tax notes international

Volume 57, Number 12 ■ March 22, 2010

Canada's 2010 Budget Heavy With Major Tax Initiatives

by Steve Suarez

Reprinted from *Tax Notes Int'l*, March 22, 2010, p. 1021

HIGHLIGHTS

Canada's 2010 Budget Heavy With Major Tax Initiatives

by Steve Suarez

Canadian Finance Minister Jim Flaherty on March 4 presented the 2010 federal budget to the House of Commons. (For the Finance Ministry's release, see *Doc 2010-4809* or *2010 WTD 44-26*.) The minority Conservative government opened a new session of Parliament with this item of business, and for it to pass and become enacted into law, at least one of the three opposition parties will have to decide not to oppose it.[1] News reports have quoted Leader of the Opposition Michael Ignatieff as stating that he would not seek to bring down the government over the budget (despite not viewing it favorably). This would indicate that the budget is likely to be enacted.

The global economic crisis has significantly affected Canada's finances, with shrinking tax revenues and increasing expenditures on social programs and economic stimulus resulting in a projected deficit of $49.2 billion for 2010-2011 (decreasing deficits are projected until 2014-2015). The budget confirms $19 billion of spending for the second year of the government's economic action plan and does not change previously scheduled reductions in corporate and personal income tax rates.

The focus of the budget is on limiting growth in spending and tightening some tax measures perceived as being unduly generous, given present conditions, or inappropriately aggressive. Remaining tariffs on machinery, equipment, and manufacturing inputs are being eliminated (although in some cases not until 2015), positioning Canada as a leader in reducing trade barriers.

The budget contains several significant tax initiatives, and in terms of tax content, it is perhaps the most important budget in many years. Among the most relevant items are the following:

- The definition of taxable Canadian property (TCP) — meaning property for which nonresidents are subject to Canadian capital gains tax — is being significantly narrowed. Most importantly, shares of Canadian corporations that are not listed on a designated stock exchange, which are TCP under current law, will now constitute TCP only if they derive their value primarily from Canadian real property or resource property any time during the preceding five years. This will be very welcome news for foreign investors (particularly private equity groups) that have found the reporting and withholding obligations applicable to dispositions of TCP to be a major irritant.
- Mirroring recent information reporting developments in the province of Quebec and in the United States, the government announced its intention to seek public consultation on a new antiavoidance regime that would require taxpayers who engage in certain perceived aggressive tax planning to either report the relevant transactions under this new regime or face denial of the related tax benefits.
- The government announced its intention to explore new rules for simplifying the taxation of Canadian corporate groups, such as a formal loss transfer system or consolidated reporting.
- The tax treatment of employee stock options is being tightened to limit available deductions and deferrals.
- Proposed amendments directed at foreign tax credit generators (schemes involving differences in the Canadian and foreign tax treatment of transactions designed to create foreign tax credits for Canadian tax purposes) have been released.
- Under legislation enacted a few years ago, income trusts and similar entities that act as flow-through vehicles for Canadian tax purposes are soon to be treated as taxable entities (like corporations), with the result that many such entities are converting themselves into corporations on a tax-deferred basis under rules intended to permit this. The budget contains antiavoidance rules targeting such transactions that are perceived as achieving ''inappropriate loss trading'' beyond what would be permitted in a corporate context.

---

[1]Current standings in the House of Commons are Conservative, 145; Liberals, 77; Bloc Quebecois, 48; New Democratic Party, 37; Independent, 1. *See* http://www/parl.gc.ca.

- The government announced its intention to effectively abandon the highly complex and widely criticized foreign investment entity rules directed at Canadians holding interests in foreign entities and to significantly amend companion rules dealing with interests in non-Canadian trusts.

Taxable Canadian Property

Canadian residents are taxed on their worldwide income, while nonresidents are taxed on a more limited basis. Essentially, nonresidents are subject to Canadian withholding tax on Canadian-source investment income such as dividends and royalties, and ordinary Canadian income tax on:

- income from employment in Canada;
- income from carrying on business in Canada; and
- gains from the disposition of TCP.

For TCP, virtually all of Canada's tax treaties significantly reduce the scope of Canadian taxation to gains from Canadian real property or interests in entities (shares of Canadian corporations or interests in partnerships and trusts) that derive most of their value from Canadian real property.

When a nonresident disposes of TCP, this activity triggers a reporting and withholding regime known as the section 116 (s. 116) system. Under the s. 116 system, a purchaser of most forms of TCP is obliged to withhold and remit to the Canada Revenue Agency a portion of the sales price as a prepayment toward the nonresident's Canadian tax liability (if any) unless the CRA authorizes otherwise, and the nonresident is typically obliged to file a notice reporting the transaction and a Canadian tax return for the relevant year. These obligations apply whether or not any gain exists or any tax is owing.

