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Canadian Finance Minister Jim Flaherty on March 22 presented the 2011 federal budget to the House of Commons,[1] but it faces steep hurdles on the path to enactment. (For the Finance Ministry news release, see *Doc 2011-6087*. For Flaherty's budget speech, see *Doc 2011-6093*.)

If the budget is to pass and be enacted into law, at least one of the three opposition parties — the Liberal Party, the Bloc Quebecois, and the New Democratic Party — must support it. After Flaherty's budget speech, all three opposition parties said they would vote against the budget as it stands. Unless the minority Conservative government is willing and able to negotiate amendments with one of the opposition parties, it appears unlikely that the current Parliament will enact the proposals into law, and therefore likely that a federal election will follow.

The most recent opinion polls indicate that an election held today would likely produce a result similar to the current standings in Parliament, and most of the tax proposals in the budget are unlikely to be contentious, because the opposition's primary demands are expenditure related. Therefore, if the budget is defeated and an election is called, the tax elements of the budget could be reintroduced and considered by the next Parliament.

The budget seeks to maintain the government's existing plans for eliminating the deficit and reducing stimulus spending related to the 2008-2009 recession.[2] The deficit for 2010-2011 is projected to shrink to C $40.5 billion, continuing to decline in subsequent years, and it is expected to be eliminated by 2014-2015. Economic growth is expected to average a little less than 3 percent per year over the next five years.

Most of the tax-related measures in the budget are technical rather than significant policy shifts. There are no broad-based tax initiatives or rate changes, and the tax measures that were announced primarily concern personal taxation.

Previous legislation reduced the general corporate tax rate from 18 percent to 16.5 percent effective January 1, with another reduction to 15 percent in 2012. (For a related Finance Ministry news release on the tax cuts, see *Doc 2010-27526* or *2011 WTD 1-25*.) Along with those that tighten perceived loopholes in the tax system, the proposed amendments of greatest interest to the business community would:

- introduce rules to eliminate corporations' ability to defer the taxation of income earned through one or more partnerships that have fiscal year-ends that are different than the corporations' year-ends;
- provide for significantly less generous tax treatment of some costs associated with Canada's oil sands to correspond with the tax treatment of similar costs relating to conventional oil and gas properties;
- allow for the tax depreciation of some property on an accelerated basis; and
- amend or extend various rules regarding flow-through shares.

Partnerships and the Deferral of Income

Corporations are taxpaying entities in Canada, and partnerships are not. A partnership computes income and loss from its activities as if it were a taxable entity, but the income or loss is imputed to the partners for inclusion in their income. The partners pay tax on the partnership's income.

A corporate partner in a partnership must include in its income for the year its share of the partnership's income or loss for the partnership's fiscal period ending during the corporation's tax year. These rules allow for the deferral of tax on partnership income when a

[1]Current standings in the House of Commons are Conservatives 143; Liberals 77; Bloc Quebecois 47; New Democratic Party 36; Independent 2; Vacant 3. *See* http://www.parl.gc.ca.

[2]Budget documents are available at http://www.fin.gc.ca/n11/11-027-eng.asp.

partnership has a later year-end than its corporate partners. For example, if the corporation has a calendar tax year and the partnership's fiscal period ends on January 31 of each year, the corporation's tax year ending December 31, 2011, will include its share of income from the partnership for the partnership year ending January 31, 2011. Income from the partnership year ending January 31, 2012, will be included in the corporate partner's year ending December 31, 2012. That creates a clear opportunity for deferral of tax on partnership income (especially when multiple levels of partnerships are used). This strategy has been particularly attractive in recent years as corporate tax rates have been declining, because the result is an absolute reduction of tax payable as well as deferral.

The 2011 budget proposes to end this deferral opportunity for corporations that have a significant interest (10 percent or more, including interests owned by affiliated and related parties) in a partnership. (Similar rules already exist for individuals.) Generally, this would be accomplished by requiring the corporate partner to include in its income for a tax year an estimate of the partnership's income for the portion of its fiscal period up to the end of the corporate partner's tax year. In the previous example, the corporate partner would be required on December 31, 2012, to include in its income not only its share of the partnership's income for the partnership year ending on January 31, 2012, but also an estimated amount for the first 11 months of the partnership's year ending January 31, 2013, occurring before the corporation's own December 31, 2012, tax year-end (the stub period). The stub-period income could be computed based on a formula that prorates the partnership's income for the partnership year that actually ended during the corporation's tax year. These rules would not apply to accrued losses for the stub period, only accrued income.

