

Taxation Bulletin

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Tax Measures in Budget 2010

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The Federal Budget 2010 (the “Budget”) contains many proposed amendments to the *Income Tax Act* (Canada) (the “Act”) and the *Excise Tax Act* (Canada) (the “ETA”), which range from providing legislative authority to the Canada Revenue Agency (the “CRA”) to issue electronic notices to those that reflect significant changes in tax policy, such as amendments to the definition of taxable Canadian property.

The Budget also includes many rules designed to combat perceived aggressive tax planning such as amendments to the specified leasing property and SIFT conversions regimes. Similarly, the federal government has announced that it is considering new proposals to require the reporting of certain tax avoidance transactions which the CRA considers to be aggressive.

This bulletin provides a summary of the tax measures that will be of greatest interest to Canadian businesses and comments on some of the historical and policy context of the budget proposals.

SIFT Conversions and Loss Trading

Under existing tax rules, certain publicly traded trusts and partnerships (predominantly income trusts) will essentially become taxed as public corporations commencing in 2011. The purpose of these rules is to “level the playing field” by taxing all publicly traded business entities and their investors in the same manner regardless of the legal form of the entity. In order to provide entities caught by these rules the opportunity to change their legal form to a corporation in a tax-efficient manner, existing rules also permit such entities to effectively convert into corporations on a tax-deferred basis any time prior to 2013. Several trusts conversions have occurred in conjunction with third-party corporations that have tax losses in a manner that is intended to permit the tax losses to be used by the profitable income trust business post-conversion. The use of the losses is not restricted as long as there is no acquisition of control of the loss corporation. In the weeks leading up to the Budget, the Minister of Finance was very critical of such transactions. In order to

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combat these “aggressive schemes” the Budget proposes that there will be deemed to be an acquisition of control of the loss corporation with the result that the utilization of its losses will be subject to the normal limitations applying on an acquisition of control.

These proposed amendments apply to transactions undertaken after 4:00 p.m. EST 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 Act. A careful review of existing agreements for conversion transactions that have not yet occurred will be necessary in order to determine whether the “grandfathering” rule applies. Furthermore, the proposed changes have not addressed those transactions that have occurred where the unitholders of the converting SIFT do not acquire control of the loss corporation as a result of the exchange.

Employee Stock Options

The Minister of Finance has included major changes to the employee stock option rules. The proposed changes have both good news and bad news for employees and employers.

First, the bad news. Under the current rules in the Act, where an employee is granted stock options, provided certain conditions are met, the employee is entitled to claim a deduction equal to 50% of the taxable benefit realized on the exercise of the option, but the employer is not entitled to claim any deduction in computing its income for tax purposes in respect of the benefit realized by the employee. For many years, however, the CRA has taken the administrative

position that if the employee is entitled to elect to exchange his or her rights under the stock option agreement for cash (i.e. a “cash-out”), the employee will not be disqualified from claiming the 50% deduction and the employer will be able to deduct the amount of cash proceeds paid to the employee.

The Budget proposes to amend the Act to eliminate the employer’s ability to claim a deduction in these circumstances. More specifically, it is proposed that the Act will be amended to provide that the 50% deduction will be available to an employee where the necessary conditions are otherwise met and the employee actually acquires the securities of the employer on the exercise of the stock options. The employee may choose to cash-out his or her option entitlement in the future, however, the 50% deduction will only be available where the employer has elected (using a prescribed form) in respect of all stock options issued (or to be issued) after 4 p.m. EST on March 4, 2010 under an agreement with the employee that the employer will not deduct any amount in respect of the benefit received by the employee. The employer will be required to file this election with the Minister of National Revenue. Further, the employer will be required to provide written evidence of the election to the employee and the employee will be required to file such evidence with his or her tax return. If the election is not made, the employee will not be entitled to the 50% deduction, but the employer will be entitled to deduct the amount of the cash out payment to the employee.

