating purposes.

Currently, heat recovery equipment in Class 43.2 is limited to that used in the recovery of heat from electrical or cogeneration equipment for reuse by such equipment to generate electricity, or in the recovery of heat generated directly in an industrial process for reuse directly in an industrial process.



Budget 2010 proposes to expand Class 43.2 to include a broader range of heat recovery equipment by removing the restrictions that require the recovered heat to be reused in a process of the same type that generated it. This will allow recovered heat to offset energy otherwise used for other productive purposes. This will encourage, for example, the installation of equipment to capture waste heat generated by a boiler in an industrial process for use in heating the plant and nearby buildings. Eligible assets will encompass only those used to extract thermal waste and will not include:

- any part of a building;
- assets related to heating water for use in a swimming pool; or
- assets employed in re-using the recovered heat (such as property that is part of the internal heating or cooling system of a building, or electrical generating equipment), though such assets may in some cases be included in another provision of Class 43.2.

By providing an incentive to invest in heat recovery equipment that can displace the use of other energy sources, such as fossil fuels, this measure will help reduce demand for primary energy and contribute to a reduction in emissions of greenhouse gases and air pollutants.

These measures will apply to eligible assets acquired on or after March 4, 2010 that have not been used or acquired for use before that date.

### **Distribution Equipment of a District Energy System**

District or community energy systems transfer thermal energy between a central generation plant and a group or district of buildings by circulating steam, hot water or cold water through a system of underground pipes. Specified distribution equipment that is part of a district energy system is currently included in Class 43.1 or 43.2 if it distributes heat produced by electrical cogeneration equipment that meets the requirements of Class 43.1 or Class 43.2, respectively.

Recent budgets have expanded Class 43.2 to include space-heating technologies such as active solar and ground-source heat pumps, which can provide low-grade energy particularly suitable for district energy systems.

Budget 2010 proposes to broaden Class 43.1 and Class 43.2 to include specified distribution equipment that is part of a district energy system used by the taxpayer to provide district heating or cooling through the use of thermal energy provided primarily by a ground source heat pump system, an active solar system, heat recovery equipment, or a combination of these energy sources, provided the generation equipment is included in Class 43.1 or Class 43.2, as the case may be.

This measure will help to increase the viability of using renewable energy sources by facilitating their use in district energy systems, which provide opportunities for efficiencies of scale. Encouraging investment in these technologies will contribute to a reduction in greenhouse gas emissions and increase diversification of Canada's energy supply.

These measures will apply to eligible assets acquired on or after March 4, 2010 that have not been used or acquired for use before that date.

### **Canadian Renewable and Conservation Expenses – Principal-Business Corporations**

If the majority of tangible property in a project is eligible for inclusion in Class 43.2, then certain project start-up expenses (for example, engineering and design work and feasibility studies) qualify as Canadian Renewable and Conservation Expenses. These expenses can be fully deducted in the year incurred or transferred to investors using flow-through shares. In order to transfer or “renounce” Canadian Renewable and Conservation Expenses to an investor using flow-through shares, a corporation must be a “principal-business corporation”.

Currently, the definition “principal-business corporation” includes a corporation the principal business of which is the generation of energy using Class 43.2 property or the development of Class 43.2 projects. Recent expansions of Class 43.2, however, have provided Class 43.2 treatment for certain assets related to energy generation even in cases where the taxpayer is not the party generating the energy.

Budget 2010 proposes that the definition “principal-business corporation” be amended to clarify that flow-through share eligibility extends to corporations the principal business of which is one, or any combination, of:

- producing fuel;
- generating energy; or
- distributing energy



using Class 43.1 or Class 43.2 property. This measure is consistent with the original policy intent of recent changes to Class 43.2 and of the proposal described above in respect of district energy equipment.

This measure will apply in respect of taxation years ending after 2004.

## **Television Set-top Boxes – Capital Cost Allowance**

The capital cost allowance (CCA) system determines how much of the capital cost of an asset a taxpayer may deduct each year. CCA rates are generally set so that the deduction of capital cost is spread over the useful life of each category of asset. This approach is meant to ensure that the tax system accurately allocates the cost of capital assets over their useful lives, resulting in a better measurement of income for tax purposes. Over time, the useful life of assets may change, for example as a result of technological advances or changes in market conditions. CCA rates are reviewed on an ongoing basis to ensure that they remain up-to-date.

Currently, satellite set-top boxes that are used to decode digital television signals are eligible for a declining-balance-CCA rate of 20 per cent under Class 8 in Schedule II to the *Income Tax Regulations*, while cable set-top boxes are eligible for a declining-balance-CCA rate of 30 per cent under Class 10 of the *Regulations*. A review of the CCA rates that apply to satellite and cable set-top boxes indicates that a higher CCA rate would better reflect the useful life of these assets.

Budget 2010 proposes that satellite and cable set-top boxes that are acquired after March 4, 2010 and that have neither been used nor acquired for use before March 5, 2010 be eligible for a declining-balance-CCA rate of 40 per cent.

## **Interest on Overpaid Taxes**

The Government pays interest in respect of overpayments of most taxes and other levies. The applicable interest rate for a quarter is equal to the average yield of three-month Government of Canada Treasury Bills sold in the first month of the preceding quarter, rounded up to the nearest percentage point, plus 2 percentage points.

The Auditor General raised concerns in her Spring 2009 report about interest paid on tax overpayments by corporations:

If the [Canada Revenue] Agency unnecessarily holds large amounts on deposit, with an obligation to pay interest when making a refund, the federal government effectively is borrowing those funds at a higher interest rate than necessary. Instead of borrowing at Treasury bill rates, it will pay a rate that is at least two percentage points higher.

