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Canadian 2012 Federal Budget: Tightening the Screws

by Steve Suarez

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FEATURED PERSPECTIVES

Canadian 2012 Federal Budget: Tightening the Screws

by Steve Suarez

Steve Suarez is a partner with Borden Ladner Gervais LLP in Toronto.

Canadian Finance Minister Jim Flaherty presented the 2012 federal budget to the House of Commons on March 29. Because the Conservative government commands a majority in the House,[1] there is every expectation that the budget will pass and become enacted into law in due course.

While the Canadian government is currently running a deficit (estimated to be $24.9 billion for 2011-2012), the nation's finances are recovering faster than expected, with a return to surpluses expected by 2015-2016. As part of the continuing effort to put Canada's fiscal house in order, the government announced a number of spending restraints, including increasing the age at which citizens are eligible for Old Age Security payments from 65 up to 67, phased in from 2023 to 2029. While there are no major changes to the general income tax system or applicable tax rates (the general federal corporate income tax rate remains at 15 percent), the budget contains important proposals directed at tax planning that Canadian tax authorities perceive as being inappropriate or abusive, with particular focus on nonresidents. The antiavoidance items addressed in the budget would:

- significantly tighten Canada's thin capitalization rules that limit the extent to which Canadian corporations can deduct interest expense on debt owing to related nonresidents, including a decrease in the maximum amount of such debt from $2 for each $1 of equity down to $1.50 of such debt for each $1 of equity;
- in a proposal of alarming breadth, attack so-called foreign affiliate dumping, applicable to investments made by Canadian subsidiaries of foreign taxpayers in corporations that are foreign affiliates of the Canadian subsidiary (other than when a business purpose test is met); and
- target the application of the section 88(1)(d) cost bump to partnership interests and the computation of the vendor's gain on the sale of a partnership interest to a nonresident.

Also, new rules are being introduced to treat transfer pricing secondary adjustments made regarding Canadian corporations as dividends to which nonresident withholding tax may apply. Canada's program of tax credits for scientific research and experimental development (SR&ED) is being scaled back, in favor of more direct grants. The investment tax credit for corporations engaged in mineral pre-production exploration and development within Canada is being phased out, as is another investment tax credit for oil and gas and mining activities in Atlantic Canada.

The principal tax measures of the budget relevant to the business community are summarized in Table 1.

Thin Capitalization

Because deducting interest expense is a relatively simple way of stripping profits out of Canada, a thin capitalization regime limits interest expense deductibility on debts owing by a Canadian corporation to some nonresidents if the corporation's leverage exceeds a specified debt-to-equity ratio. This rule applies to debt owing to ''specified nonresidents'' — that is, nonresidents who either are 25 percent plus shareholders (by votes or value) of the corporation or who do not deal at arm's length with such 25 percent plus shareholders. Under current rules, to the extent that the corporation

[1]Current standings in the House of Commons are Conservative, 165; New Democratic Party, 102; Liberals, 35; Bloc Quebecois, 4; Green, 1; Independent, 1; Vacant, 0. *See* http://www.parl.gc.ca.

Table 1. Budget 2012 Summary

Development	Effective
Thin Capitalization: limit on Canadian corporation's deductible interest expense on debt owing to related nonresidents	
Reduced 1.5-1 debt-to-equity limit	Tax years beginning after 2012
Extension to debt of partnerships with Canadian corporate partners	Tax years beginning after March 28, 2012
Disallowed interest characterized as a dividend	Tax years ending after March 28, 2012
Relief from disallowance where interest included in Canadian corporation's income as FAPI of a CFA	Tax years ending after March 28, 2012
Foreign Affiliate Dumping: deemed dividend by Canadian subsidiary to foreign parent and/or PUC suppression where Canadian subsidiary makes investment in foreign affiliate	Transactions occurring after March 28, 2012, except those between arm's-length parties agreed to in writing before March 29, 2012, and completed before 2013
Transfer Pricing Secondary Adjustments: treated as dividends	Transactions occurring after March 28, 2012
Partnership Antiavoidance	Mergers and windups occurring after March 28, 2012, except if completed before 2013 where parent acquired control of subsidiary before March 29, 2012 (or had a legal obligation to do so as of such date), and evidenced its intention to merge with or windup subsidiary in writing before March 29, 2012
Reduction in maximum section 88(1)(d) bump permitted in cost of partnership interest	
Revised computation of seller's taxable capital gain on sale of partnership interest to nonresident	Sales occurring after March 28, 2012, except where the sale was made to an arm's-length purchaser under a binding written agreement executed before March 29, 2012, and completed before 2013
Scientific Research and Experimental Development	
Reduction in general qualified expenditure ITC rate to 5%	Tax years ending after 2013
Exclusion of capital expenditures from deductibility and ITC expenditure base	Property acquired after 2013
Reduction in proxy rate for SR&ED overhead eligibility	60% in 2013; 55% thereafter
Exclusion of 20% of arm's-length contract payments for ITC eligibility	Expenditures incurred after 2012
Reduction in Resource Sector ITCs (current 10% rate)	
Reduction in mineral preproduction exploration ITC	5% for 2013; nil thereafter
Reduction in mineral preproduction development ITC	7% for 2014; 4% for 2015; nil thereafter
Reduction in Atlantic ITC for oil and gas and mining activities	5% for property acquired in 2014 and 2015; nil thereafter

owes money to specified nonresidents in excess of twice the sum of the corporation's total retained earnings plus the paid-up capital attributable to shares of the corporation owned by nonresidents who are 25 percent plus shareholders, the corporation cannot deduct interest on the excess debt. No thin capitalization restriction applies to debt owing to other creditors.