It should be noted that for stock options issued before 4:00 p.m. EST on March 4, 2010, the employer election referred to above is not available and the employee will only be entitled to the 50% deduction where the employee exercises the option and acquires securities of the employer. This places existing stock option

plans at a distinct disadvantage from the employee's perspective relative to plans under which options are issued after March 4, 2010.

The Notice of Ways and Means Motion contained with the Budget papers also states that for dispositions of stock option rights which occur after 4 p.m. EST on March 4, 2010, the rules in subsection 7(1) of the Act will be clarified to ensure that employees are taxable under this section where they dispose of their rights under a stock option agreement to a non-arm's length person.

Another proposed amendment contained in the Budget will come as a shock to employees of public companies with stock options. The Budget proposes to eliminate the \$100,000 tax deferral currently available to employees with options to receive shares in public companies. The current rule allows an employee to defer the payment of the taxes on stock option benefits up to an annual vesting limit of \$100,000 until the securities are sold. This proposed amendment will apply to employee stock options that are exercised after 4 p.m. EST on March 4, 2010. The tax deferral in respect of stock options held by employees of Canadian controlled private corporations will continue unchanged.

The good news in the Budget for public company employee stock option holders relates to a change that has been the subject of heavy taxpayer lobbying for many years. When the \$100,000 deferral is claimed by an employee at a time when the value of the benefit is significant but then the value of the securities acquired by the employee deteriorates, an employee can be left with the situation where the proceeds from the sale of the securities are insufficient to cover the tax liability in respect of the benefit that was deferred at the time of exercise. The Budget contains elective relief that is intended to ensure that the tax liability on

a deferred stock option benefit does not exceed the proceeds of disposition of the underlying securities. The election will have to be made by the employee who sold his or her securities before 2010 on or before the filing due date for the 2010 taxation year (generally April 30, 2011). Employees who did not sell their securities before 2010 must do so before 2015 in order to make this election.

The Budget also proposes measures that will ensure that employee benefits arising from stock options will be subject to full withholding on account of the employee's income taxes. This proposal effectively puts an end to some long standing CRA administrative concessions that relieve employers from their withholding obligations in respect of employee stock options. The new rules will apply after 2010 and will provide that withholdings must be remitted by the employer to the same extent as if the amount of the benefit had been paid to the employee in money as a bonus. The amount of withholding may be reduced, to the extent the 50% deduction under paragraph 110(1)(d) is available. Relief from withholding is provided under the Budget proposals where the employee acquires the securities after 2010 pursuant to an agreement entered into before 4 p.m. EST on March 4, 2010 whereby the employee is subject to a written condition that restricts his or her ability to dispose of the securities acquired upon exercise for a period of time after exercise.

The status quo continues and withholding will not be required where the employee stock option is granted by a Canadian-controlled private corporation, presumably because the taxable benefit is not realized at the time of exercise but rather when the shares acquired on exercise are ultimately disposed of.

Section 116 and Taxable Canadian Property

Non-residents of Canada are subject to Canadian income tax to the extent they are employed in Canada, carry on business in Canada or dispose of “taxable Canadian property” (“TCP”). For many years, non-resident investors have been frustrated by the application of section 116 of the Act where the non-resident has disposed of shares of a Canadian private corporation because such shares were included in the definition of TCP in the Act.

Section 116 requires that a non-resident vendor who disposes of TCP obtain a certificate of compliance in respect of the disposition (a “Section 116 Certificate”). A Section 116 Certificate is typically issued by the CRA only when the non-resident vendor (i) pays an amount equal to 25% of the amount of gain realized by the vendor on the disposition (or provides acceptable security) or (ii) satisfies the CRA that any gain from the disposition is exempt from Canadian tax by virtue of an applicable income tax treaty.

If the certificate of compliance is not provided to the purchaser of the TCP on closing, or if the certificate limit is inadequate, the purchaser is liable to withhold and remit to the Receiver General, 25% (or 50% in certain circumstances) of the amount by which the cost to the purchaser of the property exceeds the certificate limit on the Section 116 Certificate, if any. Unfortunately, the certificates of compliance were often not issued by CRA until many months after the closing of a transaction.

