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HIGHLIGHTS

Canadian Budget Delivers Outbound Tax Relief

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Canadian Finance Minister Jim Flaherty on January 27 delivered to the House of Commons the 2009 federal budget, which includes improvements to Canada's outbound taxation system as well as corporate and individual income tax relief measures. (For prior coverage, see *Doc 2009-1706* or *2009 WTD 16-1*.)

The budget is the minority Conservative government's first item of business since proroguing Parliament near the end of 2008 to avoid being defeated in the House by the three opposition parties. As *TNI* went to press, newly installed Liberal leader Michael Ignatieff signaled he would support the budget contingent on the government agreeing to provide quarterly progress reports starting in March. The other two opposition parties (the New Democratic Party and the Bloc Québécois) have already declared their intention to vote against the budget. Hence, it is likely but not certain that the budget has the support necessary to pass the House of Commons.[1]

Canada has enjoyed exceptional economic performance over the past several years, running a series of budget surpluses and reducing Canada's debt-to-GDP ratio to the lowest level in the G-7. However, Canada is not immune to the dramatic economic downturn that has swept across the globe over the past year; Flaherty announced that he anticipates Canada's real GDP will contract by 0.8 percent over the next year. As a result, the budget contains more spending than taxing, and the government has clearly adopted the same posture as other G-7 countries (particularly the U.S.) by embarking on a very substantial spending program in an effort to stimulate the economy. The budget contains a wide variety of stimulus measures amounting to about 1.9 percent of Canada's GDP (near the IMF's suggested target of 2 percent). The measures are forecast to lead to budgetary deficits totaling over C $60 billion during the next two years. The budget optimistically projects a return to budgetary surpluses by 2013 to 2014.

The budget announces some very important changes to Canada's outbound taxation system, which would be improved by withdrawing (or potentially withdrawing) existing proposed amendments.

Outbound Taxation: A Brief History

Canada's manner of taxing Canadian taxpayers' foreign-source income and the entities they invest in has been in a state of flux for almost a decade. First, very far-reaching and complex rules (the foreign investment enterprise and nonresident trust (NRT) rules) were announced in 1999 and released as draft legislation in June 2000 that dealt with the taxation of passive (or what is supposed to be passive) foreign-source income of Canadians. These rules, which have been criticized for their extreme complexity (even by tax standards) and overly broad scope, have gone through a number of variations and amendments and have still not been enacted into law (in their most recent form, they are proposed to be effective retroactively). (For prior coverage of the FIE/NRT rules, see *Doc 2005-16307* or *2005 WTD 148-2*.)

In 2004 a number of proposed changes were announced relating to Canada's foreign affiliate regime, which governs the taxation of investments in foreign entities that meet a certain ownership threshold so as to make the foreign entity a foreign affiliate (or in some cases a controlled foreign affiliate) of the Canadian taxpayer. These changes were also very complex and far-reaching and in many cases, seem to produce unintended effects. Among the proposed amendments (much of which has not yet been enacted into law) were the expansion of the controlled foreign affiliate definition (with the effect of increasing the likelihood that foreign-source passive income would be imputed to the Canadian taxpayer and taxed on an accrual basis) and so-called surplus suspension rules designed to prevent perceived abuses on the recognition of income on intragroup transactions. These provisions have created a great deal of uncertainty and made it difficult for Canadian taxpayers with foreign affiliates to plan their affairs on an ongoing basis (many of these rules are also to be effective retroactively). (For prior coverage of the 2004 package, see *Doc 2004-6779* or *2004 WTD 60-2*.)

[1]Current standings in the House of Commons are: Conservative, 143; Liberal, 77; Bloc Québécois, 49; New Democratic Party, 37; Independent, 2. *See* http://www/parl.gc.ca.

Finally, the 2007 federal budget included an initiative directed at foreign affiliates and the manner in which they are financed. The original proposal effectively eliminated the ability of Canadian taxpayers to deduct interest expense on money borrowed to invest in a foreign affiliate earning exempt surplus (active business income earned in a country with which Canada has a tax treaty). The basis for this proposal was that because exempt surplus is not taxable in Canada when repatriated, allowing interest deductibility on borrowed money used to earn such income amounted to an undue subsidy of foreign business operations.

Widely condemned by the business community as putting Canadian multinationals at a severe disadvantage relative to their foreign competitors, these rules were ultimately scaled back to a more limited objective of denying interest deductibility on money borrowed by a Canadian taxpayer and used to finance a foreign affiliate that in turn made some kinds of intragroup loans that generated deductible interest in another jurisdiction (double dipping). These more modest provisions were ultimately enacted in the form of section 18.2 of the Income Tax Act (Canada), effective after 2011, and remain controversial because of both their underlying rationale and the uncertainty of their application in a variety of circumstances. (For prior coverage, see *Doc 2007-7732* or *2007 WTD 60-1*; see also *Doc 2007-11796* or *2007 WTD 94-1*.)