The budget proposes to tighten the thin capitalization regime in several respects. First, the debt-to-equity limit would be reduced from 2 to 1 down to 1.5 to 1, thus reducing the amount of intragroup debt into Canada that could be created on an interest-deductible basis. This measure (which is effective for tax years beginning after 2012) had been suggested to the government in the report issued by the Advisory Panel on Canada's System of International Taxation, dated December 10, 2008.[2] Canada does not levy withholding

[2] *See* Recommendation 5.1 of the advisory panel's report, *available at* http://www.apcsit-gcrcfi.ca/07/cp-dc/index-eng.html. For detailed and insightful commentary on the report, see Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 1,'' *Tax Notes Int'l*, Jan. 19, 2009, p. 247, *Doc 2009-79*, or *2009 WTD 12-16*; and Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 2,'' *Tax Notes Int'l*, Jan. 26, 2009, p. 345, *Doc 2009-84*, or *2009 WTD 15-11*.

tax on interest (other than participating interest) paid to nonresident creditors that deal at arm's length with the debtor, and its tax treaty with the U.S. now has a 0 percent withholding rate on interest (other than participating interest) paid to a U.S. resident (arm's length or non-arm's-length) entitled to benefits under that treaty. As a result, the thin capitalization rules have become more important recently in limiting the extent to which interest expense can be used to reduce the taxable income of Canadian corporations. The reduction in the thin capitalization debt-to-equity limit can thus be seen as a measure to protect the Canadian tax base from what the government apparently perceives is inappropriate erosion. Unfortunately, applying a uniform debt-to-equity ratio to all businesses regardless of size constitutes somewhat rough justice, particularly in industries in which the typical arm's-length debt-equity ratio is higher than the proposed 1.5-1 rule.

The existing thin capitalization rules do not apply to partnerships (which are flow-through entities for Canadian tax purposes); they apply only to corporations resident in Canada. In some cases when a Canadian corporation is a member of a partnership, debt is incurred at the partnership level such that the thin capitalization rules did not apply. In its report, the advisory panel also recommended extending the reach of the thin capitalization rules to partnerships, trusts, and Canadian branches of nonresident corporations. The budget would extend the thin capitalization rules to debt incurred by partnerships that have one or more Canadian resident corporations as members, by imputing to the Canadian corporation for this purpose its proportionate share of the partnership's debts owed to specified nonresidents, effective to debt outstanding during tax years beginning after March 28. When this would result in debt in excess of the permitted debt-equity limit, the corporation would have an income inclusion equal to that amount of any interest on its share of the partnership debt that would otherwise have been nondeductible.[3] This provision would apply regardless of the size of the Canadian corporation's interest in the partnership or its ability to influence or control the partnership's borrowings.

A further measure suggested by the advisory panel and adopted in the budget is to treat interest that is made nondeductible under the thin capitalization rules[4] as a dividend, effective for tax years ending after March 28. Currently, such amounts retain their character as interest for withholding tax purposes, meaning that they will be subject to a rate of withholding tax ranging from 25 percent (for nonresidents not entitled to any reduction under an applicable tax treaty) to 0 percent (in the case of U.S. residents entitled to benefits under the Canada-U.S. tax treaty).[5] A recharacterization of such amounts as dividends could therefore produce more or less Canadian withholding tax, depending on the circumstances.

Finally, one minor relieving change in the thin capitalization rules was made. In some cases the thin capitalization rules could apply to loans made to a Canadian corporation from a controlled foreign affiliate (CFA, essentially a foreign corporation controlled by the Canadian corporation itself or by related persons). Under Canada's anti-deferral system, foreign accrual property income (FAPI) earned by a CFA of a Canadian taxpayer is imputed to the Canadian taxpayer and taxed in its hands currently (less an allowance for foreign taxes paid) to the extent of the Canadian taxpayer's ownership interest in the CFA.[6] The budget would provide that a Canadian corporation would not be denied a deduction for interest under the thin capitalization rules to the extent of any portion of the interest that is included in its income as FAPI from a CFA (for example, when a CFA is the creditor). This measure (which is also effective for tax years ending after March 28) would prevent double taxation from arising on a loan to a Canadian corporation from one of its CFAs when the Canadian debtor is both denied an interest expense deduction under the thin capitalization rules and required to include such interest income in its own income as FAPI.

Foreign Affiliate Dumping

Some background is required to explain the budget's sweeping proposals described as addressing ''foreign affiliate dumping.'' Paid-up capital (PUC) essentially reflects amounts received by a corporation in exchange for issuing shares (that is, the Canadian tax version of the corporate law concept of stated capital). When a corporation issues shares of a particular class, it adds to the stated capital (and PUC) of that class of shares the amount received in exchange for issuing shares of that class, and thus each class of shares has its own PUC amount. When distributing property to holders of a class of its shares, a Canadian corporation can designate that distribution as being either a dividend or (to the extent of its PUC) a return of PUC, with a PUC return reducing the holder's basis in the share but not being taxable as a dividend. PUC is an important tax attribute for two reasons:

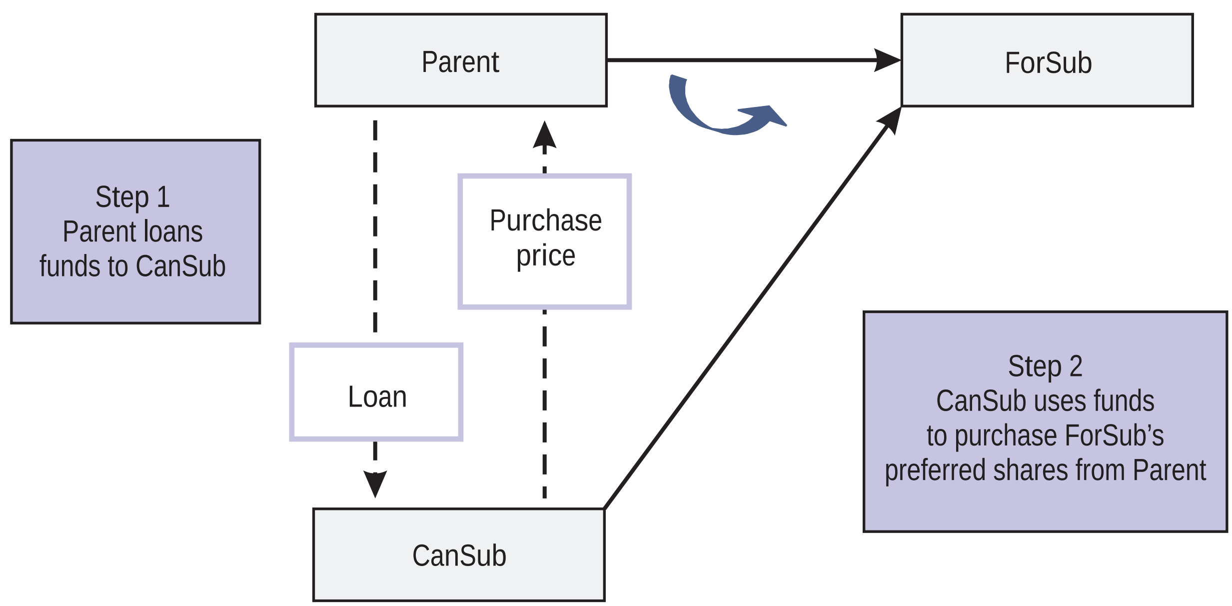
[3]This mechanic is a reflection of the fact that for Canadian tax purposes, a partnership computes its income (including any deduction for interest expense) as if it were a taxpayer, and the resulting income or loss is then automatically included in the hands of its partners, such that tax is paid at the level of the partners.