The CRA’s practice has been to issue a “comfort letter” on an application for a Section 116 Certificate such that the purchaser would be required to withhold, but not remit, the 25%

amount. However, the purchaser could not release the funds to the non-resident vendor until a Section 116 Certificate was issued. For investors resident in treaty jurisdictions, these delays caused great frustration. For investors that were not entitled to benefits under a treaty, costly tax planning was often required before acquiring TCP to avoid Canadian capital gains tax on disposition.

In the 2008 Budget, the Minister of Finance made changes to section 116 that were intended to narrow the application of these rules but with limited success. The 2008 amendments exempted the Section 116 Certificate application requirements for TCP that was considered treaty protected property but still required notice to be given to the Minister where the purchaser and vendor were related or if the purchaser wanted additional protection from the withholding liability. Furthermore, the exemption would often not be available where the purchaser was not comfortable the TCP would be considered treaty protected property. In such cases, the purchaser would often require that the non-resident vendor undertake the full Section 116 Certificate application process.

Effective after March 4, 2010, the definition of “taxable Canadian property” in the Act will be amended so that unlisted shares of a corporation will only be TCP where at any time in the prior 60 months more than 50% of the fair market value (“FMV”) of the share was derived, directly or indirectly from one or any combination of real property situated in Canada, Canadian resource properties, timber resource properties and options in respect of such properties (whether or not the property exists). The rules will also apply for an interest in a partnership or an interest in a trust (but not a mutual fund trust or an income interest in a Canadian trust).

Furthermore, after March 4, 2010, listed corporate shares and interests in mutual fund corporations and trusts will only be TCP if at any time during the last 60 months 25% or more of the shares (of any class) or units belonged to the vendor and/or any person not dealing at arm's length with the vendor AND more than 50% of the FMV of the share or unit was derived directly or indirectly from one or any combination of properties described above.

This is an important shift in Canadian tax policy. While the Budget papers focus on the elimination of the compliance obligations associated with the Section 116 Certificate, the proposed changes go further by eliminating capital gains taxes payable by non-residents on the disposition of corporate shares except where more than 50% of the value of such shares is derived from real property situated in Canada, Canadian resource properties or timber resource properties.

Foreign Investment Entities and Non-Resident Trusts

The 1999 federal budget ("Budget 1999") proposed measures regarding the taxation of (i) non-resident trusts and their beneficiaries ("NRT" proposals), and (ii) taxpayers resident in Canada holding interests in foreign investment entities ("FIE" proposals). Draft legislation to implement these Budget 1999 measures was first released in 2000 and modified on successive occasions since then. Legislation implementing these proposals has not yet been enacted. The government is proposing significant modifications to these measures in the Budget to address concerns raised by interested taxpayers and tax practitioners.

The FIE rules previously proposed are not to be enacted. Rather, existing offshore investment

fund property rules are to continue to apply. However, the prescribed rate of interest used to compute the income inclusion under these rules is to be increased by two percentage points. The relevant reassessment period in respect of investments in offshore investment fund properties is to be extended by three years. These proposals apply to taxation years ending after budget day. Taxpayers who filed prior year tax returns on the basis of the outstanding FIE proposals can have those earlier years reassessed or can claim a current year deduction for any over-reported income.

The Budget also proposes a broadening of circumstances where resident beneficiaries of certain non-resident trusts or where taxpayers resident in Canada who have contributed property to certain non-resident trusts may be required to report income based on a modified foreign accrual property income ("FAPI") basis.

Foreign reporting requirements in respect of "specified foreign property" are to be expanded.

Significant revisions are also to be made to the NRT proposals. Pension plans and other tax-exempts are to be exempted from the NRT rules. Exemptions to the application of the NRT rules are to be expanded for bona fide commercial trusts, subject to new anti-avoidance provisions. Loans made by Canadian financial institutions in the ordinary course of the financial institution's business will not result in the financial institution being regarded as a resident contributor to the non-resident trust.