The Advisory Committee's Report

An offshoot of the 2007 budget was the minister of finance's establishment of an advisory committee to review Canada's international taxation system and make recommendations. The advisory committee delivered its report to the minister in December 2008, making a number of detailed recommendations concerning both inbound and outbound taxation. (For prior coverage, see *Tax Notes Int'l*, Jan. 26, 2009, p. 345, *Doc 2009-84*, or *2009 WTD 15-11*.)

Among the report's recommendations were:

- Canada should move to a broader exemption system for taxing foreign-source active business income earned through foreign affiliates;

- the Department of Finance should reconsider the need for the FIE/NRT rules, in particular with a view to reducing complexity and overlap in Canada's antideferral regimes (while ensuring that passive foreign-source income earned by Canadian taxpayers is taxed on a current basis); and

- ITA section 18.2 should be repealed, and no new interest deductibility restrictions should be imposed on borrowing to finance foreign affiliates of Canadian taxpayers.[2]

The Budget

The budget's most important business tax measure is the announcement that ITA section 18.2 would be repealed as recommended by the advisory panel. The government cited the negative effect that this provision could have had on foreign investment by Canadian multinationals. This development should please that segment of the tax community. In the current economic environment more than ever, Canadian businesses must be competitive internationally in order to survive, and a disadvantageous tax system is an illogical, unnecessary cost. The government should be commended for assembling a very knowledgeable panel of experts and then acting on their advice. The repeal of section 18.2 is a very important and welcome development for Canadian business.

The budget also indicates that the government has carefully considered the advisory panel's views on other elements of the outbound taxation regime. The budget states that the government will: review the existing FIE/NRT rules in light of the advisory panel's comments and the many submissions it has received about them; and consider the advisory panel's comments on the foreign affiliate system before proceeding to enact the outstanding measures contained in the 2004 foreign affiliate amendments (a number of which would be unnecessary under a full exemption regime).

Although statements about reconsidering legislative initiatives that have been so heavily criticized do not constitute an outright abandonment of those proposals, they are a positive development for the many taxpayers who are overwhelmed by the complexity of the tax system and these provisions in particular and who would welcome simpler, more narrowly targeted rules that do a better job of focusing on the real areas of potential abuse. Many of the current proposals are simply not working satisfactorily, and it would not be surprising if these statements are the first step toward a larger redesign of the outbound taxation system. The government should again be commended for listening to the business community. Making the entire outbound taxation system simpler, more efficient, and more internationally competitive would significantly boost the Canadian economy.

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[2]Measures against a specific practice referred to as debt dumping were advocated.

Other Business Tax Measures

Accelerated Capital Cost Allowance

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,[3] 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) on eligible machinery and equipment used in manufacturing and processing. Instead of the usual 30 percent declining balance CCA rate generally applicable, the 2007 budget allowed most such property 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). The 2008 budget then extended this deduction for an additional three years by proposing that:

- for eligible property acquired in 2009, the same CCA rate announced in the 2007 budget would apply; and
- for eligible property acquired in 2010 and 2011, less generous CCA rates would apply.[4]

The 2009 budget would extend to eligible property acquired in 2010 or 2011 the more generous 50 percent straight-line CCA rate applicable to eligible property acquired in 2009 (the half-year rule would still apply).

Another budget proposal would offer faster CCA on eligible computers and software acquired after January 27, 2009, and before February 2011. Instead of the 55 percent declining balance rate currently applicable, the CCA rate would be 100 percent and the half- year rule would not apply, meaning that the cost of the property would be written off entirely in the year it is acquired by the business. The property eligible for this faster write-off would be most general purpose electronic data processing equipment (and related systems software) that:

- is located in Canada;
- is acquired by the taxpayer for use in a Canadian business or to earn income from property located in Canada (or to lease to someone so using it); and
- was not previously used (or acquired for use) before being acquired by the taxpayer for use in Canada.

Canadian-Controlled Private Corporations

A corporation that is a Canadian-controlled private corporation (CCPC) enjoys a number of advantages within the Canadian tax system. In particular, a CCPC may benefit from a low 11 percent tax rate on the first C $400,000 of qualifying active business income that it earns via a mechanism called the small-business deduction.[5] The budget would increase the maximum income eligible for the deduction from C $400,000 to C $500,000 effective January 1, 2009.[6]

CCPCs are also eligible to earn investment tax credits at an enhanced 35 percent rate on up to C $3 million of qualifying scientific research and experimental development. The C $3 million threshold is reduced once the CCPC's taxable income for the previous year reaches C $400,000 and eliminated entirely once previous-year taxable income reaches C $700,000. The budget would increase the C $400,000 and C $700,000 amounts to C $500,000 and C $800,000, respectively, expanding the availability of the enhanced ITCs.

