



## BUDGET 2010

Budget 2010 contained more substantive tax proposals from the Government of Canada than expected. Many of those proposals are detailed below. Given opposition pronouncements following introduction of Budget 2010, we expect that most, if not all, of the proposals in Budget 2010 will eventually be enacted with effect retroactive to 4:00 p.m. EST on March 4, 2010, which is when the Government of Canada released Budget 2010.

### BUSINESS

#### A. TAX RATES

Budget 2010 contained nothing new on corporate tax rates. Canada is still on track for the general federal corporate tax rate to drop to 15% in 2012 (each province imposes tax as well, and the combined provincial and federal general corporate tax rate in British Columbia is expected to be 25% in 2012).

#### B. REPORTING TAX AVOIDANCE

In the U.S. there are requirements to report certain types of tax planning. Recently, Quebec introduced a number of requirements to report aggressive tax planning. Now, the Government of Canada is proposing reporting requirements as well.

A reportable transaction would be an avoidance transaction, as currently defined in the *Income Tax Act* ("ITA"), 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 affected by these proposals, but will be subject to the existing requirements for tax shelters and flow-through shares.

According to Budget 2010, upon discovery of a reportable transaction that has not been reported when required, the Canada Revenue Agency ("CRA") 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 CRA 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 CRA 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.

The foregoing requirements would apply to avoidance transactions entered into after 2010, or in the case of a series of transactions, completed after 2010.

#### C. EMPLOYEE STOCK OPTIONS

There are a number of proposals in Budget 2010 with respect to employee stock options:

- (1) Employees who exercise stock options realize an employee benefit equal to the value of the shares less what they paid for those shares. Employees are generally entitled to deduct one-half of that stock option benefit. This is called the stock option deduction. It is intended to give capital gains-like treatment to

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the employee. The deduction was also available where the employee elected to receive cash instead of shares. The Government of Canada is concerned that, where an employee receives cash in lieu of shares, the employee receives the stock option deduction and the employer could also claim a deduction for the cash paid (the employer does not get a deduction with respect to any shares issued on exercise of the option). In Budget 2010 the Government of Canada proposes to eliminate that possibility. Employees receiving cash will not be entitled to the stock option deduction (i.e., the full amount of the benefit will be included in income) unless the employer elects to forgo claiming a deduction for the payment. Budget 2010 included a table demonstrating that the stock option deduction had mostly benefited employees who earned in excess of \$500,000.

(2) A second change deals with employee stock options for employees of publicly traded companies. While the obligation to pay tax on the employee benefit for stock options in Canadian controlled private corporations is automatically deferred until the time the employee disposes of the shares, there has been an election available for employees of public companies to have the same deferral, though the deferral was limited to up to \$100,000 in benefits per year. In Budget 2010 the Government of Canada proposes to eliminate this elective deferral and justifies it on the basis of protecting the employee. This deferral facilitated employees holding onto shares which might drop significantly in value during the holding period, leaving the employee with a significant tax bill but without an asset valuable enough to sell and pay the tax bill. This change occurs starting with stock options exercised after the Budget 2010 announcement. However, there will be grandfathering for existing option agreements that have restrictions on the subsequent disposition of the shares.

(3) Related to the second change, a third change is to clarify that the employer must remit tax on behalf of the employee with respect to the stock option benefit. These newly clarified remittance requirements will apply to securities issued after 2010.

(4) The fourth change to employee stock options is a relieving provision to deal with past Nortel-type problems. In many cases, particularly in the tech industry, employees who exercised stock options had a taxable benefit equal to one-half of the value of the shares. When the shares later dropped in value they would realize a capital loss, but a capital loss cannot be off-set against an employee benefit. This meant, particularly in the Nortel case, that the employee had a large tax bill with no cash to pay it. Sometimes this problem was created by the employee choosing to hold onto the shares instead of selling them

immediately and thereby taking the risk that the shares would drop in value. However, sometimes the employees were under restrictions that prevented them from selling the shares for a certain period. Now, the employee can elect to pay a tax equal to 100% of the proceeds from the sale of the shares instead of having a taxable employee benefit combined with an otherwise useless capital loss. This solves the employee's tax-but-no-cash problem in the Nortel-type situation. Individuals who disposed of their shares before 2010 will have to make an election for this special tax treatment on or before the filing due-date for their 2010 tax returns. In addition, individuals who have not disposed of their optioned shares before 2010 must do so before 2015 in order to qualify for this special tax, in which case the individuals must file the tax election by the filing due-date for the year of disposition.