Where a foreign trust is subject to the NRT rules, the Budget proposes significant modifications to the resulting taxation of the trust, its contributors and its beneficiaries. The trust's property is to be divided into a non-resident portion and a resident portion, based on contributions by residents and certain former

residents. Generally, income from the non-resident portion would not be included in the trust's income for Canadian tax purposes. Income payable to beneficiaries or attributed to resident contributors will be deductible for the trust such that it may only be taxable on income derived from contributions from certain former resident contributors. The trust will also be entitled to claim a foreign tax credit in respect of taxes paid to another country that also treats the trust as a resident of that country for income tax purposes. A resident contributor is to be liable for tax on trust income attributed to the resident contributor, but not for the trust's own income tax liability. A reasonable portion of foreign tax credits are to be permitted to be designated to contributors.

The relevant reassessment period for income of trusts subject to the NRT proposals is to be extended by three years.

The NRT proposals are to apply to the 2007 and subsequent taxation years. An election will permit a trust to be deemed resident for the 2001 and subsequent taxation years.

The FIE and NRT proposals are subject to a further consultation period.

Information Reporting of Tax Avoidance Transactions – Public Consultations

The Budget announces that there will be public consultation on proposals to require the reporting of certain tax avoidance transactions. The Act contains a number of substantive rules intended to counter what is considered by the tax authorities to be aggressive tax planning. The Budget indicates that in order to effectively apply these rules, the CRA must be able to identify aggressive tax planning in a timely manner. This Budget measure was presumably influenced by measures introduced by the

Government of Quebec on October 15, 2009 and is also consistent with a recent announced policy of the Internal Revenue Service Announcement 2010-9 dealing with “uncertain tax positions” which are not certain to be upheld on audit.

These measures will be in addition to the existing provisions regarding tax shelters and the reporting requirements for tax shelters. However, because a significant number of aggressive tax planning arrangements do not meet the definition in the Act of a tax shelter, these proposals are being put forward.

The proposals require the reporting of an avoidance transaction which constitutes a “reportable transaction”. For this purpose a reportable transaction would be a transaction that bears at least two of the three following hallmarks:

1. a promoter or tax advisor in respect of the transaction is entitled to fees that are to any extent
 - (a) attributable to the amount of the tax benefit from the transaction,
 - (b) contingent upon the obtaining of a tax benefit from the transaction, or
 - (c) 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.

A transaction that is a tax shelter or a flow-through share arrangement will not be impacted by these proposals.

Upon discovery of a reportable transaction that has not been reported when required, the CRA could deny the tax benefit resulting from the transaction. Alternatively, if the taxpayer still wanted to claim the tax benefit, it would be required to file with the CRA any required information and to pay a penalty. It is expressly stated that 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 consultations which follow the introduction of the specific proposals would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

Charities: Disbursement Quota Reform

The Budget has called for significant changes to be made to the disbursement quota obligations imposed on registered charities pursuant to the provisions of the Act. It is likely that these changes will be met with great relief by the charitable sector, which has struggled with an increasingly complex and onerous disbursement quota regime.

As the commentary introducing the Budget notes, the impact of the existing disbursement quota rules “can vary considerably, for reasons unrelated to the manner in which a charity conducts its charitable activities.” For example, the current rules require registered charities to either expend the bulk of the gifts for which receipts were issued or to hold the capital of

such gifts for specified periods of time. As a result, these rules are often in conflict with the program needs and planning goals of registered charities.

In response to the concerns raised by the charitable sector, the Budget has proposed the following significant changes be made to the disbursement quota obligations imposed on registered charities. These changes will apply to fiscal years ending on or after March 4, 2010.

The Elimination of the Charitable Expenditure (80%) Rule

The charitable expenditure rule (i.e., the requirement that 80% of all receipted gifts received in the previous year must be expended) will be eliminated. This means that a number of very complex concepts will no longer be required to calculate the disbursement quota of registered charities, including:

- (a) Enduring Property (i.e., endowed ten year gifts and other specified gifts which are not subject to the existing charitable expenditure rule);
- (b) Capital Gains Reduction and Capital Gains Pool (i.e., provisions relating to capital gains realized from the disposition of enduring property); and
- (c) Specified Gifts (i.e., provisions that allow registered charities with disbursement excesses to assist registered charities with disbursement shortfalls by means of making inter-charity gifts).