Budget 2010 proposes that, effective July 1, 2010, the interest rate payable by the Minister of National Revenue to corporations will be set at the average yield of three-month Government of Canada Treasury Bills sold in the first month of the preceding quarter, rounded up to the nearest percentage point. This new rate for corporations will apply in respect of income tax, Goods and Services Tax / Harmonized Sales Tax (GST/HST), employment insurance premiums, Canada Pension Plan contributions, excise tax and duty (except in respect of excise duty on beer), the Air Travellers Security Charge and the softwood lumber products export charge. The interest rate calculations in respect of non-corporate taxpayers will not change.

## **Federal Credit Unions**

Consequential to the Budget 2010 proposal to allow for the establishment of federal credit unions, certain amendments may be required to the *Income Tax Act* to provide that federal credit unions that satisfy the existing definition “credit union” in the *Income Tax Act* will be subject to the same income tax rules as other credit unions.

## **SIFT Conversions and Loss Trading**

The *Income Tax Act* includes provisions intended to allow specified investment flow-through (SIFT) trusts and partnerships – commonly referred to as income trusts and partnerships – to convert their structures into corporate form on a tax-deferred basis. Aggressive schemes have been designed to use these provisions to achieve inappropriate tax loss trading that would not be allowed as between two corporations.



In particular, the ability of a corporation to utilize its tax losses is constrained where control of the corporation has been acquired. In the case of a “reverse takeover” of a public corporation, an existing rule in the *Income Tax Act* generally deems there to be an acquisition of control of the public corporation in situations where shares of the public corporation are exchanged for shares of another corporation. Budget 2010 proposes to extend this rule to ensure that it also applies to impose restrictions on the use of losses in situations where units of a SIFT trust or SIFT partnership are exchanged for shares of a corporation.

Budget 2010 also proposes to amend the acquisition-of-control rules in the *Income Tax Act* to ensure that they do not inappropriately restrict the use of losses where a SIFT trust is wound up and distributes the shares of a corporation it holds. The rules will be amended to provide that where a SIFT trust, the sole beneficiary of which is a corporation, owns shares of another corporation, the wind-up of the trust will not cause an acquisition of control of the other corporation and restrict the subsequent use of that corporation’s losses.

It is proposed that these amendments apply to transactions undertaken after 4:00 p.m. Eastern Standard Time on March 4, 2010, other than transactions that the parties are obligated to complete pursuant to the terms of an agreement in writing between the parties entered into before that time. A party shall be considered not to be obligated to complete a transaction if the party may be excused from completing the transaction as a result of changes to the *Income Tax Act*. These amendments will also apply to other SIFT conversion transactions if the parties to the transaction make the appropriate election.

## International Taxation

### Section 116 and Taxable Canadian Property

Canada taxes non-residents on their income and gains from the disposition of “taxable Canadian property”. Where such property is disposed of by a non-resident, generally the purchaser must withhold a portion of the amount paid, and remit it to the Government on account of the non-resident vendor’s potential Canadian tax liability. However, the purchaser’s obligation to withhold does not apply if the non-resident vendor obtains a “clearance certificate” from the Canada Revenue Agency. To obtain a clearance certificate, the non-resident vendor needs to remit an amount, post security, or satisfy the Canada Revenue Agency that no tax will be owing. These rules are contained in section 116 of the *Income Tax Act*.

Taxable Canadian property includes shares of corporations resident in Canada, as well as real or immovable property (including Canadian resource property and timber resource property) that is situated in Canada. It also includes certain shares and other interests the value of which is, or was within the previous 60 months, derived principally from such real or immovable property. Gains from dispositions of taxable Canadian property by non-residents, other than of taxable Canadian property that is real or immovable property or shares that derive their value principally from real or immovable property, are generally exempt under many of Canada’s tax treaties.

Dispositions of shares of corporations resident in Canada that do not derive their value principally from real or immovable property are still subject to the withholding process contained in section 116 of the *Income Tax Act*, regardless of the possibility of a treaty exemption. It was with this in mind that Budget 2008 implemented certain changes to streamline and simplify the section 116 compliance process.

Building upon the measures introduced in Budget 2008, Budget 2010 proposes that the definition of taxable Canadian property in the *Income Tax Act* be amended to exclude shares of corporations, and certain other interests, that do not derive their value principally from real or immovable property situated in Canada, Canadian resource property, or timber resource property (subject to the 60 month rule mentioned above). This measure will eliminate section 116 compliance obligations for these types of properties and will also bring Canada’s domestic tax rules more in line with our tax treaties and the tax laws of our major trading partners.



Narrowing the definition of taxable Canadian property will eliminate the need for tax reporting under section 116 of the *Income Tax Act* for many investments, enhancing the ability of Canadian businesses, including innovative high-growth companies that contribute to job creation and economic growth, to attract foreign venture capital.

This measure will apply in determining after March 4, 2010 whether a property is taxable Canadian property of a taxpayer.

## **Refunds under Regulation 105 and Section 116**

Section 105 of the *Income Tax Regulations* and section 116 of the *Income Tax Act* impose requirements on payors of funds to non-resident service providers and purchasers of taxable Canadian property from non-residents, respectively, to withhold and remit to the Canada Revenue Agency a portion of the amount paid to the non-resident in certain circumstances. The amounts are to be withheld and remitted on account of the non-resident's potential Canadian tax liability. The obligation to withhold and remit can arise even where the non-resident is not liable for Canadian tax, for example because of protection under an applicable tax treaty.

