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by Steve Suarez

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Canada's Minister of Finance Jim Flaherty on March 19 delivered the second budget of the minority Conservative government elected early in 2006.

For the budget to pass the House of Commons, the government will require the support of at least one of the three opposition parties.[1] That seems quite likely, however, as the leader of the Bloc Quebecois suggested shortly after the budget's release that his party intends to support it.

Canada enjoyed another year of excellent economic performance. For the 2006-2007 fiscal year, the government projects a surplus of C $9.2 billion. Real gross domestic product growth is expected to be 2.3 percent in 2007, rising to 2.9 percent for 2008. The ratio of federal debt to GDP is projected to fall to 29.7 percent by 2008-09, the first time it will be below 30 percent since 1981-82. The unemployment rate, meanwhile, is at historic lows at a little over 6 percent.

Tax cuts were a major focus of last year's budget, with reductions in the federal goods and services (VAT) tax, corporate income tax (and surtax), and corporate capital tax. (For prior coverage, see *Tax Notes Int'l*, May 8, 2006, p. 469.) This year's budget has significant tax measures but is more focused on spending initiatives (particularly transfers to provincial governments). The tax highlights of the budget come in the international area, where a couple of fundamental developments will attract the attention of businesses and investors with interests in Canada. Specifically:

- withholding tax on interest paid to nonresidents is being eliminated (including non-arm's-length lenders if resident in the United States); and
- major tightening changes are being made to the foreign affiliate system, in particular to interest deductibility on money borrowed by a Canadian corporation to invest in foreign affiliates.

Cross-Border Interest Withholding

Canada levies a tax (Part XIII tax) on various forms of passive income (such as interest, dividends, royalties) when paid by a Canadian resident to a nonresident of Canada. That form of tax is often termed a "withholding" tax, because the payer is made responsible for collecting the tax out of the amount paid to the nonresident (that is, withholding from the payment) and remitting it to the Canada Revenue Agency on the nonresident's behalf. The basic withholding rate is 25 percent, subject to relief under the terms of any tax treaty between Canada and the nonresident's home country. In the case of interest payments by Canadians to U.S. residents entitled to benefits under the Canada-U.S. income tax treaty, the rate of Part XIII tax is generally reduced to 10 percent under Article XI. Also, some forms of interest payments are exempted from Part XIII tax under domestic law, most notably interest payable by a Canadian corporation to an arm's-length lender on debt with a term of at least five years (the 212(1)(b)(vii) exemption).

Canada and the United States have been negotiating changes to the Canada-U.S. tax treaty for some time now; while the negotiations are not yet complete, the budget announced that both countries have agreed in principle to eliminate cross-border

[1]Current standings in the House of Commons are Conservatives, 125; Liberals, 101; Bloc Quebecois, 50; New Democratic Party, 29; Independents, 1; with 2 seats vacant. *See* http://www.parl.gc.ca.

withholding tax on payments of interest by a resident of one country to a resident of the other. Thus, Part XIII withholding on interest payable to a U.S. resident entitled to benefits under the Canada-U.S. treaty will fall from 10 percent to 0 percent once the negotiations are completed (stated to be expected "in the very near future") and the changes to the treaty are in force. While most in the tax community foresaw the elimination of Part XIII withholding on interest payable to an *arm's-length* U.S. lender (to be effective in the first calendar year following the entry into force of the treaty revisions), the budget indicates that withholding tax on Canada-U.S. interest payments to *non-arm's-length* lenders will also be reduced to zero. The elimination of non-arm's-length interest withholding occurs over a three-year period, with the tax rate dropping to 7 percent and 4 percent (respectively) in the first and second years following the entry into force of the treaty revisions and zero withholding thereafter.

In addition to those changes under the Canada-U.S. tax treaty, the budget announced that Canada proposes to amend its domestic law to unilaterally eliminate Part XIII withholding on interest payments to all arm's-length foreign lenders (U.S. or otherwise). This amendment would be effective at the same time that the Canada-U.S. treaty interest withholding changes are effective.