[4]Including for this purpose interest on partnership debt that is the subject of an income inclusion for a partner under the new rule for partnerships.

[5]In most Canadian tax treaties the applicable interest withholding tax rate is 10 percent.

[6]For more on Canada's CFC rules, see http://miningtaxcanada.com/investment-outside-of-canada/.

Figure 1. Debt Dumping



- the PUC of shares held by a specified nonresident is included in the equity portion of the debt-to-equity limit under the thin capitalization rules described above (for example, more PUC allows greater potential interest-deductible intragroup debt); and
- PUC allows a corporation to make distributions of property to shareholders as a tax-free return of capital that does not give rise to nonresident dividend withholding tax.[7]

Another suggestion made by the advisory panel concerned a practice sometimes referred to as ''debt dumping.'' While the term ''debt dumping'' is capable of a variety of meanings, the situation that most concerned the advisory panel was a Canadian subsidiary incurring intragroup debt owing to a non-Canadian member of the corporate group in order to acquire limited participation shares in another foreign group member. The resulting interest expense could be used to significantly reduce the Canadian subsidiary's income tax owing (at the cost of whatever withholding tax, if any, applied to the interest), and moreover, Canada's CFC rules generally do not either (1) impute active business income earned by a foreign subsidiary of a Canadian corporation to the Canadian corporation or (2) tax dividends received by a Canadian corporation from a foreign subsidiary carrying on an active business in a country with which Canada has a tax treaty or tax information exchange agreement. While the advisory panel took no issue with a Canadian subsidiary of a foreign corporation incurring intragroup debt ''as part of the normal expansion of its business'' (that is, when ordinary business considerations motivate the transaction), it did express tax policy concerns with transactions in which a Canadian subsidiary incurred debt to acquire preferred shares of another non-Canadian member of the corporate group.[8] Figure 1 represents this scenario.

The advisory panel concluded that allowing the Canadian subsidiary to reduce its income by the resulting interest expense is inappropriate:

> where there is no other connection between the businesses conducted by CanSub and ForSub and especially where CanSub does not take part in the management of ForSub or share or benefit from an increase in the value of ForSub's operations subsequent to CanSub's investment.[9]

In recommending that such transactions be curtailed, the advisory panel identified two alternatives:

- restricting the deductibility of interest on the intragroup debt (noting that this may violate the nondiscrimination provisions of many of Canada's tax treaties); or
- treating the purchase price paid by the Canadian subsidiary as a taxable distribution by it.[10]

[7]For more on PUC, see Steve Suarez and Susan Wooles, ''10 Essential Elements of Canada's Tax System,'' *Tax Notes Int'l*, Sept. 8, 2008, p. 825, *Doc 2008-17137*, or *2008 WTD 177-11*.

[8]Report, at section 5.51.

[9]Report, at section 5.53.

[10]Report, at section 5.57.

In the budget the government not only addresses this type of planning, but also introduces proposals that go far beyond this relatively narrow scenario. The budget materials state:

> The Government also has concerns with variations of these transactions, including, for example:
>
> — acquisitions of shares of a foreign affiliate that are made with internal funds of the Canadian subsidiary — such transactions provide a mechanism for foreign parent corporations to extract earnings from their Canadian subsidiaries free of Canadian dividend withholding tax;
>
> — acquisitions of newly issued shares of a foreign affiliate, whether financed with internal or borrowed funds, when previously issued shares of the foreign affiliate are owned by the foreign parent or another nonresident member of the same corporate group;
>
> — acquisitions of foreign affiliate shares from a foreign subsidiary of the foreign parent; and
>
> — acquisitions of foreign affiliate shares from an arm's-length party at the request of the foreign parent.

In response, the budget proposes a sweeping new anti-surplus-stripping rule that applies when a Canadian corporation (Canco) that is controlled by a nonresident corporation (Parent) invests in another nonresident corporation (Forco), if immediately thereafter Forco is (or as part of the series of transactions that includes the investment becomes) a ''foreign affiliate'' of Canco.[11] When this new rule applies:

- Canco is deemed to have paid a dividend to Parent equal to the value of any property (other than shares of Canco) transferred by Canco or any obligation assumed by Canco in respect of the investment.
- No amount is to be added to the PUC of any Canco shares as a result of Canco having made the investment, that is, to the extent that Canco issues shares of itself, the value received in exchange is not included in the PUC of the Canco shares issued. Since PUC is a key component of ''equity'' under the thin capitalization debt-equity test, this result effectively limits a Canadian subsidiary's ability to create more PUC (and thereby increase its maximum potential tax-deductible intragroup debt) by acquiring foreign group members in exchange for issuing shares of the Canadian subsidiary.[12] The denial of a PUC increase also prevents the amount of the investment from later being extracted from Canada as a return of capital to which dividend withholding tax does not apply.

For this purpose, Canco makes an ''investment'' in Forco by acquiring shares of Forco, making a contribution to Forco's capital, loaning money to (or otherwise becoming a creditor of) Forco other than in the ordinary course of its business, acquiring an option in Forco shares or debt, or completing any other transaction ''similar in effect'' to the foregoing.