Section 164 of the *Income Tax Act* permits a taxpayer to receive a refund of tax overpaid for a taxation year provided that the taxpayer has filed its income tax return for the year in question within the period prescribed in the *Income Tax Act*. A unique problem affecting non-residents has been noted in the interaction of the prescribed time limits to obtain a refund and the lack of a deadline for the Canada Revenue Agency to assess a payor who fails to withhold taxes. In some circumstances, this interaction could result in the non-resident being unable to recoup any overpayment of tax.

Budget 2010 proposes an amendment to section 164 of the *Income Tax Act* to also permit the issuance of a refund of an overpayment of tax under Part I of the *Income Tax Act* if the overpayment is related to an assessment of the payor or purchaser in respect of a required withholding under section 105 of the *Income Tax Regulations* or section 116 of the *Income Tax Act* and 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.

## Foreign Tax Credit Generators

The Canadian income tax system generally taxes Canadian residents on their worldwide income. However, in recognition of the fact that foreign countries may also assert the right to tax income earned in their territory by a Canadian resident, Canada generally provides a credit for foreign income taxes paid in respect of such income. This foreign tax credit (FTC) is aimed at relieving Canadian residents from double taxation.

Similar relief is provided in the computation of the income of a foreign affiliate that is subject to tax in the hands of its Canadian shareholder. This relief is provided either through the foreign accrual tax (FAT) mechanism, in the case of the foreign accrual property income (FAPI) of a controlled foreign affiliate, or through the underlying foreign tax (UFT) mechanism, in the case of dividend distributions out of taxable surplus.

Some Canadian corporations have recently been engaging in schemes, often referred to as “foreign tax credit generators”, that are designed to shelter tax otherwise payable in respect of interest income on loans made, indirectly, to foreign corporations. These schemes artificially create foreign taxes that are claimed by the Canadian corporation as a FTC, or a FAT or UFT deduction, in order to offset Canadian tax otherwise payable.

There are two main categories of these schemes, and many variations within these categories. The first category involves the use of a foreign partnership, the second involves the use of a foreign corporation that is intended to qualify as a foreign affiliate. The main thrust of all of these schemes is to exploit asymmetry, as between the tax laws of Canada and those of a foreign country, in the characterization of the Canadian corporation’s direct or indirect investment in a foreign entity earning the income that is subject to the foreign tax.



These foreign tax credit generator schemes generally involve a complex series of transactions which, in substance, amount to a Canadian corporation making a loan to a corporation resident in a foreign jurisdiction that taxes on the basis of the substantive effect of the transaction, while relying on Canadian tax law looking only to the form of the transaction. The form is that of an investment by the Canadian corporation in a foreign special purpose entity which pays full foreign tax on an amount of income that is, in part, the return derived on the Canadian taxpayer's investment. However, 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, the interest income on that loan would generally not be subject to any foreign tax. As such, no FTC, nor any UFT or FAT deduction, would be available in Canada and full Canadian tax would be levied on the interest income in respect of that loan. By using these foreign tax credit generator schemes, the foreign corporation receives the same substantive foreign tax treatment as it would for a simple borrowing but the Canadian corporation is able to claim an FTC, or a UFT or FAT deduction, in order to partly or fully offset its Canadian tax otherwise payable in respect of its interest income. The Canadian tax savings are generally shared between the Canadian lender and the foreign borrower in determining the terms of the loan and related matters.

Although the Government believes that these foreign tax credit schemes can be successfully challenged under existing rules in the *Income Tax Act*, the magnitude of this problem warrants greater assurance through specific and immediate legislative action. Consequently, Budget 2010 proposes measures that will deny claims for FTCs, and FAT and UFT deductions, in circumstances in which the income tax law of the jurisdiction levying the foreign income tax, or another relevant jurisdiction, considers the Canadian corporation to have a lesser direct or indirect interest in the foreign special purpose entity than the Canadian corporation is considered to have for the purposes of the *Income Tax Act*. This measure should generally put the Canadian corporation in the same tax position as if it had made a simple loan to the foreign corporation.

This measure is proposed to be effective for foreign taxes incurred in respect of taxation years that end after March 4, 2010. The Government will be accepting comments in the finalization of the legislation to implement this measure and encourages stakeholders to submit any such comments before May 4, 2010.

## Foreign Investment Entities and Non-Resident Trusts

The *Income Tax Act* includes rules designed to prevent Canadians from using foreign intermediaries to avoid paying their fair share of tax. However, the rules are not fully effective in certain circumstances where aggressive offshore tax-planning schemes are used to circumvent their application.

The Government continues to make efforts to ensure that appropriate rules exist to counter these schemes. Most recently, proposals for amendments were tabled during the second session of the 39<sup>th</sup> Parliament. Those proposals were not enacted before Parliament was dissolved in September 2008. Budget 2009 stated that the Government would review the outstanding proposals before proceeding with measures in this area. As a result of this review, the Government has developed the following revised proposals to replace the outstanding proposals for public consultation with a view to developing revised legislation, which will then also be released for comment.

### Foreign Investment Entities

The revised proposals replace the outstanding proposals with respect to foreign investment entities with the following limited enhancements to the existing rules in the *Income Tax Act*:

- Section 94.1 of the *Income Tax Act* currently requires an income inclusion with respect to interests in an “offshore investment fund property” in certain circumstances. It is proposed that the prescribed rate applicable in computing the income inclusion for an interest in an offshore investment fund property be increased to the three-month-average Treasury Bill rate plus two percentage points. This increase in the prescribed rate is intended to better reflect actual long-term investment returns.
- Section 94 of the *Income Tax Act* currently requires certain beneficiaries of a non-resident trust that is not otherwise deemed resident in Canada to report income on a modified foreign accrual property income basis where the fair market value of the beneficiary’s interest in the trust exceeds 10 per cent of the value of all interests in the trust. It is proposed that these rules be broadened to apply to any resident beneficiary who, together with any person not dealing at arm’s length with the beneficiary, holds 10 per cent or more of any class of interests in a non-resident trust determined by fair market value. They will also apply to any resident who has contributed “restricted property” (as proposed to be defined, which is described below) to a non-resident trust. These changes will be relevant for beneficiaries of non-resident trusts that are not deemed resident in Canada by the revised proposals discussed below.