Specified exclusions from the calculation of the base of the 3.5% disbursement quota rule will also be eliminated, as these provisions were meant to ensure that funds subject to the 80%

disbursement quota rule are also not subject to the 3.5% rule.

The Modification of the Capital Accumulation (3.5%) Rule

The capital accumulation rule (i.e., the requirement that 3.5% of all assets not currently used in charitable programs or administration be disbursed if such assets exceed \$25,000) will be modified.

The \$25,000 threshold applicable where this requirement is imposed will be increased to \$100,000 for charitable organizations. As the Budget materials suggest, 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.

In addition, in order to allow registered charities to accumulate property for particular projects, the CRA will be given the discretion to exclude such accumulated property from the 3.5% disbursement quota obligation.

The Imposition of Anti-Avoidance Rules

Anti-avoidance rules will be extended to situations where “it can be reasonably considered that the purpose of a transaction was to delay unduly or avoid the application of the disbursement quota.” Provisions will be introduced to ensure that amounts transferred between non-arm’s length registered charities can only be used to satisfy the disbursement quota obligations of one of the registered charities. These provisions will require the recipient charity to either spend the entire amount it receives on its own charitable activities or to transfer the amount to an arm’s length qualified donee in the current or subsequent taxation year. Alternatively, the

registered charity that transfers the funds will be able to elect that its gift not count toward satisfying its own disbursement quota. This will relieve the recipient charity from being required to make the aforementioned disbursements.

Mineral Exploration Tax Credit

The Mineral Exploration Tax Credit (“METC”), available to flow-through share investors, has been extended to flow-through share agreements entered into on or before March 31, 2011. The METC is available to individuals investing in flow-through shares and is a 15% investment tax credit in respect of “specified mineral exploration expenses” incurred in Canada and renounced to flow-through share investors. The METC was first introduced on October 18, 2000 as a temporary measure applicable to eligible exploration expenses incurred after October 17, 2000, and before January 1, 2004. The program has since been extended several times. It was most recently extended by Canada's Economic Action Plan, announced in March 2009, to flow-through share agreements entered into during the period from April 1, 2009 to March 31, 2010. This Budget extends the expiration date by another year.

The purpose of the METC is to assist junior mining companies to raise new equity through the issuance of flow-through shares. Flow-through shares allow companies to renounce or “flow through” tax expenses associated with their Canadian exploration activities to investors who are eligible to deduct the expenses from their own taxable income.

With the extension of the METC to flow-through share agreements entered into on or before March 31, 2011, it will be possible, in combination with the “look-back” rule, to obtain the METC in 2011 in respect of expenditures

incurred from the date of an agreement in the first three months of 2011 to the end of 2012.

Accelerated Capital Cost Allowance for Clean Energy Generation

As part of the federal government's commitment to encourage new and environmentally friendly methods of energy production and the development of clean energy technology, the Budget proposes to expand the accelerated capital cost allowance for clean energy generation and expand the concept of Canadian renewable and conservation expenses ("CRCEs") for purposes of the Act.

In the recent past, the federal government introduced an accelerated capital cost allowance ("CCA") regime that is aimed at clean energy generation.

Class 43.2 of Schedule II to the *Income Tax Regulations* (the "Regulations"), introduced in 2005, provides accelerated CCA at the rate of 50 per cent per year on a declining basis. Class 43.2 applies to assets acquired on or after February 23, 2005 and before 2020. For assets acquired before February 23, 2005 and those that meet lower energy-efficiency standards, accelerated CCA is provided under class 43.1 at the rate of 30 per cent per year.

Class 43.2 covers a variety of stationary clean energy generation equipment used to produce electricity (i.e. wind turbines, fuel cells) or heat (i.e. ground source heat pump equipment and active solar equipment), or used to produce certain fuels from waste that are in turn used to produce electricity or heat (i.e. equipment used to convert biogas through anaerobic digestion or biomass into bio-oil).