An exception from this new regime applies if the investment may not reasonably be considered to have been made by Canco (instead of Parent or another foreign group member) primarily for bona fide purposes other than to obtain a Canadian tax benefit. Given the breadth of the charging provision of this new rule, the business purpose exception is vitally important. The draft legislation accompanying the budget identifies a number of factors to be considered in determining whether Canco's purpose in making the investment was other than to obtain a tax benefit, such as the involvement of Canco's senior officers in negotiating the terms of the transaction, whether Forco's business activities are connected to Canco's, whether Canco's shares of Forco are fully participating, and whether the investment was made at Parent's direction or request. The Department of Finance has indicated that it is accepting submissions on the details of the business purpose test until the end of May. The new rule applies to transactions occurring after March 28, with grandfathering provided for contemplated transactions only when occurring between arm's-length parties under a binding written agreement made before March 29 that are in fact completed by the end of 2012. Related changes are being made to the treatment of corporations that emigrate from or immigrate to Canada (albeit without any exception for transactions having a business purpose). The analytical framework of this proposal is summarized in Table 2.

The scope of this new rule is alarming, going far beyond the original concern identified by the advisory panel. While an exclusion for transactions meeting a business purpose test makes sense, too much reliance is

[11]Generally, a foreign corporation is a foreign affiliate of a Canadian taxpayer if the Canadian taxpayer owns (directly or indirectly), alone or together with related persons, 10 percent or more of any class of the foreign corporation's shares. Foreign affiliate status is necessary in order for dividends received by a Canadian corporation from a foreign corporation to be eligible for exemption from Canadian taxation.

[12]Similar rules are proposed to prevent contributed surplus (which is also included in equity for thin capitalization purposes) from being created on a contribution of foreign group member shares to Canco for no consideration (for example, a capital contribution). The denial of a PUC increase on the transfer of interests in a nonresident company to a Canadian subsidiary would appear to be a legislative response to the decision of the Federal Court of Appeal in *The Queen v. Collins & Aikman Products Co*, 2010 FCA 25. For prior coverage, see Timothy Fitzsimmons, ''Plain Vanilla Reorganization Did Not Trigger GAAR, Appeals Court Rules,'' *Tax Notes Int'l*, Oct. 11, 2010, p. 80, *Doc 2010-21527*, or *2010 WTD 191-1*.

Table 2. Foreign Affiliate Dumping Proposal

A Canadian resident corporation (Canco) controlled by a nonresident corporation (Parent) makes an ''investment'' in a nonresident corporation (Forco) that is or becomes a foreign affiliate of Canco. ''Investment'': • Canco acquires share of Forco. • Canco makes contribution of capital to Forco. • Amount becomes owing by Forco to Canco outside of ordinary course of business. • Canco acquires Forco debt from a third party (except from an arm's-length third party in ordinary course of business). • Canco acquires options or interests in Forco shares or debt. • Any transaction similar in effect to any of the foregoing.	— Yes →	It is unreasonable to consider that the investment was made by Canco (instead of Parent or another non-arm's-length nonresident) primarily for bona fide purposes other than reducing or deferring Canadian tax.	— Yes →	Consequences: • Canco deemed to pay a dividend to Parent equal to value of property (other than Canco shares) transferred by Canco or obligations assumed or incurred by Canco in respect of the investment. • No increase in PUC of any Canco shares because of the investment. • Any contributed surplus created not included in equity for thin capitalization purposes and cannot be converted to PUC without triggering a deemed dividend.

being placed on that test (particularly without any safe harbors or definitive guidance). The uncertainty inherent in a ''purpose'' test could put a chill on taxpayers considering any transaction that might potentially engage these rules, particularly as it is framed with reference not to why the investment itself was made but rather why the entity making it is Canco instead of a foreign group member. Read literally, it could make problematic generally accepted tax planning, such as advising nonresidents acquiring a Canadian corporation to use a new Canadian corporation to make the investment (rather than making it directly), in order to get full cross-border PUC into Canada instead of inheriting whatever PUC exists in the shares of the Canadian target. If the Canadian target has foreign affiliates, the post-acquisition restructuring that typically occurs (including the merger of the Canadian acquirer and the Canadian target) will often involve a Canadian corporation acquiring the shares of those foreign affiliates. Indeed, under the existing proposal the acquisition of the Canadian target by itself might constitute an ''investment'' in its foreign affiliates, as being a transaction ''similar in effect'' to the direct acquisition of the target's foreign affiliates (particularly where the Canadian target is later merged or wound up into the Canadian acquisition company, as typically occurs).

Apart from the ''business purpose'' test, several other elements of this proposal entail considerable uncertainty for taxpayers:

- the rule may be engaged not only where Forco is a foreign affiliate of Canco immediately following the ''investment,'' but also where it becomes a foreign affiliate as part of the same ''series of transactions,'' a concept that has been interpreted broadly by the courts;
- as noted, an ''investment'' includes any transaction ''similar in effect'' to those specifically enumerated;
- the deemed dividend is determined to be the value of property transferred or obligations incurred by Canco ''in respect of'' the investment, another phrase that has a very wide meaning in Canadian tax jurisprudence[13]; and
- the charging provision is supported by a further rule that disentitles Canco from asserting the ''business purpose'' exception where Forco makes an investment (directly or indirectly) that if made by Canco would be caught by the new rule.

In many cases when the rule may apply, it is at best unclear what tax policy objective is being served by

[13]In *Nowegijick v. The Queen*, 83 DTC 5041, the Supreme Court of Canada described this phrase as ''probably the widest of any expression intended to convey some connection between two related subject matters.''

deeming a dividend or suppressing Canco's PUC. The charging provision covers both investments in existing foreign affiliates of Canco and foreign corporations that become foreign affiliates as a result, and virtually any transaction involving an investment in a foreign affiliate will have the Canadian tax benefit of producing a potential deduction from taxable income on an eventual dividend from the foreign affiliate. Presumably the intention is not to create a deemed dividend (either immediately or in the future via the denial of any addition to Canco's PUC) simply because Canada's CFC system provides a full deduction for dividends from foreign affiliates carrying on an active business in most countries, especially where no tax-deductible interest expense is being created (directly or indirectly).

More broadly, from a policy perspective, the rationale for deeming an investment by a foreign-owned Canadian corporation in a foreign subsidiary to be a taxable distribution to Canco's foreign parent is puzzling. There is no requirement that Parent (or any entity above or beside Canco) be the recipient of any property from Canco in order to engage the rule. When the business purpose test cannot be adequately demonstrated, the rule will apply to:

- Canco purchasing a foreign corporation from an arm's-length seller; or
- Canco using its own funds to make a downstream investment in a foreign subsidiary, even one that is wholly owned by Canco.

