Canada's 2008 Budget Is Light on Business Tax Measures

by Steve Suarez

Canadian Finance Minister Jim Flaherty on February 26 delivered the 2008 federal budget to Canada's House of Commons.

The budget was not expected to contain any major tax measures, in part because of the tax initiatives already announced in last fall's economic statement. (For prior coverage, see *Doc 2007-24571* or *2007 WTD 215-12*.) The budget is relatively light on business tax measures (a welcome development after last year's interest deductibility proposal) (for prior coverage, see *Doc 2007-11796* or *2007 WTD 94-1*), and most of what was announced is in the nature of relief. Highlights include:

- relieving changes in Canada's withholding and notification system for dispositions of taxable Canadian property by nonresidents;
- modest enhancements to the scientific research & experimental development (SR&ED) tax credit regime; and
- minor improvements to the system of depreciating property for tax purposes.

While there are no significant tax policy changes in the budget, the pragmatic approach taken by the government in loosening the withholding and notification rules for dispositions by nonresidents in circumstances where no Canadian tax is likely to be due is particularly welcome.

The budget is the minority Conservative government's third since being elected, and will require the support of at least one of the three opposition parties in order to pass the House of Commons.[1] If the budget fails to pass the House, a federal election would be triggered, and the two smaller opposition parties have already announced that they would not support the government. However, shortly after Flaherty's budget speech, the leader of the opposition Liberals announced that he "did not see enough in this budget that would justify that we precipitate an election that Canadians do not want for now." Therefore, the budget is expected to pass.

Section 116 Withholding

Canada taxes nonresidents when they dispose of certain forms of property (taxable Canadian property, or TCP). In some cases, the Income Tax Act requires the purchaser to effectively act as a collection agent on behalf of the government, as it creates an

[1] Current standings in the House of Commons are: Conservative, 126; Liberals, 94; Bloc Quebecois, 49; New Democratic Party, 30; Independent, 4; with five seats vacant.

obligation on the purchaser to withhold and remit a portion (usually 25 percent) of the purchase price. The amount remitted to the Canada Revenue Agency (CRA) is effectively a payment on account of the nonresident's Canadian tax, and if the amount actually due is less than the amount withheld (for example, because there is little or no gain or the gain is treaty-exempt), the nonresident can apply for a refund.

Alternatively, the nonresident can apply to the CRA for a section 116 certificate, which allows the CRA to examine the transaction before (or shortly after) it closes and decide for itself whether any Canadian tax is due. Receipt of a section 116 certificate relieves the purchaser from liability for not withholding from the purchase price (or may provide for a lesser amount to be withheld). The nonresident also generally is required to file a Canadian income tax return for any year in which it disposes of TCP, regardless of whether any tax is due.

The section 116 withholding system (and in particular the process of obtaining a section 116 certificate) has come under fire from various sources as being slow, cumbersome, and an impediment to investment in Canada. (For a related article, see *Doc 2007-21714* or *2007 WTD 203-6*.) The system can be particularly frustrating when a gain on the disposed-of property is exempt from Canadian taxation under a Canadian tax treaty with the vendor's country of residence, as is often the case. Indeed, most of Canada's treaties limit its right to tax gains realized by nonresidents to Canadian real or resource property (or interests in entities that derive most of their value from such property). It is quite common for nonresidents with no Canadian tax due on a disposition to be surprised by the fact that there is nonetheless a Canadian compliance obligation that potentially delays the receipt of some of their sale proceeds.