- It is proposed that the relevant reassessment period in respect of interests in offshore investment fund property and interests in trusts described in the previous paragraph be extended by three years. It is also proposed that the existing reporting requirements with respect to “specified foreign property” be expanded so that more detailed information is available for audit use. These additional measures are needed to ensure that the Canada Revenue Agency has the information and time required to identify and reassess those taxpayers who have not properly reported their income from transactions involving offshore investment fund properties and non-resident trusts.

## **Non-Resident Trusts**

The revised proposals are based on the outstanding proposals with respect to non-resident trusts, but with substantial modifications meant to simplify the outstanding proposals and to better target arrangements that seek to avoid paying the appropriate amount of Canadian tax.

### ***Scope of the Rules***

The existing rules in the *Income Tax Act* deem a non-resident discretionary trust to be resident in Canada if it has a Canadian contributor and a related Canadian beneficiary. Such a trust is required to pay tax on its income in the same manner as other residents of Canada. The Canada Revenue Agency, however, has identified complex tax-planning arrangements that attempt to frustrate the fundamental policy objectives of these rules. The outstanding proposals were intended to prevent this type of tax avoidance by broadening the scope of non-resident trusts to which deemed residence would apply.

The outstanding proposals would have applied to non-resident trusts (other than exempt foreign trusts) with a resident contributor regardless of the current existence of a Canadian beneficiary. They would have also applied where the non-resident trust had a Canadian beneficiary and the contributor had been resident in Canada within 60 months of having made the contribution to the trust (referred to as a resident beneficiary under the outstanding proposals). A deemed resident trust would have been taxed on all of its income, regardless of who contributed the property upon which the income was earned or the source of the income. The outstanding proposals would have generally made both resident contributors and resident beneficiaries jointly and severally, or solidarily, liable for tax payable by a trust deemed resident.

The Government has received representations from taxpayers citing the complexity of the outstanding proposals and the difficulty for taxpayers in proceeding with legitimate, non-tax-motivated transactions because of uncertainty as to how those proposals would apply in a variety of particular situations. It is proposed that the scope of the outstanding proposals be simplified and better targeted in several ways.

First, concerns have been expressed that the outstanding proposals would have inadvertently caused a Canadian tax-exempt entity, such as a pension plan, that invested in a non-resident trust to become jointly and severally, or solidarily, liable for the trust's income tax liability despite its tax-exempt status under the *Income Tax Act*. 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 *Income Tax Act* (for example, pension funds, Crown corporations and registered charities). However, if a tax-exempt entity were to be used as a conduit to allow a resident of Canada to make an indirect contribution to a non-resident trust, provisions in the outstanding proposals would continue to ensure that the resident of Canada making the indirect contribution is still considered a resident contributor to the trust.

Secondly, concerns have been raised that under the outstanding proposals, an investor would be unable to determine with certainty whether any particular commercial trust would be deemed resident in Canada. Concerns have also been raised about the possibility that a commercial trust might be deemed resident in Canada due to circumstances beyond the investor's control. It has been argued that these uncertainties with respect to the potential application of the outstanding proposals deter genuine commercial investments from being made.

It is not intended that investments in *bona fide* commercial trusts be deterred; nor is it intended that *bona fide* commercial trusts be deemed resident in Canada. Consequently, it is proposed that the provision in the outstanding proposals that would have imposed deemed Canadian residence on a trust by reason only of the trust acquiring or holding restricted property be eliminated. This change will have the effect of expanding the exemption for commercial trusts under paragraph (b) of the definition "exempt foreign trust" in the outstanding proposals. Furthermore, a commercial trust will not be deemed resident in Canada if the trust satisfies all the following conditions:

- each beneficiary is entitled to both the income and capital of the trust;



- any transfer of an interest by a beneficiary results in a disposition for the purposes of the *Income Tax 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 interests;
- 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 (discretion only with respect to the timing of distributions will not prevent a trust from being an exempt foreign trust);
- 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 the beneficiaries or, in the case of a widely held trust, a majority of the beneficiaries; and
- the trust is not a personal trust.

A commercial trust that is varied in a non-permitted way will lose its status as an exempt foreign trust and, at that time, will be taxable on all the trust's income that has been accumulated (together with an interest amount) since the time it first acquired a resident beneficiary or resident contributor. Taxing the trust on its accumulated income in this manner reflects the fact that the trust would not have qualified as an exempt foreign trust in the first place had the terms of the trust always provided for the trust to be varied in that manner; and consequently, the trust should have been subject to tax in Canada in earlier years. This new anti-avoidance rule is intended to reduce the incentive for Canadians to seek to avoid tax on their personal investments by structuring an arrangement to mimic a genuine commercial trust. However, recognizing that legitimate circumstances may exist 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 under a *de minimus* threshold.

Thirdly, as a result of the proposed changes to the definition “exempt foreign trust”, the role of restricted property will be significantly reduced. Restricted property will, however, remain relevant for certain other purposes (for example, in determining whether a particular transfer of property results in an “arm’s length transfer” as defined in the outstanding proposals). It is proposed that the definition “restricted property” 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” (as defined in the outstanding proposals being, generally, shares with fixed entitlement rights) of a closely-held corporation were issued at a tax cost less than their fair market value.