#### D. 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. In Budget 2010 the Government of Canada 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.

#### E. INCOME TRUSTS

The income trust was a popular business structure for a while. The tax benefit was that the partnerships and the trusts in the structure were effectively non-taxable, and the large pension plans and RRSPs who were typical unit holders at the top of such structures are also non-taxable (until benefits are paid out to beneficiaries down the road at low tax rates), so there was a significant loss of current year revenue for the Government of Canada. A few years ago the Government of Canada made a number of changes to eliminate this tax benefit, and existing income trusts were given a few years to convert back to corporate structures on a tax-deferred basis. However, the conversion rules were being used to allow what the Government of Canada has labeled "inappropriate tax loss trading that would not be allowed as between two corporations". In Budget 2010 the Government of Canada introduces some new provisions to eliminate such abuse.

The proposed amendments will apply to transactions undertaken after the budget announcement on March 4, 2010, other than transactions that the parties are obligated to complete pursuant to the term of the agreement in writing

between the parties entered into before the budget announcement. If the agreement itself allows the parties to not complete as a result of these proposals, then the transaction will not be excepted from the proposed changes.

#### F. FEDERAL CREDIT UNIONS

In Budget 2010 the Government of Canada proposes to allow credit unions to incorporate and continue federally, with the intent that this will allow them to grow and remain competitive on a national scale and improve services across provincial borders. The related tax changes are limited to ensuring that the new federal credit unions are subject to the same rules as existing credit unions.

#### G. CONSOLIDATED CORPORATE GROUP TAX RETURNS

Many other countries, including the U.S., allow corporate groups to file tax returns on a consolidated basis. Canada does not. This leads to elaborate loss-utilization planning within corporate groups. The Government of Canada states in Budget 2010 that it is looking into allowing consolidated returns. Since this would require agreement from the provinces, it is unlikely that consolidated tax filings will be permitted in the near future. Budget 2010 signals that the Government of Canada does not consider it against public policy for losses to be utilized within the corporate group.

#### H. TARIFF RELIEF

In Budget 2010 the Government of Canada proposes to eliminate the remaining tariffs on manufacturing inputs and machinery and equipment, which had varied from 2% to 15.5%. This should further assist Canadian businesses taking advantage of the value of the Canadian dollar to update and modernize their equipment.

#### I. GST

The GST proposals in Budget 2010 were limited to minor changes to clarify that cosmetic surgeries are subject to GST and to change the accounting requirements for direct sellers.

## INTERNATIONAL

#### J. SECTION 116 AND TAXABLE CANADIAN PROPERTY

Unless a clearance certificate is obtained under section 116 of the ITA, a purchaser of certain property listed in the definition of "Taxable Canadian Property" under the ITA must withhold 25% (or in some cases 50%) of the purchase price and remit such amount to the Canada Revenue Agency within 30 days of the end of the month in which the acquisition takes place.

Until Budget 2010, private Canadian corporation shares were taxable Canadian property, and the section 116 requirements could be a hassle in acquisition transactions involving private Canadian corporation and non-resident shareholders. After March 4, 2010, the shares of any corporation and certain other interests (such as interests in trusts and partnerships) which, in each case, have not derived their value, at any time in the previous 60 months, principally from real or immovable property (including Canadian resource (mining) property or timber resource property) will be excluded from the definition of Taxable Canadian Property.