The budget includes proposals designed to reduce the section 116 burden in many such cases for dispositions occurring after 2008. Under this initiative, three relieving measures are being proposed. First, the section 116 withholding and notification regime would not apply if the property being disposed of is in fact treaty-exempt (that is, if a tax treaty prevents Canada from taxing the nonresident vendor on any gain). If the purchaser and vendor are related, the purchaser would be required to provide the CRA with certain basic information about the transaction in order for the relief to apply. Second, in those same circumstances, the disposition would not oblige the nonresident to file a Canadian income tax return, provided that the nonresident owes no Canadian taxes. And third, there would be no liability on the purchaser for not withholding under section 116, provided that the following conditions are met:

- after making reasonable inquiries, the purchaser concludes that the vendor is resident in a country with which Canada has a tax treaty;
- under that treaty, any gain on the property in question would in fact be exempt from Canadian tax, assuming that the vendor is indeed a treaty resident; and
- the purchaser provides the CRA with certain information about the transaction within 30 days.

Effectively, this measure creates a reasonable inquiry safe harbor for purchasers in situations in which the vendor appears to be resident in a treaty country, if the relevant treaty would exempt any gain from Canadian tax.[2] Exactly what constitutes "reasonable inquiries" by the purchaser to establish the treaty residence of a nonresident vendor remains open to interpretation.

The budget proposals do not address all of the deficiencies of the section 116 withholding regime. Establishing the treaty residence of a vendor (especially in difficult circumstances such as partnerships) is not always easy and even assuming treaty residence, there can also be uncertainties in determining that a treaty exempts any gain on a particular property from Canadian tax. (No reasonable inquiry safe harbor applies to that part of the analysis.) Purchasers who do not withhold or require the vendor to obtain a section 116 certificate are assuming at least some degree of risk, and it would not be surprising to see purchasers err on the side of caution in situations that are not straightforward. If that occurs, then the new amendments will change the purchaser's conduct mostly in related-party transactions. The budget changes are nonetheless a significant improvement to the section 116 regime and are most welcome.

SR&ED Enhancements

SR&ED expenditures generally receive favorable tax treatment. In particular, qualifying SR&ED expenditures incurred in Canada, up to certain limits, entitle the taxpayer to investment tax credits.

Currently, there is an enhanced ITC at a 35 percent rate (as opposed to the general 20 percent rate) applicable to qualifying expenditures of up to C $2 million incurred by a Canadian-controlled private corporation (CCPC). In order to restrict the 35 percent ITC rate to smaller CCPCs, the C $2 million expenditure ceiling for the 35 percent ITC is reduced if either the CCPC's taxable income in the previous year exceeded C $400,000, or its taxable capital employed in Canada (TCEIC) in the previous year exceeded C $10 million. The limit for expenditures that qualify for the 35 percent rate is reduced to zero if, in the previous year, the CCPC's taxable income was C $600,000 or more, or its TCEIC was C $15 million or more.

The budget increases the availability of the 35 percent ITC in two ways, effective from February 26, 2008. First, the limit for qualifying expenditures is increased from C $2 million to C $3 million. And second, a CCPC will be permitted to have more taxable income or TCEIC in the previous year before the expenditure limit is reduced to zero, meaning that a CCPC can be somewhat larger and still have some entitlement to the 35 percent ITC. Specifically, the enhanced ITC rate will not be completely phased out until the previous year's taxable income reaches C $700,000 (a C $100,000 increase from the current limit) or until its previous year's TCEIC reaches C $50 million. These changes are summarized below.

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[2] This is similar to the existing safe harbor in section 116 that protects purchasers who, after making reasonable inquiries, have no reason to believe that the vendor is a nonresident.

Current and Proposed Expenditure Limit and Taxable Income and Capital Phase-Out Ranges

	CurrentSystem	ProposedSystem
Expenditure Limit	C $2 million	C $3 million
Taxable Income Phase-Out Range	C $400,000 - C $600,000	C $400,000 - C $700,000
Taxable Capital Phase-Out Range	C $10 million - C $15 million	C $10 million - C $50 million

Illustrative Examples of Maximum ITCs Earned at the Enhanced 35 Percent Rate Under the Current and Proposed Systems