Finally, it was noted that under the outstanding proposals a conventional loan made by a Canadian financial institution to a non-resident trust in the ordinary course of its business could be viewed as a contribution to that trust, if as part of the terms and conditions of the loan, there was a potential for a transfer of restricted property between the parties (on default of the loan, for example). It is proposed that a new rule be added to ensure 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.

### *Application of the Rules*

#### Taxation of a Deemed Resident Trust

Where a non-resident trust has a resident beneficiary or a resident contributor, the outstanding proposals would have imposed tax on all of the trust’s income and generally made the resident beneficiaries and resident contributors jointly and severally, or solidarily, liable for that tax. It is proposed that a number of refinements to the taxation of a trust deemed resident in Canada be made. For this purpose, it is proposed that the trust’s property 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 any property that is not part of the resident portion.

It is proposed that any income arising from property that is part of the non-resident portion, other than income from sources in Canada upon which non-residents are normally required to pay tax, be excluded from the trust’s income for Canadian tax purposes. In addition, it is proposed that the trust’s income be attributed to its resident contributors in proportion to their relative contributions to the trust (discussed below). The trust will be entitled to a deduction for both the amount of its income that is payable to its beneficiaries in the year and for amounts attributed to resident contributors. As a result, the trust itself will ordinarily pay tax in Canada only on income derived from contributions of certain former resident contributors.



It is proposed that, when income of the trust is not distributed to beneficiaries, the amount of the accumulated income for the relevant taxation year 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.

In addition, it is proposed that ordering rules be introduced with respect to distributions to beneficiaries of the trust. 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.

It has been noted that the outstanding proposals do not fully recognize the foreign taxes paid to another country that also treats the trust as a resident for tax purposes. It is proposed to address this concern by permitting a trust that is deemed to be resident in Canada under these rules 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, irrespective of the limits under subsection 20(11) of the *Income Tax Act* but up to the Canadian tax rate (which generally limits the foreign tax credit in respect of property income to 15% of the foreign income).

### Attribution

As noted, the outstanding proposals would have generally made both resident contributors and resident beneficiaries jointly and severally, or solidarily, liable for tax payable by a trust deemed resident. This liability has raised concerns on the basis that resident contributors could be held liable for tax on income that has no connection with the property they contributed to the trust.

In response to these concerns, it is proposed that resident contributors to a trust that is deemed to be resident under these rules be attributed, and taxed on, their proportionate share of the trust's income for Canadian tax purposes. They will not be jointly and severally, or solidarily, liable for the trust's own income tax obligations (although resident beneficiaries will be liable with respect to the trust's income tax payable to the same extent as under the outstanding proposals).

The income attributed to resident contributors will generally be based on the proportion of the fair market value of their 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. When a resident contributor dies or otherwise ceases to be resident in Canada in a year, the income to be attributed to that person for that year will be limited to the relevant portion of the trust's income earned to the date of death or departure, as the case may be.

As part of the attribution rules, the amount attributed to resident contributors will be reduced by the amount of losses of other years claimed by the trust. In addition, it is proposed that a trust be able to designate a reasonable portion of its foreign tax credit to those contributors to whom amounts have been attributed, in a manner similar to the allocation of foreign tax credits to beneficiaries under the existing rules.

It is further proposed that the relevant reassessment period for income in respect of trusts subject to these rules be extended by three years. As indicated above with respect to foreign investment entities, this will assist the Canada Revenue Agency in identifying and reassessing those taxpayers who have not properly reported their income from transactions involving these trusts.

It is further proposed that the *Income Tax Conventions Interpretation Act* 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 *Income Tax Act* for tax treaty purposes. One of the major purposes of Canada's tax treaties is to prevent tax avoidance and tax evasion. These proposals are anti-avoidance rules aimed at ensuring that residents of Canada pay tax on their worldwide income and as such, they are consistent with Canada's treaty obligations.

## **Date of Application**

It is proposed that the measures regarding foreign investment entities apply for taxation years that end after March 4, 2010. A taxpayer who voluntarily complied with the outstanding proposals in previous years will have the option of having those years reassessed. If the taxpayer does not wish to be reassessed for those years, and had more income than would have been the case under the existing rules, the taxpayer will be entitled to a deduction in the current year for the excess income.



It is proposed that the measures regarding non-resident trusts apply for the 2007 and subsequent taxation years. An election allowing a trust to be deemed resident for the 2001 and subsequent taxation years will be available. The attribution of trust income to resident contributors will apply only to taxation years that end after March 4, 2010.

## **Public Consultation Process**

The revised proposals described above will be subject to a consultation process before being tabled in Parliament. The public is welcomed and encouraged to submit comments with respect to these proposals before May 4, 2010. A panel consisting of respected tax practitioners will be formed to work with the Department of Finance in reviewing any issues identified in comments received and in making recommendations on the design of the draft legislation to implement the revised proposals, following which draft legislation will be released for public commentary.

## **Sales Tax Measures**

### **GST/HST and Purely Cosmetic Procedures**

Basic health care services are exempt from the Goods and Services Tax/Harmonized Sales Tax (GST/HST). Purely cosmetic procedures, as well as goods and services related to these procedures, are not considered to be basic health care and are subject to tax. For instance, the GST/HST legislation currently specifies that surgical and dental services performed for cosmetic purposes and not for medical or reconstructive purposes are taxable.

Budget 2010 proposes to clarify that GST/HST applies to all purely cosmetic procedures, to devices or other goods used or provided with cosmetic procedures, and to services related to cosmetic procedures. Taxable procedures would generally include surgical and non-surgical procedures aimed at enhancing one's appearance such as liposuction, hair replacement procedures, botulinum toxin injections, and teeth whitening.

A cosmetic procedure will continue to be exempt if it is required for medical or reconstructive purposes, such as surgery to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. As well, cosmetic procedures paid for by a provincial health insurance plan will continue to be exempt.