Those changes (once implemented) will have a significant impact on how Canadian businesses are financed. Currently, a significant amount of debt into Canada is structured so as to qualify for the 212(1)(b)(vii) exemption, which among other things requires that the borrower not have to repay more than 25 percent of the debt principal within the first five years of the debt except in the event of a default. Because there are a number of situations in which lenders would legitimately wish to be repaid within that period, a considerable amount of CRA administrative guidance and tax community practice has developed over the years regarding what circumstances can cause the borrower to be required to make early repayment without jeopardizing the withholding tax exemption. By doing away with such restrictions and the associated legal and transactions costs they entail, a complete exemption for arm's-length debt will make it easier for Canadian borrowers with medium-to-long-term borrowings. Moreover, Canadian borrowers seeking short-term loans (for which the 212(1)(b)(vii) exemption is not available) will now be able to access foreign capital markets without incurring Canadian interest withholding taxes.

The elimination of interest withholding on non-arm's-length Canada-U.S. debt is particularly interesting. Given the large number of U.S. businesses with Canadian subsidiaries (and to a lesser extent vice versa), the ability to pay interest out of Canada free of interest withholding tax will affect how intragroup financing into Canada is structured (note that the 2-1 debt-equity limit under Canada's thin capitalization rule still limits how much deductible interest a Canadian corporation can pay to non-arm's-length nonresidents). The fact that interest payable to a non-arm's-length foreign lender will be exempt from withholding only if the lender is a U.S. resident suggests that it will be advantageous (at least from a Canadian tax perspective) for multinational groups to use a U.S. group member to lend into Canada rather than a lender elsewhere in the group. In general, North American groups with Canada-U.S. cross-border debt will want to spend the coming months carefully considering how to optimize their capital structure.

LLCs and the Canada-U.S. Tax Treaty

The budget confirmed that the Canada-U.S. tax treaty will be amended to allow U.S. limited liability companies to claim benefits under the treaty. Currently, Canada takes the position that LLCs are not U.S. residents eligible for treaty benefits, typically making LLCs impractical to use to invest into Canada. Venture capitalists and others who favor using LLCs will benefit from this pending change.

The budget also indicates that the pending revisions to the Canada-U.S. tax treaty (once finalized) will offer greater mobility to residents of Canada working in the United States, in terms of harmonizing the tax treatment of pension contributions and clarifying the tax treatment of stock options.

Outbound Financing

The most dramatic and unexpected changes in the budget are those relating to Canada's foreign affiliate rules dealing with the taxation of foreign entities in which Canadian corporations have a significant interest (analogous to the U.S. controlled foreign corporation rules). The foreign affiliate proposals in the budget will put Canadian corporations expanding outside Canada at a significant disadvantage relative to foreign competitors. If these proposals are ultimately enacted (amid what is anticipated to be serious resistance from the Canadian business community), most Canadian corporations with foreign subsidiaries (including those that are part of a foreign multinational group) will have to review the effect of these proposals on their Canadian tax planning and likely engage in some restructuring.

Background

The Canadian foreign affiliate system has two basic objectives. The first is to impute some forms of passive income earned by a controlled foreign affiliate back to its Canadian shareholders, whether or not the foreign affiliate actually pays the underlying income back to Canada. That is intended to prevent

Canadian taxpayers from deferring Canadian tax on investment-type income by putting the money into a foreign entity and simply having it earn the passive income outside Canada. The type of income earned by a controlled foreign affiliate that gets imputed back to the Canadian shareholder is called foreign accrual property income (FAPI) and is essentially passive income, such as interest and rents. Active business income (ABI) is excluded from FAPI, as are some forms of passive income that are deductible in computing the ABI of another foreign entity that is "related" to the foreign affiliate (that is, ultimately controlled by the same person).

The second broad objective of the foreign affiliate system is to determine how dividends paid by a foreign affiliate to the Canadian corporate shareholder are taxed. Earnings of a foreign affiliate are divided into two categories: exempt surplus and taxable surplus. For countries with which Canada has a tax treaty, ABI earned in such countries by a foreign affiliate resident in such a country is included in exempt surplus, while ABI earned in (or by a foreign affiliate resident in) a nontreaty country is included in taxable surplus. When a foreign affiliate pays a dividend to its Canadian shareholder out of its exempt surplus, the shareholder receives a full deduction such that the dividend is received free of Canadian tax, the underlying premise being that treaty countries have sufficiently high levels of tax that Canada should not tax the same income. Conversely, a dividend that is attributable to its foreign affiliate's taxable surplus is included in the Canadian shareholder's income when received, subject to a deduction for any foreign taxes the underlying income has borne; that is, like a foreign tax credit.