The mechanics of the proposal are considerably more detailed and include various supporting rules (such as an allowance for resource-sector deductions taken at the partner level and special rules requiring all partnerships in a multilevel partnership structure to have the same year-end).

The rules would apply to corporations' tax years ending after March 22, 2011, subject to transitional rules providing for what amounts to a five-year recognition period for the first year of stub-period income.

Oil Sands Expenditures

Canada's oil sands, located primarily in northern Alberta, constitute an enormous potential reserve of oil but are challenging to exploit economically because of the technical difficulty of extraction and the costs involved. The tax treatment of capital expenditures is an important element of the economic feasibility of exploration and development of natural resources, and the faster the expenditures incurred on an activity can be deducted for income tax purposes, the more economically attractive that activity will be.

Expenditures relating to Canadian resource property fall into one of four general categories (for related coverage, see *Doc 2010-24370* or *2010 WTD 238-19*):

- the cost of depreciable property, which may be deducted for income tax purposes on a declining balance basis over a period of years as capital cost allowance (CCA), with different rates applied to different classes of property as specified in the tax statute;
- Canadian exploration expense (CEE), deductible at a 100 percent rate;
- Canadian development expense (CDE), deductible at a rate of 30 percent per year on a declining balance basis; and
- Canadian oil and gas property expense (COGPE), deductible at a rate of 10 percent per year on a declining balance basis.[3]

The cost of acquiring conventional oil and gas property is currently treated as COGPE, while the cost of acquiring oil sands leases and other oil sands resource property generally is eligible for CDE treatment. Effective for acquisitions made on or after the budget date (March 22), the budget proposes to eliminate CDE treatment for oil sands acquisition costs.

Pre-production development expenses incurred to bring oil sands mines into production in reasonable commercial quantities also benefit from favorable tax treatment under the existing rules. Those expenditures are treated as CEE. The budget proposes to end that treatment and instead characterize the expenses as CDE, like the development costs of production wells for conventional oil and gas and *in situ* oil sands projects. As a transitional measure, the current CEE treatment would be preserved for pre-production development expenditures incurred before the budget date, as well as for expenses incurred before 2015 on new mines on which major construction began before the budget date. For other pre-production development expenditures, the CEE/CDE treatment would be as described below:

Year Incurred	2011	2012	2013	2014	2015	2016
CEE proportion	100%	100%	80%	60%	30%	-
CDE proportion	-	-	20%	40%	70%	100%

[3]For more information on these expenditures, see http://miningtaxcanada.com/treatment-of-expenditures.

Because these changes would not be retroactive and leases have already been issued on most oil sands property, a change in the tax treatment of the cost of acquiring oil sands leases and other oil sands resource property is unlikely to significantly affect valuations. (Acquisition costs tend to be much lower than development costs in this sector.)

Oil sands mining is very expensive, and as a policy matter it is not obvious that the appropriate basis for comparison for oil sands mining is other forms of oil and gas development rather than other forms of mining (which generally receive CEE treatment on such expenses). As a practical matter, however, it wouldn't seem that the eventual loss of CEE treatment on oil sands mining would significantly affect economic development in this area, given the government's estimate that the combined effect of the changes would be to increase tax revenue by C $220 million over five years.

Accelerated Capital Cost Allowance

CCA is the Canadian tax version of depreciation, entitling the taxpayer to annual deductions (typically on a declining balance basis) for the cost of most capital property used in a business. As noted above, different types of property fall into different classes for CCA purposes, each with a different rate of depreciation.

Machinery and equipment acquired before 2012 primarily for use in Canada for the manufacturing or processing of goods for sale or lease is currently eligible for temporary accelerated CCA. This accelerated rate is 50 percent on a straight-line basis (subject to the half-year rule for the year of acquisition). The budget proposes to extend the favorable tax treatment for this type of depreciable property for two more years, applicable to eligible machinery and equipment acquired before 2014 (after which the applicable rate would be 30 percent on a declining balance basis).