The proposed clarifying measures will apply to supplies made after March 4, 2010 and to supplies made on or before March 4, 2010 if the supplier charged, collected or remitted GST/HST in respect of the supply.

## **Simplification of the GST/HST for the Direct Selling Industry**

The direct selling industry distributes goods to final consumers through a large number of contractors and sales representatives, rather than through retail establishments. The direct selling industry generally employs two business models:

- the buy and resell model, where contractors purchase goods from a direct seller and resell the goods to consumers with a mark-up; and
- the commission-based model, where a network of sales representatives of a direct selling organization (referred to as a “network seller”) receives commissions for arranging for the sales of the network seller’s goods (“select products”) to consumers.

To simplify the operation of the Goods and Services Tax/Harmonized Sales Tax (GST/HST) for network sellers employing the commission-based model, Budget 2009 proposed allowing network sellers that meet certain qualification criteria to apply for the use of a special GST/HST accounting method. Simplified GST/HST accounting already exists under the *Excise Tax Act* for direct sellers that utilize the buy and resell model.

Budget 2010 confirms the Government’s intention to implement the Budget 2009 proposals for simplification of the GST/HST for the direct selling industry and proposes the following enhancements and clarifications to the previously announced measure:

- a clarification that new entrants in the direct selling industry, who meet the qualification criteria and who have never before made a supply of a select product, may apply to the Minister of National Revenue at any time during a fiscal year for approval to use the special GST/HST accounting method for network sellers;
- a clarification that the supply of host gifts by a network seller to hosts would not be subject to the GST/HST; and



- a “safety mechanism” for a network seller that does not meet the qualification criterion concerning the commissions paid by the network seller to its sales representatives for a particular fiscal year; as a result of this “safety mechanism”, there would be no adjustment to the GST/HST net tax of a network seller in respect of:
  - the first fiscal year that the network seller fails to meet the requirement that all or substantially all of its sales representatives have annual commissions not exceeding \$30,000, provided that at least 80 per cent of the sales representatives have annual commissions from the network seller not exceeding \$30,000 in that first fiscal year; or
  - the second fiscal year that the network seller fails to meet the above-noted requirement, provided that the network seller requests in writing, within the first six months of that second fiscal year, that the Minister of National Revenue revoke its approval to use the special GST/HST accounting method and provided that at least 80 per cent of the sales representatives have annual commissions from the network seller not exceeding \$30,000 in that second fiscal year.

Budget 2010 proposes that these enhancements apply in respect of fiscal years of a network seller that begin after 2009, matching the timing of the Budget 2009 proposals. A network seller, other than a new entrant, will be required to apply for approval to use the special GST/HST accounting method before the first day of the fiscal year of the network seller in respect of which that method is to begin applying. However, for a fiscal year of the network seller beginning in 2010, it is also proposed that a transitional measure allow a network seller to apply in 2010 for approval to start using the special GST/HST accounting method in 2010 in respect of the remaining part of that fiscal year.

## Other Tax Measures

### Specified Leasing Property Rules

Arrangements to acquire and finance depreciable assets can have varying tax implications depending upon how the arrangement is structured. A taxpayer could borrow money from a financial institution to finance the acquisition, putting the property up as security for the loan, or lease the property from a financial institution that acquired the property for the purpose of leasing it to the taxpayer. Thus, economically, a lease and a loan are highly substitutable. The main difference between the two is the fact that they result in title to the asset being in different hands: in the case of a lease, the financial institution holds the title, whereas in the case of a loan the taxpayer holds this title.

However, unlike accounting rules, the income tax law does not reclassify the legal nature of lease arrangements. Because the income tax law looks at ownership to determine who may claim capital cost allowance, leases have been used to transfer capital cost allowance deductions from the user of an asset to the person financing its acquisition. To seek to neutralize the tax consequences of substituting a lease for a loan, the existing Specified Leasing Property rules in the *Income Tax Regulations* effectively recharacterize such a lease from the lessor's perspective to be a loan, with the lease payments received being treated as blended payments of principal and interest. The rules restrict a lessor's claim for capital cost allowance on the leased property to the lesser of the amount of capital cost allowance that would otherwise be deductible and the amount of lease payments received, less a calculation of notional interest amount for the year. In effect, the Specified Leasing Property rules put lessors in the same position as lenders who receive blended payments of principal (non-taxable) and interest (taxable).

The Specified Leasing Property rules contain certain exceptions. In particular, they do not apply to short-term leases or to leases of property with a value of less than \$25,000, since generally such leases provide an immaterial tax benefit or do not, in substance, provide financing to the lessee. The rules also include an exception for certain types of property ("exempt property").

Some taxpayers have exploited these exemptions by leasing exempt property, and claiming capital cost allowance in respect of that property, to a lessee who is not subject to Canadian income tax and therefore cannot make use of the capital cost allowance, either because the lessee is tax-exempt or non-resident.



Budget 2010 proposes to extend the application of the Specified Leasing Property rules to otherwise exempt property that is the subject of a lease to a government or other tax-exempt entity, or to a non-resident. However, such a lease will continue to be exempt if the total value of the property that is the subject of the lease is less than \$1 million. In this regard, an anti-avoidance rule will apply if it may reasonably be considered that one of the purposes of dividing property (or a class of property) among separate leases is to meet the \$1 million exception.

These measures will apply to leases entered into after 4:00 p.m. Eastern Standard Time March 4, 2010.

## **Information Reporting of Tax Avoidance Transactions – Public Consultation**

Budget 2010 announces a public consultation on proposals to require the reporting of certain tax avoidance transactions. The Government will undertake consultations with stakeholders on these proposals, with a view to improving the fairness of the Canadian tax system. Details of these proposals will be released at the earliest opportunity and the consultation process will be announced at that time.