Interest on Foreign-Affiliate-Related Debt

Under existing law, a Canadian taxpayer that borrows money to invest in a foreign affiliate is generally entitled to deduct the associated interest expense against its income from all sources, including its Canadian-source income. That is so even when the income earned by the foreign affiliate will not be taxed in Canada when repatriated (for example, exempt surplus), such that Canada is allowing a deduction on interest incurred to make an investment, the income from which will not be taxed in Canada. For decades Canadian tax policy has been that this element of the tax system is necessary to make it internationally competitive and allow Canadian multinationals to compete on a level playing field with their foreign counterparts.

In a fundamental tax policy shift, the budget effectively eliminates the ability of Canadian taxpayers to deduct interest expense on money borrowed to invest in a foreign affiliate earning exempt surplus. The proposal is directed at borrowed money that is used in some way to finance a foreign affiliate of the Canadian borrower (or of someone not dealing at arm's-length with it), whether through loans, share investments, or capital contributions. In essence, interest on such borrowed money will be deductible only against the borrower's net income relating to the foreign affiliate that will be taxed in Canada, such as interest, FAPI, taxable surplus dividends unsheltered by a deduction for foreign taxes paid, or taxable capital gains. Unusable interest expense will be tracked in a separate "disallowed interest pool" that can be carried forward and used in future years. For debt incurred after the budget, these rules will apply for tax years beginning in or after 2008, while for existing debt a modest transitional period is allowed before interest deductibility is denied (until the end of 2008 for non-arm's-length debt, or until the end of 2009 for arm's-length debt).

These measures will be difficult for Canadian taxpayers to deal with (especially as they appear to apply separately for each foreign affiliate), and the degree of linkage between a borrowing and an investment necessary to engage the new rule is imprecise. It is not clear that the new rule would apply, for example, if a Canadian corporation reorganizes its borrowings to use debt to finance its domestic operations and its use equity to finance its foreign affiliates. What is clear is that the earth has shifted beneath the feet of Canadian corporations with foreign affiliates, particularly multinationals seeking to expand internationally. For example, a Canadian corporation seeking to purchase a foreign corporation effectively cannot now borrow to do so on an interest-deductible basis in its home country, leaving it at a disadvantage against a foreign competitor that is able to do so. As many Canadian corporations have borrowed to finance foreign acquistions in recent years, it is certain that there will be a considerable outcry from the business community over this initiative.

Changes to Exempt Surplus and FAPI

The budget announces Canada's intention to include in all of its new tax treaties (and any renegotiations to existing treaties) comprehensive tax information exchange agreements (TIEAs) consistent with new OECD standards. The foreign affiliate system will be used to encourage countries with which Canada does not have a tax treaty to enter into TIEAs with Canada. The budget proposes to expand the scope of exempt surplus to include ABI earned in a nontreaty country that has agreed to a TIEA with Canada, presumably attracting Canadian investment. Conversely, when Canada proposes to negotiate a TIEA with a nontreaty country and that agreement is not concluded within five years (or before 2014 for negotiations already under way), the budget proposes to penalize that country by causing *all* income earned there (including ABI) to be treated as FAPI for Canadian tax purposes.

These proposals represent an interesting delinking of the exempt surplus and FAPI concepts from their original underpinnings. Previously, the policy underlying exempt surplus treatment was that treaty countries levied tax at a sufficiently high rate to make it inappropriate to apply Canadian tax on repatriation; hence the full exemption from Canadian taxation for exempt surplus dividends. Similarly, the FAPI concept has historically been limited to non-ABI income on the basis that it is not appropriate to impute active income back to Canada before actual repatriation. These proposals to amend the scope of exempt surplus and FAPI based on whether the relevant jurisdiction is willing to share tax information with Canada represent a surprising change in established tax policy.