Such transactions are hardly the economic equivalent of a distribution of property to Canco's foreign parent, and may not generate a foreign tax credit for Canadian dividend withholding tax because there is no taxable event in the parent's home country. It is hoped that the scope of this rule will be reconsidered and narrowed to address only those situations in which there is a clear tax policy concern, particularly given the presence of the general antiavoidance rule to deal with potentially abusive situations not caught by the strict wording of the charging provision. Simplistic reliance on a business purpose test to separate ''good'' transactions from ''bad'' ones was rejected over 20 years ago when the GAAR was first enacted, and this remains as sound today as it was then.

Partnerships

As in the 2011 budget, partnerships receive special attention in the 2012 budget. Two proposals are directed at what is perceived to be inappropriate planning using these entities. In both cases the antiavoidance concern seems to be situations in which property that could give rise to regular income upon a sale —as opposed to capital gains, only 50 percent of which are included in income — is transferred to a partnership on a tax-deferred basis in exchange for a partnership interest in order to hold a property (the partnership interest) any gain on which would typically be a capital gain. In both cases, however, the budget proposals go beyond this relatively narrow (but legitimate) problem and encompass more benign situations.

The 88(1)(d) Bump

Canada has no consolidation or group relief regime — each corporation is taxed individually. Accordingly, when one Canadian corporation (CanAcquireco) acquires all the shares of another Canadian corporation (Canco), it is often advantageous to cause the two entities to merge or for Canco to wind up and liquidate into CanAcquireco.[14] This consolidation occurs on a tax-deferred basis, CanAcquireco's shares of Canco disappear, and CanAcquireco acquires all of Canco's property and inherits whatever basis Canco had in that property for tax purposes.

Typically, CanAcquireco's cost for tax purposes of the shares of Canco is significantly higher than the cost of Canco's assets that CanAcquireco inherits on the merger or windup of Canco. That higher cost vanishes along with the Canco shares, creating a substantial tax penalty to consolidating the two corporations. The section 88(1)(d) bump remedies this to some extent, allowing CanAcquireco to increase its cost of some of the properties it acquires from Canco up to an amount equal to their fair market value (that is, eliminating any accrued gains). This provision effectively allows CanAcquireco to push some of the cost of the Canco shares down into the Canco assets. Figure 2 illustrates a basic section 88(1)(d) bump, in which CanAcquireco purchases the shares of Canco for $100, winds up Canco, and uses this provision to increase its cost in Canco's eligible property up to its FMV.

This ability to step up the cost of Canco's eligible property can be important to an acquirer, because it potentially eliminates the accrued gains on property that would otherwise be realized on a post-merger disposition of that property by CanAcquireco:

- CanAcquireco may want to sell some of Canco's property to a third party in order to finance the acquisition of Canco or address competition law requirements to divest property; or
- it may be desirable to transfer some of Canco's property within CanAcquireco's corporate group for various reasons. In particular, when CanAcquireco is a subsidiary of a foreign parent, it is common for the section 88(1)(d) bump to be used to eliminate accrued gains on shares of foreign entities owned by Canco so that they can be distributed to CanAcquireco's foreign parent without incurring Canadian capital gains tax in order to avoid the inefficiencies arising from having an extra country (Canada) interposed in the chain of ownership (that is, a ''sandwich structure''; see

[14]For example, to consolidate Canco's taxable income with CanAcquireco's financing expenses.