The fairness of the Canadian income tax system is essential to ensure the integrity of Canada's self-assessment system. Ensuring this fairness requires a balancing between a taxpayer's entitlement to plan their affairs in a manner that legally minimizes their tax liability and the need to ensure that the tax law is not abused. Aggressive tax planning arrangements entered into by some taxpayers can undermine the tax base and the fairness and integrity of the tax system, to the detriment of all Canadians.

The *Income Tax Act* already contains a number of substantive rules intended to counter aggressive tax planning. In some cases, these rules help identify certain transactions and their participants. In other cases, the rules deny the tax benefits sought to be obtained (including, but not limited to, the General Anti-Avoidance Rule).

However, in order to be able to effectively apply these substantive rules, the Canada Revenue Agency must be able to identify aggressive tax planning in a timely manner. In this regard, there are already information reporting requirements for tax shelters, as defined in the *Income Tax Act*. The reporting regime for tax shelters assists the Canada Revenue Agency to ensure that the benefits provided by a tax shelter are not unintended, inappropriate or contrary to a provision of the tax law. However, a significant number of aggressive tax planning arrangements do not meet the definition in the law of a tax shelter. Currently, there is no specific information reporting regime that identifies for the Canada Revenue Agency other types of potentially abusive tax avoidance transactions.

Budget 2010 therefore proposes a regime under which a tax “avoidance transaction” that features at least two of three “hallmarks” would be a “reportable transaction” that must be reported to the Canada Revenue Agency. The proposed hallmarks would reflect certain circumstances that commonly exist when taxpayers enter into tax avoidance transactions. Although the hallmarks are not themselves evidence of abuse, their presence often indicates that underlying transactions are present that carry a higher risk of abuse of the income tax system. In this regard, the proposed regime is similar to, but less strict than, the reporting regimes of other jurisdictions that use hallmarks as a means of identifying aggressive tax planning, such as those of the United States, the United Kingdom and most recently, the Province of Québec. This would minimize the possibility that normal tax planning would be subject to these proposals.

For this purpose, a reportable transaction would be an avoidance transaction, as currently defined in the *Income Tax Act*, that is entered into by or for the benefit of a taxpayer that bears at least two of the following three hallmarks:

1. A promoter or tax advisor in respect of the transaction is entitled to fees that are to any extent
  - attributable to the amount of the tax benefit from the transaction,
  - contingent upon the obtaining of a tax benefit from the transaction, or
  - attributable to the number of taxpayers who participate in the transaction or who have been provided access to advice given by the promoter or advisor regarding the tax consequences from the transaction.
  
2. A promoter or tax advisor in respect of the transaction requires “confidential protection” about the transaction.



3. The taxpayer or the person who entered into the transaction for the benefit of the taxpayer obtains “contractual protection” in respect of the transaction (otherwise than as a result of a fee described in the first hallmark).

A transaction that is a tax shelter or a flow-through share arrangement will not be impacted by these proposals, but will be subject to the existing requirements for tax shelters and flow-through shares.

Upon discovery of a reportable transaction that has not been reported when required, the Canada Revenue Agency could deny the tax benefit resulting from the transaction. If the taxpayer still wanted to claim the tax benefit, it would be required to file with the Canada Revenue Agency any required information and to pay a penalty. The disclosure of a reportable transaction would have no bearing on whether the benefit is allowed under the law; rather it would simply assist the Canada Revenue Agency in identifying the transaction. In this regard, the disclosure of a reportable transaction would not be considered in any way as an admission that the General Anti-Avoidance Rule applies to the transaction.

These proposals, as modified to take into account the consultations, would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

## **Online Notices**

In 2000 the *Personal Information Protection and Electronic Documents Act* introduced a legislative framework by which requirements in federal statutes and regulations, which contemplate the use of paper or do not expressly permit the use of electronic technology, may be administered or complied with in the electronic environment. This gave the Canada Revenue Agency general legislative authority to provide information electronically in most circumstances. However, the provisions of some of the various statutes dealing with notices issued by the Canada Revenue Agency were enacted at a time when electronic alternatives were not contemplated. As a result of the specific language of these provisions, some notices cannot be provided in electronic format even with the general permission accorded by the *Personal Information Protection and Electronic Documents Act*. As such, taxpayers can receive notices, such as notices of assessment under the *Income Tax Act*, from the Canada Revenue Agency only through the mail system or personally.

Budget 2010 proposes that the *Income Tax Act*, *Excise Tax Act*, *Excise Act, 2001*, *Air Travellers Security Charge Act*, *Canada Pension Plan* and *Employment Insurance Act* be amended to allow for the electronic issuance of those notices that can currently be sent by ordinary mail. However, notices that are specifically required to be served personally or by registered or certified mail will not be eligible to be transmitted electronically.

These measures will provide the Canada Revenue Agency with the legislative authority to issue electronic notices, if authorized by a taxpayer, which will be made available on the Canada Revenue Agency's existing secure online platforms (My Account and My Business Account). The Canada Revenue Agency will inform taxpayers that provide such authorization that a new electronic document is available in their secure online account by sending the taxpayer an email to that effect. The Canada Revenue Agency intends to provide this service in respect of notices of assessment and reassessment of tax under Part I of the *Income Tax Act*, and notices of determination and re-determination in respect of the Goods and Services Tax / Harmonized Sales Tax (GST/HST) credit and the Canada Child Tax Benefit. Legislative authority will also be provided to the Canada Revenue Agency to issue electronic notices for GST/HST, excise tax and duty (other than the duty on beer), and the Air Travellers Security Charge.