Finally, another important change to the foreign affiliate rules is directed at what constitutes ABI (which in turn affects both FAPI and exempt surplus determinations). As noted earlier, in some cases passive income (for example, interest, rents, royalties) earned by a foreign affiliate of a Canadian corporate taxpayer that would otherwise constitute FAPI will be deemed to be ABI if it is deductible in computing the payer's ABI and the payer is a nonresident corporation related to the Canadian corporation (that is, one controls the other, or both are subject to common control). That deemed ABI rule (which gives a corporate group flexibility to structure its operations by preserving the character of income that is derived from active business operations within the group) is being tightened to require that the Canadian corporation or a related Canadian corporation have a qualifying interest in the payer (roughly, direct or indirect equity of at least 10 percent in terms of both votes and value). This will prevent such beneficial treatment from arising when the payer is a sister company to the Canadian corporation (for example, they share a common foreign parent) in which the Canadian corporation has no economic interest. The budget states that deemed ABI treatment "is not appropriate where the Canadian company has little or no equity interest in the payor foreign corporation, as the Canadian company will not share in the profits of, or any increase in the value of, the payor foreign corporation," and proposes that this amendment be effective for tax years of foreign affiliates beginning after 2008.

Other Business Tax Measures

The budget contains a number of less significant tax measures of relevance to businesses.

Capital Cost Allowance

There are some changes to the system of capital cost allowance (CCA) which allows the cost of capital property to be deducted over time on a declining-balance basis (that is, depreciation for tax purposes). Most significantly, as a temporary incentive to invest in capital equipment, the normal 30 percent CCA rate for most machinery and equipment used in manufacturing and processing is being increased for machinery and equipment acquired after March 19, 2007, and before 2009. Such equipment can be written off entirely over three tax years, through a special 50 percent straight-line CCA rate (subject to the normal half-year rule limiting the first year's deduction). Reaction to this proposal from the manufacturing sector was swift and positive.

The CCA rates on some other types of capital property have also been increased, effective for property acquired on or after March 19, 2007:

	Current rate	Increased rate
Buildings used for manufacturing or processing	4%	10%
Other nonresidential buildings	4%	6%
Computer equipment	45%	55%
Natural gas distribution lines	4%	6%
Liquefied natural gas facilities	4%	8%

As part of a green power initiative, the accelerated CCA rates for Class 43.1 and 43.2 property are being extended to equipment used to generate electricity from wave and tidal energy. Eligibility for that accelerated CCA is also being extended to a broader range of applications involving other forms of "clean" energy generation such as active solar equipment (commercial and residential air and water heating now permitted), photovoltaic and fixed-location fuel cells (minimum size restrictions eliminated), biogas production equipment (eligible feedstocks expanded), pulp and paper waste fuels (expanded list of eligible fuels), and biomass drying. However, the accelerated CCA offered to property used in oil sands projects is being phased out (the regular 25 percent CCA remains).

Section 116 Withholding

Canadian tax legislation uses the concept of shares that are listed on a "prescribed stock exchange" for various purposes, one of which is section 116 withholding. Canada taxes nonresidents on the disposition of some forms of capital property (taxable Canadian property). For some forms of taxable Canadian property, the purchaser has an obligation to withhold a portion of the purchase price (usually

New Categories of Stock Exchanges

Category	What's Included	When Relevant
Designated stock exchanges	All existing prescribed stock exchanges	Most existing rules that prescribed stock exchange
Recognized stock exchanges	All designated stock exchanges and stock exchanges in Canada or OECD countries with Canadian tax treaty	Section 116 withholding on shares of Canadian corporations; other rules to be determined
Stock exchanges, recognized stock exchanges, and any other stock exchange	All designated and recognized stock exchanges and any other stock exchange	Securities lending rules; other rules to be determined

25 percent) and remit it to the CRA on the nonresident seller's behalf, as a prepayment of the nonresident's Canadian tax payable on the disposition (if a lesser amount of tax is actually owing, the nonresident can apply for a withholding exemption or file a Canadian income tax return and claim a refund). That withholding system (section 116 withholding) gives the CRA an opportunity to consider whether Canadian tax is owing on the nonresident's disposition of taxable Canadian property while some portion of the sale proceeds are still within reach.

Shares that are listed on a prescribed stock exchange are exempt from section 116 withholding. However, there are a number of public stock exchanges that have not been "prescribed" (that is, listed by name in the tax regulations). As a result, dispositions of shares of most Canadian corporations listed on such nonprescribed stock exchanges are subject to section 116 withholding, and consequently, Canadian corporations often find it infeasible to list their shares exclusively on such exchanges.