Figure 2. Basic Bump Transaction

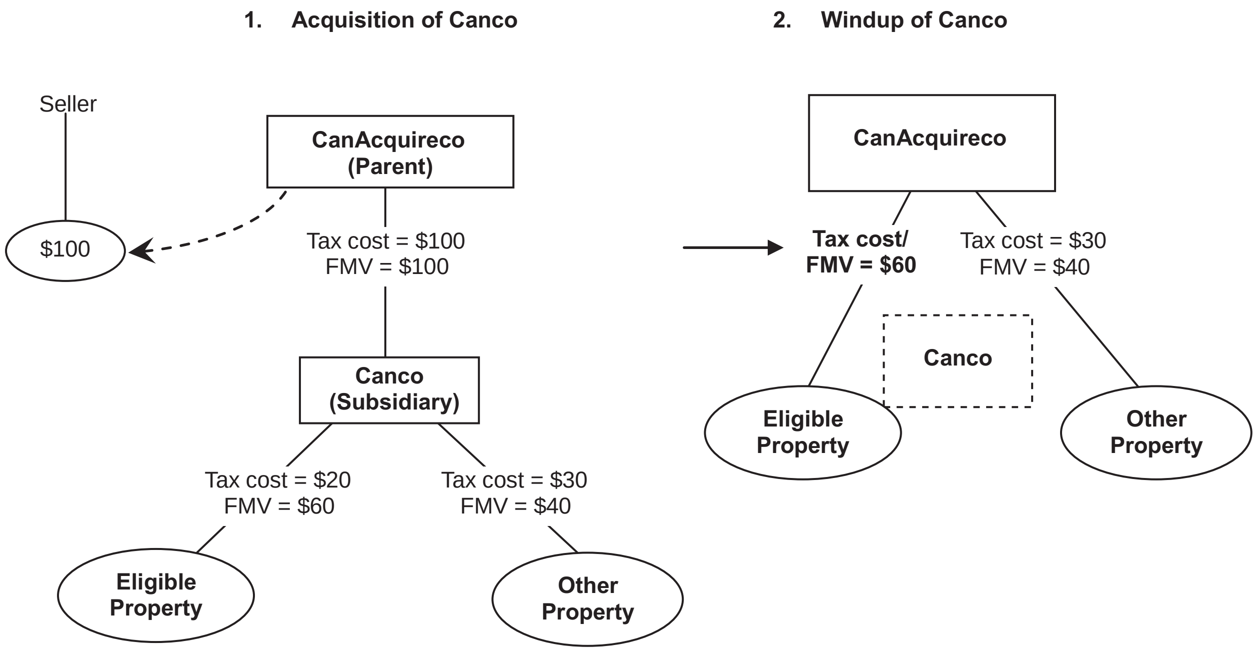


Figure 3. Foreign Subsidiary Extraction

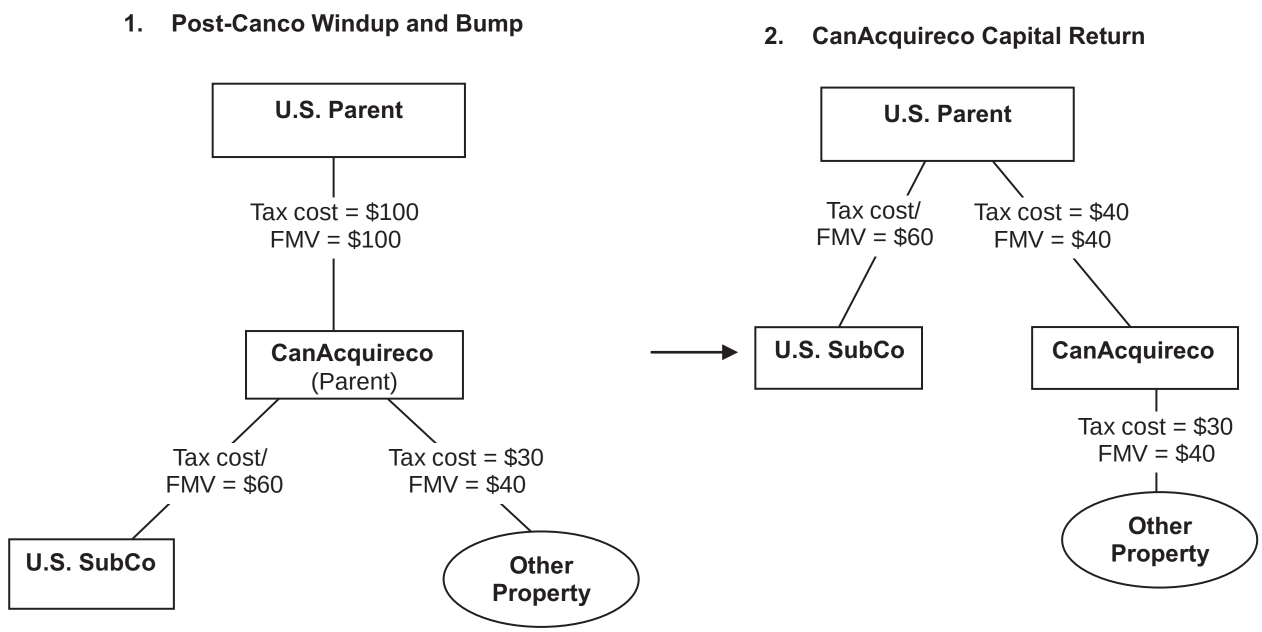


Figure 3, in which shares of U.S. Subco are the eligible property from the section 88(1)(d) bump in Figure 2).

While the provisions governing section 88(1)(d) bumps are complex,[15] for present purposes it suffices to note that only nondepreciable capital property is eligible for this cost increase — effectively this constitutes land, shares of corporations, and interests in partnerships. Depreciable property, interests in most natural resource properties, inventory, and most intangibles (collectively, ineligible property) are not eligible for the step-up in cost. This limitation reflects the fact that the basis being pushed down under a section 88(1)(d) bump arises from property (Canco shares) that is itself nondepreciable capital property, which does not generate regular income when sold (nor annual amortizing deductions from income) such as ineligible properties can.

The Department of Finance is apparently concerned that partnerships were being used to circumvent the denial of the section 88(1)(d) bump to ineligible property, by holding such property within a partnership ''instead of [Canco] holding income assets directly.''[16] As a result, for section 88(1)(d) bump purposes, the budget proposes to effectively look through interests in a partnership held by Canco and distributed to CanAcquireco by limiting the amount that the cost of a partnership interest may be increased to on a section 88(1)(d) bump. Instead of allowing the cost of a partnership interest to be increased up to its FMV at the time when CanAcquireco acquired control of Canco, under the budget proposal, the maximum amount to which the cost of a partnership interest may be increased would be that FMV less the portion of the accrued gain on the partnership interest that is attributable to:

- the gross fair market value of Canadian and foreign resource properties; and
- the accrued gains (excess of gross FMV over cost amount) on any other ineligible properties.

This rule would be effective to mergers and windups occurring after March 28. Grandfathering relief would be limited to situations in which CanAcquireco acquired control of Canco before (or was legally obligated to do so under a written agreement entered into before) March 29, *and* had before that date evidenced in writing its intention to merge or wind up Canco. Any such merger must be completed before 2013 or, in the case of a windup, be initiated before 2013.

The scope of this initiative again goes well beyond the perceived mischief that is the stated basis of the tax policy — that is, conscious attempts to circumvent the denial of the section 88(1)(d) bump to ineligible property. For example, the bump limitation would apply without regard to whatever the reason is for the existence of the partnership (that is, whether or not intended to circumvent the ineligible property denial rule), and would not be limited to partnerships created or partnership interests acquired by Canco as part of the series of transactions that includes the windup or merger. Similarly, the new rule would not be limited to situations in which substantially all the accrued gain on the partnership interest would be attributable to ineligible property.

As a practical matter, it may be difficult to determine what portion of the accrued gain on the partnership interest is attributable to accrued gains on ineligible property, and it is not obvious that computing the bump reduction to include the entire value of any resource property without regard to its cost would lead to appropriate results in all cases.[17] The scope of this provision could have been restricted to situations in which the denial rule was being circumvented, and the practical effect of this proposal may be to cause acquirers to insist that vendors cause any partnerships to be incorporated before the target corporation is sold to the acquirer (it remains possible to transfer ineligible property to a Canadian corporation in exchange for shares of the corporation and subsequently get a full section 88(1)(d) bump in the cost of those shares).

Sales to Nonresidents

Another initiative directed at partnerships would extend an existing rule providing that when a partnership interest is disposed of to a tax-exempt entity, the seller's taxable capital gain (being the portion of the capital gain that is included in the seller's income) is computed differently than would otherwise be the case. Instead of the normal rule that would simply include 50 percent of the seller's capital gain in income, the seller's taxable capital gain would be computed as:

- 50 percent of the portion of the capital gain on the partnership interest that is reasonably attributable to increases in the value of nondepreciable capital property (that is, the same property that is eligible for a section 88(1)(d) bump); and
- the entirety of the remainder of the capital gain.