Finally, the budget would correct a technical problem arising from a court decision in 2006, which affects the precise time at which control of a CCPC is acquired on the relevant day. The ruling had created anomalous results arising from determining exactly when control of the corporation had been acquired, and the CCPC had thereby lost its status as a CCPC.

Administrative Matters

The budget proposes to require that some taxpayers file their tax returns electronically, effective for tax years ending after 2009. Corporations with annual gross revenue over C $1 million would be required to file electronically except in situations (to be announced

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[3]Declining balance means that the depreciation rate is applied in each year against the remaining portion of the property's cost, such that each year's deduction is smaller than the preceding year's. For example, a C $100 property depreciated at 50 percent on a declining balance yields a C $50 deduction in year 1 (C $100 x 50 percent), a C $25 deduction in year 2 (50 percent x (C $100 - C $50)), and so forth.

[4]In both cases the deduction in the first year was limited by the half-year rule.

[5]When two or more corporations are associated, they must share the limit. To limit this tax preference to smaller businesses, the deduction begins to phase out when the CCPC has taxable capital employed in Canada of C $10 million, and is eliminated completely when the CCPC has C $15 million of taxable capital employed in Canada.

[6]This increase in the small-business limit would also: result in some CCPCs earning between C $400,000 and C $500,000 in taxable income having an additional month to pay any balance of tax owed; and entitle some CCPCs to be eligible to pay their taxes in quarterly installments rather than monthly.

later) when the Canada Revenue Agency believes electronic filing would be inefficient.[7] Some minor amendments to related penalty provisions have also been proposed. The budget also proposes that in 2010 and thereafter a taxpayer that files 50 or more of any particular type of information return would be required to do so electronically. This would occur most frequently in the case of T4 reporting returns for employment income.

Previously Announced Measures

When Parliament was prorogued in December 2008, a number of tax measures had not yet been enacted into law and were automatically terminated. The budget confirms the government's intention to reintroduce many of these previously announced proposals, including:

- changes to the taxation of financial institutions to better align income tax laws with accounting rules; and
- draft amendments relating to the rules allowing some taxpayers to report their Canadian income tax in a foreign (''functional'') currency.

Personal Tax Measures

The budget also contains a number of relatively minor personal income tax amendments, largely directed at low- and middle-income earners. These include:

- the basic personal amount (the amount of income that can be earned before any tax is payable) would increase from C $9,600 for 2009 to C $10,320 for 2010 and would thereafter be indexed to inflation;
- the upper limit of the two lowest tax brackets would be increased for 2009, with the 15 percent tax bracket ending at C $40,726 instead of C $37,885 and the 22 percent tax bracket ending at C $81,452 instead of C $75,769 both brackets would be indexed to inflation thereafter; and
- the tax credit for persons 65 and older would increase by C $1,000 to C $6,408.

A new home renovation tax credit of up to C $1,350 would be introduced for qualifying home renovation expenditures (excluding routine repairs and furniture) of up to C $10,000 incurred between January 28, 2009, and February 1, 2010. This tax credit may not cost the government much in forgone tax revenue because much home renovation activity occurs under the table as part of the underground economy. That activity would have to come into the tax system for the credit to be claimed. The budget would also introduce a small first- time home buyer's tax credit on qualifying homes acquired after January 27, 2009. Also, the amount of money that a first-time home buyer could withdraw from his registered retirement savings plan (RRSP, a tax-sheltered individual retirement fund analogous to a U.S. 401(k)) would increase from C $20,000 to C $25,000. The budget also proposes relief provisions to compensate for the decrease in the value of investments in an RRSP (or some similar retirement-related vehicles) following the death of the annuitant to prevent undue hardship when investments decline in value postmortem before the deceased's property is distributed.

Finally, the 15 percent mineral exploration tax credit available to individuals who invest in flow-through shares of mining exploration companies would be extended another year for flow-through share agreements entered into by March 31, 2010. ◆

Full Text Citations

- Finance Minister Jim Flaherty describes Canada's 2009 budget economic action plan. *Doc 2009-1816*; *2009 WTD 17-9*
- Summary of 2009 budget tax relief measures. *Doc 2009-1817*; *2009 WTD 17-10*
- Prime Minister Stephen Harper notes home renovation tax credit. *Doc 2009-1819*; *2009 WTD 17-11*
- Flaherty's budget speech. *Doc 2009-1823*; *2009 WTD 17-12*

[7]Examples provided of such exceptions include nonresidents and insurance companies.