The 2008 federal budget made changes to the s. 116 system that were designed to offer alternatives to the existing process in which the nonresident was treaty exempt on any gain from the property, in order to simplify the system when no tax was likely to be due.[2] However, the s. 116 system remained an irritant to foreign investors (particularly private equity investors and those using partnerships) investing in Canadian entities whose securities were not publicly traded, and an advisory committee established by the Ministry of Finance in 2007 suggested further changes to the s. 116 system in its report to the MOF in December 2008.[3]

The budget takes the important step of amending the TCP definition under the Income Tax Act (Canada) and restricting its scope to bring it closer toward what Canada's tax treaty network provides for on the taxation of capital gains. In broad terms, effective immediately, interests in entities will not be TCP unless those interests derive their value primarily from land or resource rights situated in Canada.

Under the budget proposals, shares in corporations (Canadian or nonresident) that are listed on a designated stock exchange will be TCP to a nonresident holder if at some point during the preceding five years they meet both of the following conditions:

- *The 25 percent plus test*: The nonresident or persons not dealing at arm's length with the nonresident collectively held 25 percent or more of any class of the corporation's shares.
- *The over 50 percent test*: More than 50 percent of the value of those shares was attributable to some combination of Canadian real property, Canadian resource properties, timber resource properties in Canada (collectively Canadian real property), and options relating to, or interests in, Canadian real property.

Before the budget, merely meeting the 25 percent plus test was enough to cause listed shares of a Canadian corporation to be TCP. (For listed shares of non-Canadian corporations, a different property test was also required.)

The real impact of the budget will be on shares of Canadian corporations that are *not* listed on a designated stock exchange, however. Unlisted shares of a Canadian corporation are always TCP under the existing TCP definition. The budget changes this by providing that unlisted shares of a Canadian corporation will be TCP only if the over 50 percent test is met any time during the preceding five years.[4] Table 1 summarizes these changes to the TCP definition.

The result is that many investments in Canada that were effectively exempt from Canadian tax because they were held by a resident of a tax treaty country but were still TCP and hence subject to the s. 116 system on disposition will now be outside the s. 116 system. By bringing the scope of the domestic TCP definition closer into line with what most of Canada's tax treaties provide for, there should be significantly fewer cases in which the parties need to go through the s. 116 system despite the fact that no Canadian tax is owing. Because of the five-year look-back nature of the

---

[2]*See* Steve Suarez and David Gaskell, ''Canada's Revised Section 116 Regime for Nonresident Vendors,'' *Doc 2008-27299* or *2009 WTD 16-10*.

[3]*See* ''Canadian Panel Releases International Tax Report,'' *Doc 2008-26028* or *2008 WTD 242-18*. For an extensive discussion of the Advisory Panel's final report, see Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations,'' parts 1 and 2, see *Doc 2009-79* or *2009 WTD 12-16*; and *Doc 2009-84* or *2009 WTD 15-11*.

[4]Interests in partnerships and most trusts will also now constitute TCP only if the over 50 percent test is similarly met. The new rule treats units in a mutual fund trust the same as listed shares.

Table 1. Summary of Major TCP Changes

	Pre-2010 Budget	Post-2010 Budget
Unlisted shares of Canadian corporations; most interests in Canadian resident trusts	TCP	TCP if 50%+ test met
Publicly listed shares of Canadian corporations; units of mutual fund trusts; shares of mutual fund corporations	TCP if 25%+ test met	TCP if both 25%+ and 50%+ tests met
Partnership interest	TCP if broader property test met	TCP if 50%+ test met (narrower)

25%+ Test: Nonresident and/or non-arm's-length persons held 25% or more of any class of corporation's shares (for mutual fund trusts, 25% or more of its issued units) any time during preceding five years.

50%+ Test: More than 50% of the value of the share (or trust unit or partnership interest) was derived from Canadian real/resource/timber property any time during preceding five years.

Note: Shares of non-Canadian corporations are treated the same as shares of Canadian corporations post-2010 budget.

over 50 percent test, however, it will not always be clear that shares that today do not derive their value primarily from Canadian real property are not TCP. Where material uncertainty exists, purchasers may continue to insist on section 116 compliance or alternatively demand representations and indemnities for not withholding and remitting under section 116. In general, however, investors into Canada (particularly private equity investors and venture capitalists) will welcome this change, because in many cases it will relieve them (and their counterparties) of a significant compliance burden when they dispose of their investment.

Moreover, many investments that were previously TCP and had to be held by a shareholder resident in a country with which Canada has a tax treaty in order to avoid Canadian taxation of gains will now be exempt from Canadian gains tax under the revised domestic law TCP definition. As such, it would not be surprising to see greater holding of shares of Canadian corporations by residents of nontreaty jurisdictions.