The tax policy behind this rule is that since a tax-exempt person is able to dissolve the partnership without the accrued gains on the partnership property being subject to tax, absent this provision such accrued gains would likely never be taxed.

[15]This topic is discussed at length in Steve Suarez, ''Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know,'' *Tax Notes Int'l*, Dec. 4, 2006, p. 779, *Doc 2006-21865*, or *2006 WTD 237-7*.

[16]See Annex 4 of the budget materials, discussing the proposal.

[17]The expenditure pools generated by costs incurred on resource properties are generally maintained at the level of the partners rather than at the partnership level.

Under the budget, this rule would be expanded to apply to a sale of a partnership interest to a nonresident person, effective to dispositions made after March 28.[18] The only exception to this rule would be when at the time of the disposition all of property of the partnership is used in carrying on business through a permanent establishment in Canada — that is, when there is no possibility of the nonresident being exempt from Canadian tax on the gain under a tax treaty. The basic rule is also being reinforced by an antiavoidance element applicable to ''indirect'' transfers to a tax-exempt or nonresident.

While there are instances in which nonresidents may be able to acquire a partnership interest and cause a dissolution of the partnership without being taxable on gains on the partnership's property, equating nonresident purchasers with tax-exempts overshoots this objective. As the rule is proposed, even a de minimus amount of partnership property not held through a Canadian permanent establishment will taint the entire gain on the partnership interest. Moreover, the budget proposal contains no ownership threshold that nonresidents should have before the rule applies, and it is unlikely that a nonresident acquiring a relatively small interest in a partnership will be in a position to cause it to be dissolved such that accrued gains on partnership property go untaxed in Canada. Indeed, since the rule would not increase the cost to the partnership of its property, the underlying accrued gains would remain in place and may be the subject of tax again should the nonresident subsequently sell the partnership interest back to a purchaser that is taxable in Canada. The practical effect of this proposal would be to make the use of partnerships less feasible in a variety of circumstances.

Transfer Pricing Secondary Adjustments

Canada's transfer pricing regime applies to transactions between a taxpayer subject to Canadian tax rules (that is, a Canadian resident) and nonresidents not dealing at arm's length with the Canadian taxpayer, to ensure that the amounts payable or receivable by the Canadian taxpayer conform to what an arm's-length party would demand.[19] To the extent that transfer pricing rules apply to adjust a Canadian taxpayer's transfer prices (a primary adjustment), the adjusted amount is also often the subject of a secondary adjustment to reflect a benefit that a nonresident counterparty has received by virtue of having been paid too much or charged too little. The budget cites an example of a Canadian corporation paying $100 to its foreign parent for goods when an arm's-length party would have paid only $80. In addition to reducing the Canadian corporation's deductible expense by $20, the CRA would typically treat the $20 paid to the nonresident parent corporation as a benefit (either under the shareholder benefit rules in section 15(1) of the Income Tax Act (Canada) or more general benefit provisions) that when paid to a nonresident is characterized as a dividend for Canadian withholding tax purposes.

The budget introduces a specific provision deeming secondary transfer pricing adjustments made to a Canadian corporation's transfer prices to be dividends paid by the corporation and received by the nonresident counterparty. This will generally result in the imposition of nonresident withholding tax, which applies at the rate of 25 percent unless reduced under an applicable income tax treaty, whether or not the nonresident counterparty is in fact a shareholder in the Canadian corporation.[20] Moreover, consistent with the CRA's existing administrative practice, no deemed dividend will arise to the extent that the relevant nonresident pays the amount of the primary adjustment back to the Canadian corporation, subject to obtaining the CRA's concurrence. A specific statutory amendment will also provide that the benefit provisions previously relied on by the CRA to support secondary adjustments will not apply, to prevent double taxation. These measures (which were also recommended by the advisory panel) apply to transactions occurring after March 28, 2012.

SR&ED

In October 2011 an expert panel commissioned by the government delivered a report on federal government support for research and development in Canada.[21] Among its recommendations were changes to the tax credits for scientific research and experimental development provided in the ITA. The budget amends the tax regime for SR&ED in several ways:

- The general investment tax credit for qualifying expenditures would be reduced from 20 percent to 15 percent of the amount of such expenditures, for tax years ending after 2013 (the 35 percent ITC rate applicable to the first C $3 million of qualifying expenditures incurred by Canadian-controlled private corporations remains unchanged).

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[18]The coming into force rule exempts a disposition of a partnership interest occurring after March 28 if the disposition was:
- made to a person dealing at arm's length with the vendor;
- completed before the end of 2012; and
- the subject of a binding written agreement entered into before March 29.

[19]For more detail on Canada's transfer pricing rules, see Suarez and Wooles, *supra* note 7, at p. 834.

[20]The new rule will not apply when the nonresident counterparty is a controlled foreign affiliate of the Canadian taxpayer leaving aside shares held by nonresidents, because this effectively amounts to a capital contribution rather than a distribution.

[21]The report is available at http://rd-review.ca/eic/site/033.nsf/eng/home.

- In contrast to the existing rules that allow some SR&ED expenditures of a capital nature (that is, not otherwise deductible on a current basis) to be fully deducted and eligible for ITCs, SR&ED expenditures of a capital nature would cease to be currently deductible or be eligible for ITCs, effective for property acquired after 2013. This rule would also apply to amounts paid or payable for the right to use property after 2013 and to otherwise eligible contract payments made by a taxpayer benefiting from SR&ED tax incentives to the extent in respect of a capital expenditure made in fulfillment of the contract.
- The inclusion allowance for overhead expenditures directly attributable to SR&ED activities under the simplified proxy method would be reduced from 65 percent to 60 percent for 2013 and 55 percent for subsequent years.
- The expenditure base for ITCs would exclude the profit element of arm's-length SR&ED contracts by allowing only 80 percent of such payments to be eligible for the ITC (effective to expenditures after 2012).
- The amount of an arm's-length contract payment eligible for SR&ED tax incentives would exclude any amount paid for a capital expenditure incurred in performance of the contract, beginning in 2014.

Reduction in Resource Sector ITCs

Some mining sector activities relating to qualifying minerals undertaken in Canada by taxable Canadian corporations entitle those corporations to an ITC equal to 10 percent of the amount of qualifying expenditures.[22] Qualifying expenditures are those included in the taxpayer's pool of Canadian exploration expenses by virtue of being incurred (before the mine is producing in reasonable commercial quantities) on:

- ''grass roots'' exploration to determine the existence, location, extent or quality of a mineral deposit in Canada (exploration expenses); or
- activities undertaken in order to bring a new mine in Canada into production (development expenses).