The budget indicates that, effective upon royal assent of the enabling legislation, the prescribed stock exchange concept will be subdivided into three new categories (see below), and the new category applicable for purposes of the exemption from section 116 withholding will be significantly broader than the existing list of prescribed stock exchanges. Specifically, section 116 withholding will not apply to shares listed on a recognized stock exchange, which will include all existing prescribed stock exchanges *and* any stock exchange located in Canada or an OECD country that has a tax treaty with Canada. As a result, while these changes will not affect whether shares are taxable Canadian property (and hence whether the nonresident is subject to Canadian taxation on gains), they will relieve purchasers from section 116 withholding obligations, thus facilitating a Canadian corporation listing its shares exclusively on such exchanges. This will make it easier for smaller Canadian corporations to access foreign capital markets, in particular those such as the Alternative Investment Market (AIM) of the London Stock Exchange and the NYSE Arca, with more flexible regulatory regimes that have proven very popular with newer Canadian issuers looking for foreign equity capital.

Other

A variety of other business tax measures are included in the budget:

- Some Canadian provinces continue to impose a corporate capital tax. To discourage that, the federal government will provide financial incentives to provinces that eliminate their corporate capital tax (or in the case of a capital tax on financial institutions, convert it into a corporate minimum tax) on or before January 1, 2011.
- The budget introduces an incentive for businesses to create licensed child-care spaces generally for the benefit of their employees. Taxpayers carrying on business in Canada can claim a nonrefundable investment tax credit (up to C $10,000 per child-care space) of 25 percent of eligible expenditures incurred on or after March 19, 2007.
- Corporations that donate medicines from their inventories to approved charities for use in their foreign charitable activities will receive a special incremental deduction, over and above the existing deduction for the fair market value of the donated property.

The government reiterated its commitment to some previously introduced initiatives in the budget, including the changes announced in October 2006 to the taxation of income funds and similar publicly traded flow-through entities and the proposal from the 2006 budget to allow Canadian taxpayers that do their financial reporting in a foreign currency to use the same functional currency for income tax reporting purposes. There is still no sign of the long-awaited proposal to allow shares of a Canadian corporation to be exchanged for shares of a foreign corporation on a tax-deferred basis (the cross-border share-for-share rollover) originally proposed in October 2000. Accordingly, one would expect to continue to see "exchangeable share" structures in foreign acquisitions of Canadian corporations for consideration that includes shares of the foreign acquirer (those are also still desirable for Canadian residents from a dividend taxation perspective). Also absent is any mention of the proposal in the Conservative election platform to allow a deferral of capital gains realized by individuals who reinvest the sale proceeds within six months, although in postbudget comments to the media, Finance Minister Flaherty reiterated the government's intention to follow through on this later in its term.

Personal Tax Measures

The budget includes many personal income tax measures. Those include various changes in the taxation of retirement income, changes in the taxation of private foundations (including the donation of publicly listed shares to such foundations), and the full exemption of scholarships and bursaries for those attending elementary and secondary schools. A limited exemption exists for farmers, fishermen, and small-business owners realizing capital gains on the disposition of qualified farm or fishing property or shares of qualified small-business corporations. This maximum lifetime exemption of C $500,000 is being increased to C $750,000, effective for dispositions occurring after March 19, 2007 (transitional rules apply for gains realized in 2007).

Registered retirement savings plans (similar in concept to U.S. 401(k) plans) and some other tax-exempt entities are restricted to investing their assets in qualified investments. The budget proposes to expand the range of qualified investments to include (1) any investment-grade debt issued as part of a minimum C $25 million offering, and (2) any security (other than a futures contract) listed on a designated stock exchange (see above). That change will remove impediments on these entities investing in securities such as foreign-listed trust and partnership units and Canadian dollar-denominated bonds of foreign issuers. 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 corporation to "flow out" the exploration deductions to the shareholder) is being extended another year, for flow-through share agreements entered into by March 31, 2008. Finally, relief from various forms of Canadian taxation is being provided for nonresident participants in the 2010 Vancouver Winter Olympics. ◆

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Full Text Documents

- Department of Finance release on tax relief for families and businesses. *Doc 2007-6905*; *2007 WTD 54-12*
- Department of Finance release on Budget 2007. *Doc 2007-6935*; *2007 WTD 55-10*