Among other things, the 2008 Budget extended eligibility for Class 43.2 to ground-source heat pump systems used in applications other than

industrial processes or greenhouses and for biogas production equipment used in anaerobic digestion, equipment used to produce heat from waste sources, and equipment used to produce bio-oil.

Similarly, the Budget proposes to expand Class 43.2 to include certain heat recovery equipment and distribution equipment used in certain district energy systems in the class of property that is eligible for this depreciable expense. 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

The Act was amended in 1996 to add the concept of Canadian renewable and conservation expenses ("CRCE") to the definition of Canadian exploration expense ("CEE") under paragraph 66.1(6)(g.1) of the Act. The intention of the addition was to foster investment in the start-up phases of renewable energy and energy conservation projects. CRCEs include certain intangible costs such as feasibility studies and pre-construction development expenses associated with renewable energy and energy efficiency projects for which at least 50 per cent of the cost of depreciable assets relates to equipment eligible for Class 43.1 or Class 43.2 CCA treatment.

CRCEs can be fully deducted in the year incurred or transferred to investors using flow-through shares. Flow-through shares may only be issued by a "principal-business corporation".

Over the past decade, the Department of Finance has made a number of amendments to the CRCE provisions in an effort to encourage the production of more renewable energy in

Canada and to ensure that renewable energy projects can raise financing in the same manner as non-renewable energy projects.

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.

The Budget 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 will apply in respect of taxation years ending after 2004.

Interest on Overpaid Taxes

Where there has been an overpayment of taxes and other levies, the federal government pays interest to taxpayers at a rate for a particular quarter equal to the average yield of the three-month Government of Canada Treasury Bills that are auctioned during the first month of the preceding quarter plus 2 percentage points.

The concern is that the interest rate on tax overpayments which corporations are receiving is higher than warranted given that the federal government should theoretically be borrowing (and paying interest) at the yield reflected by the Treasury Bill market.

The Auditor General had raised this concern in her Spring 2009 report:

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.

The federal government proposes to eliminate this premium by removing the additional 2 per cent from the interest rate calculation. This new rate applies to income tax, GST/HST, EI premiums, CPP contributions and others but will not apply to non-corporate taxpayers.

Refunds under Regulation 105 and Section 116

In certain circumstances, section 116 of the Act and section 105 of the Regulations require that, respectively, a taxpayer acquiring “taxable Canadian property” from a non-resident vendor and a taxpayer paying fees to a non-resident in respect of services rendered by the non-resident in Canada, withhold and remit amounts to the CRA on account of the potential Canadian income tax liability of the non-resident vendor or service provider. This withholding requirement may apply even where the non-resident may, ultimately, have no Canadian income tax liability owing to the application of a tax treaty. Where tax is withheld and remitted, but the non-resident is not liable to Canadian income, the non-resident will file a Canadian income tax return and claim a refund of the tax.

Under the Act, the CRA may assess, at any time, a taxpayer who fails to withhold and remit tax as required under section 116 of the Act and section 105 of the Regulations. However, under the Act, a taxpayer is only permitted to receive a refund of overpaid tax for a taxation year if the taxpayer has filed its income tax return for that taxation year within three years from the end of that taxation year. The interaction of these time limits has sometimes resulted in the CRA assessing a taxpayer for failing to withhold tax

on payments to a non-resident in a particular taxation year and then denying payment of a refund of tax to which the non-resident is otherwise entitled because the non-resident did not file a Canadian income tax return claiming the refund within three years from the end of the particular taxation year. The result was a tax windfall for the CRA and, potentially, double taxation for the non-resident.

The Budget proposes to amend the Act to permit the issuance of a refund of an overpayment of tax under the Act if the overpayment relates to an assessment of a purchaser or a payor in respect of a required withholding under section 116 of the Act or section 105 of the Regulations and the non-resident files a Canadian income tax return no more than two years after the date of the assessment. The amendment is proposed to be effective for applications for refunds claimed in returns filed after March 4, 2010.