Prior-YearTaxable Income	Prior-YearTaxable Capital	Current Amountof FullyRefundable ITC	Proposed Amountof FullyRefundable ITC
C $400,000	C $10 million	C $700,000	C $1,050,000
C $400,000	C $30 million	0	C $525,000
C $500,000	C $10 million	C $350,000	C $700,000
C $600,000	C $10 million	0	C $350,000

In addition, some SR&ED performed outside Canada now will qualify for ITCs, also with effect from February 26. Salaries and wages paid to Canadian-resident employees performing qualifying SR&ED directly for the taxpayer outside Canada will be eligible to generate SR&ED ITCs, if the work is done solely in support of SR&ED carried on by the taxpayer in Canada. Such qualifying salaries and wages are limited to 10 percent of the salary and wages directly attributable to the taxpayer's Canadian SR&ED for the year. Remuneration that is a bonus or is based on profits or that is subject to foreign income tax will not qualify.

The modest SR&ED enhancements proposed by the budget are useful but are rather limited in scope. The enhanced ITC remains limited to CCPCs, and in general, the budget proposals are significantly less than what the business community suggested in recent public consultations held by the government. It is hoped that further improvements to the SR&ED system will be forthcoming.

Capital Cost Allowance

The capital cost allowance (CCA) is the Canadian tax version of the accounting concept of depreciation. Under the CCA system, the cost of capital property is deducted from income over a period of years on a declining balance basis, matching (to some degree) the expenditure on the property to the business income it produces.

The 2007 budget provided a temporary incentive to invest in capital equipment by accelerating the rate at which CCA could be claimed (thereby allowing a larger deduction from income sooner for tax purposes). Instead of the usual 30 percent declining balance CCA rate generally applicable, the 2007 budget allowed most machinery and equipment used in manufacturing and processing acquired before 2009 to be written off entirely over three years, under a special 50 percent straight-line CCA rate (subject to the usual half-year rule limiting the first year's deduction). (For prior coverage, see *Doc 2007-6959* or *2007 WTD 55-1*.)

The 2008 budget extends that initiative for three more years. For eligible property acquired in 2009, the same CCA rate announced in the 2007 budget will apply. A somewhat less generous accelerated CCA deduction will apply for eligible property acquired in 2010 and 2011. For property acquired in 2010, a 50 percent declining balance rate will apply in the first year, with a 40 percent declining balance rate in the following year and the normal 30 percent declining balance rate thereafter. For property acquired in 2011, a 40 percent declining balance rate will apply in the first year, with the normal 30 percent declining balance rate thereafter. In both cases, the half-year rule will apply to limit the deduction in the first year.

In addition to the extension of that previous initiative, the budget makes some minor changes to other elements of the CCA system. First, the CCA rate on certain property acquired on or after February 26, 2008, is to be changed to better correspond with the useful life of those assets. For trains (including capital refurbishments thereof), the CCA rate would increase from 15 percent to 30 percent, and for carbon dioxide pipelines, the rate would increase from 4 percent to 8 percent. (For related pumping and compression equipment, the rate is set at 15 percent.)

Finally, accelerated CCA is offered to equipment and structures used in various forms of ecologically friendly (or green) energy generation. The 2007 budget broadened the range of equipment eligible for such accelerated CCA, and the 2008 budget takes further steps in that regard. Specifically, a number of eligibility restrictions for the accelerated CCA rules are being removed to allow for various applications of ground-source heat pump systems, feedstocks used in biogas production, and other uses of otherwise-eligible technology to qualify.

Other Business Tax Measures

On October 31, 2006, the Canadian government announced a crackdown on income trusts, a form of widely held business organization that functioned as an effective flow-through entity.[3] (For prior coverage, see *Doc 2006-22275* or *2006 WTD 212-1*.) This was to be achieved by imposing a new tax regime on specified investment flow-through (SIFT) trusts and partnerships and their holders, subject to a grandfathering

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[3] The government released certain technical amendments to the specified investment flow-through (SIFT) proposals on December 20, 2007.

period for existing entities. The 2008 budget reiterates the government's intention to follow through on those rules (including introducing a procedure to allow SIFTs to convert to corporations), and to fine-tune the provincial component of the SIFT tax.