The necessary legislative amendments will be effective as of the date of Royal Assent of the implementing legislation. However, the application of these measures will commence at such time as will be announced by the Minister of National Revenue.

## **Tax Evasion and the Proceeds of Crime and Money Laundering Regime**

The *Criminal Code* was amended in December 2001 as part of an internationally coordinated effort by developed countries to counter criminal and terrorist activities. The proceeds of crime and money laundering regime in the *Criminal Code* provides the Crown, in respect of certain criminal and terrorist activities, with enhanced powers to search, to seize and to retain proceeds of crime and to apply minimum terms of imprisonment to convicted criminals and terrorists who do not forfeit their proceeds of crime. In such cases, Canada is also assisted in investigating these serious offences (referred to as "designated offences" in the *Criminal Code*) by foreign governments under mutual legal assistance treaties.



Provisions in the *Criminal Code* can be applied to prosecute tax evasion offenses that constitute fraud, in which case the proceeds of crime and money laundering regime may be applicable. Indictable tax offences prosecuted under the *Income Tax Act*, the *Excise Tax Act*, the *Excise Act* (except for subsections 233(1) and 240(1)) and the *Budget Implementation Act, 2000*, however, were excluded from falling within the ambit of the proceeds of crime and money laundering regime.

Budget 2010 proposes to rationalize the rules concerning the application of the proceeds of crime and money laundering regime, and provide further support for international efforts to counter criminal and terrorist activities, by repealing the exclusion for indictable tax offences under the *Income Tax Act*, the *Excise Tax Act*, the *Excise Act*, and the *Budget Implementation Act, 2000* from the definition of “designated offence” under the *Criminal Code*, such that the Crown will be able to prosecute these tax offences using that regime, regardless of whether prosecuted under the *Criminal Code* fraud provisions or the tax statutes. Budget 2010 also proposes consequential amendments to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* consistent with the proposal above with respect to the *Criminal Code*.

## **Taxation of Corporate Groups**

Over the last several years, the Government has taken significant steps to improve the competitiveness of the tax system for Canadian businesses, and followed through on *Advantage Canada* commitments to reduce taxes on business investment. However, there are still specific structural elements of the tax system where it may be possible to make improvements. For example, the Government has heard various concerns from the business community and from the provinces regarding the utilization of tax losses within corporate groups. Going forward, the Government will explore whether new rules for the taxation of corporate groups - such as the introduction of a formal system of loss transfers or consolidated reporting – could improve the functioning of the tax system. Stakeholder views will be sought prior to the introduction of any changes.

## **Aboriginal Tax Policy**

Taxation is an integral part of good governance as it promotes greater accountability and self-sufficiency and provides revenues for important public services and investments. Therefore, the Government of Canada supports initiatives that encourage the exercise of direct taxation powers by Aboriginal governments.

To date, the Government of Canada has entered into 32 sales tax arrangements under which Indian Act bands and self-governing Aboriginal groups levy a sales tax within their reserves or their settlement lands. In addition, 12 arrangements respecting personal income taxes are in effect with self-governing Aboriginal groups under which they impose a personal income tax on all residents within their settlement lands. The Government reiterates its willingness to discuss and put into effect direct taxation arrangements with interested Aboriginal governments.

The Government of Canada also supports direct taxation arrangements between interested provinces or territories and Aboriginal governments and enacted legislation to facilitate such arrangements in 2006.

## Customs Tariff Measures

### Tariff Reductions on Manufacturing Inputs and Machinery and Equipment

Budget 2010 proposes to eliminate the remaining tariffs on manufacturing inputs and machinery and equipment. The Department of Finance consulted extensively with stakeholders in preparing this measure, including through the publication of a notice in the *Canada Gazette* on September 19, 2009.

This measure will assist Canadian industry by lowering the costs of manufacturing inputs and machinery and equipment that are imported from outside North America. Tariffs on the affected goods vary from 2 per cent to 15.5 per cent and represent a non-recoverable tax on production inputs and on new investments that companies make in order to enhance their competitiveness and productivity.

The reductions apply to 1,541 tariff items as currently listed in the Schedule to the *Customs Tariff*. For these items, the Most-Favoured-Nation (MFN) rates of duty will be reduced to “Free” as outlined in the Notice of Ways and Means Motion to Amend the *Customs Tariff*. Of these:

- 1,160 tariff items will have the MFN rates of duty reduced to “Free” as of March 5, 2010; and
- 381 tariff items will have the MFN rates of duty gradually reduced, beginning as of March 5, 2010 and going to “Free” by no later than January 1, 2015.



In certain instances, these MFN reductions will lead to consequential reductions to the rates of duty under other tariff treatments, namely the General Preferential Tariff, the Costa Rica Tariff, the Peru Tariff, the Australia Tariff and the New Zealand Tariff. In a few instances, additional tariff items will be created to take into consideration comments received from stakeholders.

The tariff reductions will be given effect by amendments to the *Customs Tariff* and will be effective in respect of goods imported into Canada on or after March 5, 2010.

## Previously Announced Measures

Budget 2010 confirms the Government's intention to proceed with the following previously-announced tax measures, as modified to take into account consultations and deliberations since their release:

- Paperwork Burden Reduction Initiative for small excise taxpayers announced by the Minister of National Revenue on March 31, 2009;
- Enhanced tobacco stamping regime to deter contraband tobacco released on August 6, 2009;
- Improvements to the application of the GST/HST to the financial services sector released on September 23, 2009;
- Additional measure proposed in relation to the Canada-U.S. Softwood Lumber Agreement contained in the detailed Notice of Ways and Means Motion to amend the *Softwood Lumber Products Export Charge Act, 2006*, tabled in 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 on 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 form 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 the 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.