Accordingly, where one is certain that "value" of the target company (or other entity) is not derived principally from such real property interests then section 116 compliance procedures can be dispensed with. This proposal *promises* to make transactions easier. However, the challenge may come in convincing a purchaser that section 116 withholding is not required because of the factual requirements regarding the ownership of real property interests over the 60 month period ending with the transaction.

#### K. REFUNDS OF REGULATION 105 AND SECTION 116 WITHHOLDING

Withholding under the ITA is required in certain circumstances when:

1. a **payor** pays an amount to a non-resident service provider for services performed in Canada (Regulation 105 requires 15% to be withheld and remitted); or
2. a **purchaser** pays the purchase price of Taxable Canadian Property (section 116 requires up to 25% and in some case 50% to be withheld and remitted).

Failure to withhold can result in an "assessment" against the payor, if regulation 105 applies, or the purchaser, if section 116 applies. This assessment usually results in the payment, on behalf of the non-resident, of more tax than is actually payable and can be made outside the normal time limits for a non-resident to file a return and claim a refund.

The budget now allows the non-resident, for any return filed after March 4, 2010, to file a return and apply for a refund within two years after the regulation 105 or section 116 assessment has been made.

#### L. FOREIGN INVESTMENT ENTITIES ("FIE'S") AND NON RESIDENT TRUSTS ("NRT'S")

In 1999 the Government of Canada tabled budget proposals which would tighten the rules related to the taxation of FIE's and NRT's. These proposals found their way into draft legislation in June of 2000 and were subsequently revised on numerous occasions until November 9, 2006 when a Notice of Ways & Means Motion was tabled with the intent that these



provisions would become effective for 2007. The proposals were never enacted and were reviewed during 2009.

The Government of Canada has now developed and announced "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.

The existing FIE rules (i.e. those which existed before those in the process of being developed since 1999) will apparently only be slightly modified.

However, the NRT rules, which were complex in their November 9, 2006 form but were never enacted by Parliament, will apparently be reintroduced with "relieving modifications". The new proposals, with the modifications, are therefore likely to be even more complex. Further comment on how these new NRT legislative proposals will apply will be somewhat speculative until the new draft legislation has been released and studied. Suffice it to say, however, that the intention of the Government of Canada to proceed with the proposals, as they stood at September 2008 and as they would have applied to non-resident discretionary trusts, with further modifications, is clear.

## CHARITIES

In Budget 2010 the Government of Canada proposes to eliminate a significant portion of the disbursement quota regime.

There has been a long-standing requirement that charities spend on charitable activities in Year 2 at least 80% of receipted donations received in Year 1 plus 3.5% of the charity's investments. These disbursement quota obligations had been a complex and costly administrative burden for charities. There had been a long-standing call for change. Budget 2010 proposes to eliminate all disbursement quota requirements except those related to the requirement to annually disburse a minimum amount of investments and other assets not used directly in a

charity's operations. The reformed disbursement quota rules will apply to charities for fiscal years ending on or after March 4, 2010. These changes will have no fiscal impact for the Government of Canada.

## FIRST NATIONS TAXES

In Budget 2010 the Government of Canada states that, to date, it 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. Since the CRA administers the sales tax regime, this is generally transparent to businesses or individuals doing business on reserves. In addition, the Government of Canada states that 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. In Budget 2010 the Government of Canada reiterates its willingness to discuss and put into effect direct taxation arrangements with interested Aboriginal governments.

## INDIVIDUAL TAXES

Budget 2010 contains no changes to personal tax rates.

In shared custody arrangements where custody is basically equal, the Universal Child Care Benefit, Canada Child Tax Benefit, and the child component of the GST Tax Credit will be split between the two parents starting in July 2011.

Generally individuals are entitled a credit equal to 15% of medical expenses that exceed \$1,000. The proposal in Budget 2010 is that purely cosmetic medical expenses (i.e., those procedures not required for medical or reconstructive purposes) will no longer be claimable.

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If you have any questions, please contact any member of our Tax Group.

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