Also, Class 43.2 provides for accelerated CCA (at a 50 percent rate) for specified clean energy generation and conservation equipment. The budget would expand the list of assets eligible for Class 43.2 (effective for assets acquired on or after the budget date that were not used or acquired for use before that date) to include equipment used to generate electrical energy in a process in which substantially all of the energy input is from waste heat. Eligible equipment would include electrical generating equipment; control, feedwater, and condensate systems; and other ancillary equipment, but not buildings or other structures, transmission equipment, or distribution equipment. Equipment using chlorofluorocarbons or hydrochlorofluorocarbons would also be ineligible.

Charitable Donations of Flow-Through Shares

Flow-through shares are a financing tool available exclusively to corporations in the natural resources sector. Essentially, they allow corporations that incur qualifying exploration and development expenditures to issue new shares (flow-through shares) to investors at a premium, because the persons subscribing for the shares may deduct for tax purposes some expenditures made by the issuing corporation. The corporation's qualifying expenditures in effect flow through to the investors.[4]

In simplified terms, when an investor pays C $100 for a flow-through share, that investor will be entitled to claim deductions from income of C $100 (typically as CEE). To reflect that tax benefit, the holder's cost of the flow-through share for tax purposes is deemed to be zero, meaning that the holder immediately has a built-in accrued capital gain of C $100. As such, when the share is sold, the entire sale proceeds will be treated as a capital gain regardless of whether the share has appreciated in value.

To encourage charitable donations, an investor is exempted from tax on accrued capital gains on publicly traded securities donated to a charity. This has led to some planning strategies in which flow-through shares were issued to subscribers who then donated them to charity to eliminate the built-in capital gain inherent in their shares (C $100 in the example above) and to get the further benefit of a charitable donation tax credit for the value of the donated shares. The interaction of the flow-through share deductions (potentially including the mineral exploration tax credit described below), the charitable donation tax credit, and the elimination of the built-in capital gain on shares donated to charity could result in charitable donations of flow-through shares involving little after-tax cost to the investor.

The Department of Finance has decided that the use of the charitable donation capital gains exemption to shelter the built-in capital gain on flow-through shares is inappropriate. Therefore, the budget proposes to effectively restrict the charitable donation capital gains exemption for flow-through shares (or rights to those shares) donated to charity to the amount of the gain in excess of the subscription price originally paid for the donated flow-through shares. In the earlier example, there would be no exemption of the first C $100 of capital gain — only to the extent that the value of the donated shares exceeded C $100 (the price originally paid) would the capital gains be exempted. The Department of Finance considers it necessary to tax the portion of any capital gain up to the original subscription price (for example, C $100) in order to recover some of the investor's tax benefits associated

[4]For more information on flow-through shares, see http://miningtaxcanada.com/flow-through-shares.

with flow-through shares. The proposal applies to flow-through shares acquired under a binding flow-through share subscription agreement made on or after the budget date.

Mineral Exploration Tax Credit

Individuals other than trusts who invest in flow-through shares may be entitled to additional tax benefits above and beyond the renounced exploration expenses available on all flow-through shares. When certain qualifying expenditures (essentially expenses incurred in mining exploration above or at ground level) are incurred and renounced to a holder of flow-through shares that is an individual (other than a trust), the holder is entitled to an investment tax credit equal to 15 percent of the renounced qualifying expenditures. This tax credit on grass-roots surface exploration expenditures is called the mineral exploration tax credit.

The Income Tax Act currently requires that qualifying expenditures be incurred by the corporation by the end of 2011 and renounced to the investor under an agreement made before April 2011. The 2011 budget proposes to extend the 15 percent mineral exploration tax credit for another year by extending to the end of 2012 the date for incurring qualifying expenditures, and to March 31, 2012, the deadline for the corporation and the investor to enter into the flow-through share subscription agreement governing renunciation.

Other Business Tax Measures

Stop-Loss Rules on Dividends

When a corporation realizes a loss on the disposition of a share, the amount of that loss may be reduced by the amount of some dividends on that share received on or before the disposition (some dividends are received tax free by Canadian corporations). These stop-loss rules are generally intended to reduce the loss for tax purposes to an amount more closely reflecting the taxpayer's true economic loss on the share. In general, they do not apply to reduce a loss realized by a corporation if it held the share for 365 days or more and it owns less than 5 percent of the class of shares on which the dividend is received (including any shares owned by non-arm's-length persons).