Foreign Tax Credit Generators

The Budget also proposes to eliminate planning opportunities referred to as "foreign tax credit generators". The Budget papers describe these as schemes designed to shelter tax on interest income on loans made, indirectly, to foreign corporations through foreign partnerships or foreign affiliates by way of exploiting asymmetry between Canadian and foreign tax law in the characterization of the Canadian corporation's direct or indirect investment in the foreign entity earning the income that is subject to foreign tax.

The Budget proposes to deny foreign tax credits and deductions in respect of foreign accrual tax and underlying foreign tax where the applicable foreign tax law treats the Canadian taxpayer as having a lesser direct or indirect interest in the foreign affiliate or foreign partnership than is considered to be the case for Canadian tax

purposes. The budget proposals in this regard are not specifically limited to structures involving the earning of interest income and, accordingly, may be overly broad.

Specified Leasing Property Rules

The specified leasing property rules were originally introduced to discourage non-tax paying entities, i.e. tax-exempts or non-residents, from entering into a lease to, effectively, transfer available CCA deductions to a lessor, who is eligible to claim CCA deductions, in return for lower lease payments. Generally, the specified leasing property rules applied to a lease of specified leasing property by restricting the available capital cost allowance deductions to the lessor by effectively recharacterizing such leases from the lessor's perspective to be a loan with blended payments of interest and principal.

Exceptions to the specified leasing property rules include short-term leases, leases of property with a value of less than \$25,000 and for what is defined as "exempt property" in the Regulations.

The federal government's concern is that certain taxpayers have exploited the exemptions by entering into leasing arrangements of exempt property. Thus, the proposal is that the specified leasing property rules will be extended to property, which otherwise would be "exempt property", but that is the subject of a lease to a tax-exempt entity or to a non-resident.

Such leases will continue to be exempt if the total value of the property that is the subject of the lease is less than \$1 million. However, this exemption is qualified by an anti-avoidance rule which will apply if it may reasonably be considered that one of the purposes of dividing property among separate leases is to come

within the \$1 million exemption. These measures will apply to leases entered into after 4:00 p.m. EST on March 4, 2010.

Online Notices

The federal government will introduce new measures to provide the CRA with the legal authority to issue electronic notices including, for example, notices of assessment and reassessment under the Act and electronic notices for GST/HST.

The CRA will utilize the existing online platform, My Account and My Business Account, by informing taxpayers who provide proper authorization that new electronic documents are available on their secure account.

Legislative authority for electronic notices was provided generally as a result of the Personal Information Protection and Electronic Documents Act (the "PIPEDA") introduced in 2000 but was not reflected in the various specific tax statutes dealing with notices issued by the CRA. Accordingly, the new measures will require amendments to several statutes including the *Income Tax Act*, *Excise Tax Act*, *Canada Pension Plan* and *Employment Insurance Act*.

Taxation of Corporate Groups

The federal government has announced that it will explore new rules for the taxation of corporate groups, such as a formal system of loss transfers or consolidated reporting. The federal government has promised to seek the views of stakeholders prior to introducing any changes.

One issue which has held up the introduction of loss consolidation rules in the past is the effect that loss consolidation would have on provincial corporate income taxation. Previously, the CRA

has commented on intercompany loss consolidations without acknowledging potential provincial corporate tax concerns. At the 2005 CRA Roundtable, the CRA was asked if it had become more concerned about provincial tax implications of loss consolidation. The CRA responded that it recognized that loss consolidation transactions can have the effect of shifting income and losses between provinces with a resulting increase or decrease in provincial tax revenue. Accordingly, loss consolidation ruling requests require an analysis of the provincial tax implications of the transactions. The CRA noted that issued loss consolidation rulings provide no comfort as to the application of the GAAR in the provincial tax statutes of the affected provinces and cautioned that when a loss consolidation transaction affects a province with which the Federal government does not have a tax collection agreement, it may be advisable for the taxpayers to obtain a provincial ruling.