Expenditures on these activities (preproduction expenses) are added to a pool, and the corporation is entitled to claim an ITC (that is, a reduction in tax payable) equal to 10 percent of the pool balance for the year.

The budget announces the elimination of the preproduction mining expenditure ITC. For preproduction exploration expenditures, the credit would continue to apply at the 10 percent rate for expenditures incurred in 2012, with the rate dropping to 5 percent for expenditures incurred in 2013 and no ITC for expenditures in subsequent years. For preproduction development expenses, the 10 percent rate would apply for expenditures incurred in 2012 and 2013, dropping to 7 percent for expenditures incurred in 2014, 4 percent for expenditures incurred in 2015, and no ITC in subsequent years. Transitional relief would be provided by maintaining the 10 percent rate for preproduction development expenditures incurred before 2016 under a written agreement entered into before March 29, 2012, or as part of a new mine the construction of which (or the engineering and design work for the construction of which) had commenced before March 29, 2012.

The Atlantic ITC offers a 10 percent ITC for expenditures on property used in certain activities occurring in Atlantic Canada.[23] The budget would also phase out this ITC to the extent of expenditures incurred on oil and gas and mining activities. The 10 percent ITC rate would apply for assets acquired before 2014, with a reduction to a 5 percent rate for property acquired in 2014-2015, and no ITC thereafter. The 10 percent rate will be maintained for expenditures incurred before 2017 under a written agreement entered into before March 29, 2012, or as part of a project phase started by (or the engineering and design work for the construction of which had started by) March 29, 2012.

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.[24] Where certain qualifying expenditures (essentially expenses incurred in mining exploration above or at ground level conducted in Canada) are incurred and renounced to a holder of flow-through shares that is an individual (other than a trust), that 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 ITA currently requires that qualifying expenditures must be incurred by the corporation by the end of 2012 and renounced to the investor under an agreement made before April 2012. The budget proposes to extend the 15 percent mineral exploration tax credit for another year, by extending:

- the date for incurring qualifying expenditures to the end of 2013; and

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[22]Qualifying minerals are diamonds, base or precious metal deposits, or industrial minerals in Canada that produce base or precious metals when refined.

[23]Defined as the Gaspe Peninsula, the provinces of Prince Edward Island, Nova Scotia, New Brunswick, and Newfoundland and Labrador, or a prescribed offshore region.

[24]The taxation of flow-through shares is discussed in Steve Suarez, ''Canadian Taxation of Mining,'' *Tax Notes Int'l*, Dec. 13, 2010, p. 867, *Doc 2010-24370*, or *2010 WTD 238-19*.

- the deadline for the corporation and the investor to enter into the flow-through share subscription agreement governing renunciation to March 31, 2013.

Other Business Tax Measures

The budget also includes a number of additional measures of lesser importance.

Accelerated CCA for Clean Energy Generation

Continuing from initiatives in previous budgets, accelerated capital cost allowance (CCA, the tax version of depreciation) treatment is being expanded to encompass more forms of clean energy equipment, including waste-fueled thermal energy that is not used in an industrial process or greenhouse and energy generated by plant residue. Accelerated CCA will be permitted only when applicable environmental laws and regulations are complied with.

Application of Base Erosion Rules

Canada's anti-deferral regime for taxing Canadians on FAPI earned by their CFAs includes base erosion rules directed at Canadian-source income being earned by foreign affiliates. These rules generally treat as FAPI the income of a foreign affiliate from debt or lease obligations of Canadian residents or from providing specific services. Canadian banks seeking to access the excess liquidity of their foreign affiliates have found these rules particularly difficult to deal with. The budget undertakes to develop amendments to address this need (as well as certain transactions undertaken in the course of the bank's business of facilitating trades for arm's-length clients) to ensure that these base erosion rules do not apply in inappropriate circumstances.

Eligible Dividends

To reduce double taxation otherwise occurring from the taxation of income earned by a corporation and taxed again when distributed to shareholders, shareholders of Canadian corporations are entitled to a dividend tax credit that reduces the tax on dividends received. Some dividends (eligible dividends) are eligible for a higher dividend tax credit, on the basis that they are paid out of income that has been taxed at the general corporate tax rate rather than a lower rate. The budget proposes to simplify the method by which a corporation can designate a dividend to be an eligible dividend to allow for:

- designation of only part of a dividend as being an eligible dividend (the current rules require the designation of either the entire amount or none); and
- late-filed designations.

Overseas Employment Tax Credit

The overseas employment tax credit is available to qualifying residents of Canada employed outside Canada for six consecutive months or more in respect of certain activities. The amount of the credit is calculated as 80 percent of the federal income tax otherwise payable on their qualifying income, up to a maximum of $100,000 of income. The budget proposes to phase out the credit beginning in 2013 and ending in 2016.

Retirement Compensation Arrangements

Retirement compensation arrangements (RCAs) are a form of employer-funded retirement savings vehicle. Contributions to an RCA are subject to a tax that is refundable on certain events (most notably distributions by the RCA), but the RCA itself is generally not subject to tax. The budget proposes new rules prohibiting certain investments and transactions to prevent RCAs from engaging in non-arm's-length transactions, similar to the rules already applicable to tax-free savings accounts and registered retirement saving plans. This will be accomplished in the form of a special tax on the RCA. A further measure will restrict the ability of an RCA to obtain a refund of taxes relating to a decline in the value of the RCA's assets.

Employee Profit-Sharing Plans

Employee profit-sharing plans are a form of compensation arrangement. The budget introduces a special tax payable by a specified employee of the relevant employer, one who has a significant equity interest in the employer or who does not deal at arm's length with the employer. Employer contributions to the plan exceeding 20 percent of the specified employee's salary for the year will trigger the tax.

Life Insurance Policy Exemption Test

The budget proposes to amend the tests used to determine whether a life insurance policy is an exempt policy (the holder of an exempt policy is exempt from the income accrual rules that otherwise tax the policyholder on funds held within the insurance policy). The revised tests reflect higher life expectancy, current rates of interest, and industry practices. ◆