The budget proposes to expand the scope of the stop-loss rules to any dividend deemed received on a redemption of shares held by a corporation (directly or indirectly through a partnership or trust), regardless of how long the share was owned or the number of shares that were owned. This targets what the budget documents describe as ''tax avoidance arrangements'' that ''in effect, claim a double deduction on the redemption of shares'' — namely, the intercorporate dividend deduction generally applicable to dividends received by one Canadian corporation from another Canadian corporation (a dividend is often deemed to occur on a share redemption when the redemption proceeds exceed the paid-up capital of the redeemed shares) and the loss on the share when the existing stop-loss rule does not apply. Deemed dividends received on shares of a private corporation held by another private corporation (directly or indirectly through a partnership or trust) are excluded from the change, as long as the direct or indirect recipient is not a financial institution.

Qualifying Environmental Trusts

Qualifying environmental trusts (QETs) are a form of entity relevant to regulatory regimes in which the operator of a mine, quarry, or waste disposal site is required to create a trust to pre-fund site reclamation or restoration costs. The site operator may deduct contributions to the QET, and although withdrawals from the QET are taxable in concept, they would be offset by deductions for reclamation expenses incurred by the operator if the withdrawal occurred in the same tax year that the expenses were incurred.

The budget proposes several changes to the QET rules (generally applicable to 2012 and subsequent tax years):

- expanding the range of trusts eligible to be QETs to include trusts established to fund reclamation costs for pipeline abandonment;
- expanding the list of regulatory authorities whose obligations may come within the QET regime, to include trusts mandated by order of a tribunal (such as the National Energy Board) constituted under Canadian federal or provincial law;
- expanding the investments QETs are permitted to make; and
- revising the tax rate applicable to QETs to align with the corporate tax rate.

Property and Casualty Insurers

The government announced in the budget that it is developing a framework for the demutualization of federally regulated property and casualty mutual insurance companies that will provide an orderly and transparent process for companies that choose to demutualize. Assuming this process follows a similar format for the demutualization of life insurers several years ago, it will eventually require income tax amendments to provide for property and casualty insurance companies to demutualize on a tax-deferred basis.

Previously Announced Initiatives

The government also used the budget to reiterate its commitment to several previously announced measures, including:

- outstanding legislative proposals regarding foreign affiliates of Canadian taxpayers (an area of seemingly perpetual proposed amendment);

- legislation regarding proposals made in the March 2010 federal budget;
- previously announced legislative proposals on technical amendments to items such as restrictive covenants, partnerships, pensions, section 143.3, the general corporate income tax rate, investment income earned by cooperatives and credit unions, and draft amendments to the Income Tax Regulations;
- changes proposed on December 16, 2010, concerning the rules for qualification as a real estate investment trust and associated tax treatment; and
- proposed changes to the goods and services tax rules concerning financial institutions that were announced on January 28, 2011.

The budget also reiterated the government's intention to proceed with some legislative amendments announced on March 16, 2011, in response to three recent court decisions that it regarded as unfavorable (for prior coverage, see *Doc 2011-5774* or *2011 WTD 54-1*):

- applying nonresident interest withholding tax on interest relating to debt in cases when the principal is held by a non-arm's-length creditor and the interest entitlement is owned by an arm's-length party (coupon stripping), effective for payments on arrangements entered into on or after March 16, 2011;
- limiting the recognition of expenditures to the extent that the taxpayer or a non-arm's-length person has the right (including some contingent rights) to reduce or eliminate an amount relating to the expenditure, effective for tax years ending on or after March 16, 2011; and
- reducing the deductible policy reserves of life insurers in some circumstances for 2012 and subsequent tax years.

The potential impact of the first two amendments may be considerably broader than the circumstances giving rise to their announcement, and taxpayers who may be affected should carefully review them to ensure they aren't caught by them inadvertently.

Nonbusiness Income Tax Measures

Finally, the budget included a variety of nonbusiness income tax amendments and initiatives, many of which appear to have been drafted with an eye to a possible election. Among the most notable are the following:

- narrowly directed tax credits for items such as children's artistic activities, volunteer firefighters, and family caregivers;
- the extension of rules designed to prevent the splitting of a taxpayer's income with minor children by including capital gains within the scope of the rules;
- changes relating to Registered Retirement Savings Plans (a form of tax-assisted retirement planning), generally of an antiavoidance nature and reducing the range of investments the plans may make; and
- measures applicable to charities to combat fraud and prevent abuse of the charitable donation regime. ◆

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