In *Income Tax Technical News 41*, issued on December 23, 2009, the CRA recognized that, in some instances, loss-consolidation transactions can have the effect of shifting income and losses between provinces with a resulting increase or decrease in provincial tax revenue. In response to the question of whether the CRA planned to address provincial GAAR issues with respect to loss-consolidation ruling requests that significantly shift income among provinces, it responded that before issuing a ruling, the CRA Rulings Directorate will recommend that practitioners obtain comfort from provincial tax authorities to minimize the risk of double taxation.

Accordingly, it will be interesting to see how the federal government plans to balance the concerns from the business community and from the provinces regarding the utilization of tax losses within a corporate group.

Scientific Research & Experimental Development

The Budget announced, as part of its measures to provide support for research and development (“R&D”) in Canada, that the federal government will conduct a comprehensive review of all federal support for R&D including Canada’s Scientific Research and Experimental Development Tax Incentive Program (the “SR&ED Program”). The Budget highlights that the SR&ED Program is the single largest federal program supporting business R&D in Canada, providing over \$3 billion in tax assistance in 2009. The federal government is currently developing the terms of reference for the review and it is expected to be held in close consultation with business leaders and the provinces. It will be interesting to see what proposals arise from this review process.

The Budget highlights certain administrative improvements to the SR&ED Program which had been already announced including a new quarterly report on the time it takes to review SR&ED claims and a new manual for CRA reviewers.

Sales Tax Measures

In light of the massive changes forthcoming in July 2010 with the harmonization of Ontario’s and British Columbia’s respective provincial sales taxes with the GST/HST, the federal government evidently saw fit to keep the changes relating to GST/HST to a minimum in this Budget.

New changes were announced with respect to the application of GST/HST on purely cosmetic medical procedures and with respect to the direct selling industry, and there was confirmation of the changes announced in December 2009 with respect to clarifying the

definition of “financial services” for GST/HST purposes.

With respect to purely cosmetic medical procedures, the ETA has generally excluded purely cosmetic procedures from the general exemption from GST/HST that applies to basic medical and dental services. The Budget proposes to clarify that GST/HST is to apply to all purely cosmetic procedures (whether surgical or not), as well as to any property used or provided with the procedure. However, GST/HST will not apply in circumstances where the cosmetic procedure is required for medical or reconstructive purposes, such as to repair damage caused by trauma or illness. These changes will be effective for supplies made after March 4, 2010 and for those made before March 4, 2010 if GST/HST was charged, collected or remitted on the supply.

The Budget also confirms the Government’s intentions, announced in the 2009 Budget, to continue to simplify GST/HST accounting for the members of the direct selling industry. In addition to confirming its intention to implement the 2009 Budget proposal to allow commission-based direct sellers (“network sellers”) to use a simplified form of GST/HST accounting, the Government announced the following further enhancements and clarifications:

- new entrants to the direct selling industry will be entitled to use the simplified GST/HST accounting method if certain criteria are satisfied; and
- the supply of host gifts from a network seller to a host will not be subject to GST/HST; and
- a “safety mechanism” will be implemented to protect network sellers from GST/HST net tax adjustments in the event that they do not satisfy certain criteria required to rely on the simplified GST/HST accounting rules.

These newly announced enhancements and clarifications are to take effect for the fiscal years of a network seller that begin after 2009, so as to match the timing of the 2009 Budget proposals.

Finally, the Budget confirms the intention to implement a number of amendments to the definition of “financial services” announced in December 2009. These amendments are designed to clarify and confirm the CRA’s long-standing view that asset management services are not exempt financial services. In 2009 the

Federal Court of Appeal ruled that in certain circumstances, discretionary asset management services were “financial services” and accordingly exempt from GST/HST, and the amendments serve to effectively overrule this decision by clarifying that no asset management services qualify as exempt “financial services”. These amendments are retroactive in nature and, except in extremely rare and narrow circumstances, will be deemed to have come into force on December 17, 1990.

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