Other previously announced initiatives to which the government reaffirmed its commitment in the budget include major changes to the foreign affiliate system (the Canadian version of the U.S. controlled foreign corporation rules) announced in February 2004 (for prior coverage, see *Doc 2004-6779* or *2004 WTD 60-2*), and the November 7, 2007, draft amendments to the taxation of financial institutions to align their taxation more closely with relevant accounting standards (for prior coverage, see *Doc 2007-24996* or *2007 WTD 218-3*).

The 2007 budget announced a special deduction for businesses that donate medicines from their inventory for use in approved charitable activity. The range of eligible charities to which such donations can be made is being adjusted, and a rule has been established that donated medicine must have at least six months left before their expiry date. Other changes are being proposed to the taxation of tobacco products and imitation spirits.

Personal Tax Measures

Many of the tax measures in the 2008 budget affect the personal income tax. Most novel is the announcement of a new tax-free savings account (TFSA). Essentially, beginning in 2009 any Canadian-resident individual age 18 or older can contribute up to C $5,000 per year to a personal savings account. While the contribution itself is not tax-deductible (unlike a deduction to a registered retirement savings plan (RRSP, which is analogous to a U.S. 401(k) plan)), income earned in the TFSA is not taxed, and withdrawals from the TFSA are not subject to tax. Hence, the new TFSA proposal would allow investment income to accumulate tax-free within the account. Eligible investments for a TFSA are largely the same as those for an RRSP.

The new TFSA proposal is interesting because, for many Canadians, it will effectively amount to the elimination of taxation on investment income. Since most Canadians save less each year than the combined annual contribution limits for RRSPs and the new TFSA, those people will not have investment capital in excess of what they are able to put into these tax-sheltered plans. The new TFSA proposal might be seen as a very significant variation of the election promise made by the governing Conservatives two years ago to defer capital gains for individuals on most reinvested sale proceeds. Given the annual contribution limit, however, the TFSA is significantly more skewed to lower- and middle-income Canadians (a not insignificant consideration for a minority government). The ability to carry forward annual unused TFSA contributions indefinitely is particularly generous.

The 15 percent mineral exploration tax credit available to individuals who invest in flow-through shares of mining exploration companies (shares that effectively allow the exploration company to "flow out" the exploration deductions to the shareholder) also is being extended another year for flow-through share agreements entered into by March 31, 2008.

Other notable personal income tax changes include the following:

- Registered education savings plans (a form of tax-assisted savings plan) are being made more flexible to extend by 10 years the number of years during which contributions can be made (to 31 years), and the number of years during which the plan can remain active (to 35 years). The maximum age of plan beneficiaries for contributions is also being increased from 21 to 31.

- The list of expenditures eligible for the medical tax credit is being expanded.

- The dividend tax credit available to Canadian residents on Canadian-source dividends is being reduced to take into account tax reductions at the corporate level.

- An existing provision allowing an enhanced charitable deduction on the donation of publicly traded securities to qualified donees (generally charities) is being expanded to include certain securities exchangeable for publicly traded securities.

The Canadian economy remains relatively robust, although clearly slowing in the face of economic conditions elsewhere in the world. Economic growth is expected to come in at 1.7 percent for 2008, with the projection for 2009 being 2.4 percent. While the C $10.2 billion budget surplus for the 2007-2008 fiscal year (most of which is being directed to pay down accumulated debt) continues the trend of recent years, the surpluses projected for future years are sharply lower.

Documents

The following documents are available from Tax Analysts:

- Department of Finance news release. *Doc 2008-409*; *2008 WTD 39-17*

- Finance Minister's budget speech. *Doc 2008-4099*

- Budget overview. *Doc 2008-4103*