When considering how to structure investments into Canada, nonresidents will need to consider a number of questions:

- Will the investment take the form of listed shares of a corporation? If so, then the investor generally need not worry about Canadian CGT no matter what property is owned by the corporation, as long as the investor's ownership does not meet the 25 percent plus test.
- Will the entity in which the investment is being made (for example, a Canadian corporation) restrict the value of its Canadian real property at all times so as to make interests in that entity clearly not TCP under the over 50 percent test? If so, then investors can be resident anywhere and still be exempt from Canadian CGT when disposing of their investment. Conversely, if the investment is TCP, then investors will usually need to be resident in a treaty country (or interpose an intermediary holding entity resident in a treaty country) in order to exempt gains on their investment from Canadian tax.
- Are income streams such as dividends, royalties, or non-arm's-length interest expected from the investment entity? If so, then even if Canada does not tax gains on disposition of the investment, an investor may still want to be resident in a treaty country (or use an intermediary holding entity that is so resident) in order to take advantage of treaty-reduced rates of Canadian withholding tax on such income streams. Note that intermediary holding entities have also historically been used where a widely held fiscally transparent investment vehicle such as a partnership holds TCP to limit compliance obligations under the s. 116 system to the intermediary rather than the various investors.

These changes to the TCP definition are effective after March 4, 2010. It is understood that the CRA is treating the amended TCP definition as already being in force notwithstanding the fact that the budget legislation has yet to be enacted.

Enhanced Reporting Requirements

An ominous trend for taxpayers has been the steady encroachment of enhanced reporting requirements as governments in need of tax revenues tighten perceived loopholes and try to improve their ability to identify and respond to new developments in tax planning. The ITA already contains tax shelter reporting rules designed to require taxpayers to identify transactions that meet certain promotion and tax deduction thresholds. In January the U.S. announced a new proposal to require taxpayers to identify uncertain tax positions on their tax returns (IRS Announcement 2010-9). In October 2009 the province of Quebec introduced new rules dealing with aggressive tax planning, extending the limitation period for reassessments under the provincial general antiavoidance rule, and imposing penalties on transactions that are successfully challenged under the GAAR. The extension of the limitation period and penalties can be avoided if the transaction is disclosed in accordance with new rules introduced to provide Revenue Québec with information to identify aggressive tax planning.

The common theme is the increasing onus on taxpayers to self-report at an early stage transactions that might be perceived as objectionable. The budget continues this trend, announcing a public consultation on proposals to require some tax avoidance transactions to be the subject of additional reporting. The regime proposed would label as a reportable transaction any avoidance transaction that includes at least two of three designated hallmarks of what the Department of Finance considers potentially aggressive planning. Specifically, an avoidance transaction under the existing GAAR (a transaction that would otherwise result in a tax benefit and cannot reasonably be considered as having been carried out primarily for nontax purposes) would be subject to the new rule if two or more of the following factors are present:

- a promoter or tax adviser is entitled to fees dependent on obtaining the tax benefit, the amount of the benefit, or the number of participants;
- a promoter or tax adviser requires confidential protection concerning the transaction (that is, a confidentiality agreement); and
- persons entering into the transaction obtain contractual protection relating to the transaction.

Failure to report a transaction that comes within this regime would entitle the CRA to deny the tax benefit resulting from the transaction, subject to payment of a penalty and the provision of any information demanded by the CRA. Flow-through share transactions and transactions already within the existing tax shelter rules are excluded from this new regime.

The budget indicates the government's intention to hold consultations with the tax community to develop details of these proposals, so they appear to still be at a conceptual stage. Because these rules are stated to be effective for transactions entered into after 2010 (or transactions that are part of a series of transactions ending after 2010), the timeline on this initiative would appear to be fairly short.

The hallmarks of potentially aggressive tax planning set out in these rules are interesting, particularly the focus on confidentiality. It will be important to see how the reporting of transactions required under these rules interacts with the solicitor-client privilege to which taxpayers obtaining legal advice from a lawyer are entitled.

Group Loss Transfers/Consolidation

Unlike many other countries, Canada does not have a consolidated tax filing or group relief system. Each separate entity computes its own income or loss, pays its own taxes, and files its own return. While it is possible to structure transactions to effectively transfer losses or deductions from one member of a Canadian corporate group to another member under common control,[5] there may be significant effort and expense involved in doing so.

The budget indicates that the government ''will explore whether new rules for the taxation of corporate groups — such as the introduction of a formal system of loss transfers or consolidated reporting — could improve the functioning of the tax system.'' Public consultation will be sought before any changes to the existing system are introduced.

This is an interesting development as a matter of tax policy. Historically the Canadian provinces have not been enthusiastic about loss transfers, because they are concerned about the extent to which these may result in tax revenues flowing out of one province and into another (intentionally or not).

This resistance was the primary reason why a previous effort at legislating a federal loss consolidation system failed in the mid-1980s. The CRA has set out its views as to what constitutes acceptable loss transfers, and it effectively operates an administratively sanctioned loss transfer system. That administrative regime has the advantage of being somewhat flexible in terms of allowing policy to develop and change over time and allowing logical exceptions to be created, and in that sense it may be more flexible than a legislated system. However, many taxpayers are likely to prefer the certainty of a statutory system (depending on how it is drafted), particularly if it goes beyond loss consolidation and toward true group reporting. It will be interesting to see how this initiative develops, and multinational groups with Canadian subsidiaries will follow these events with interest. The government is to be commended on this helpful initiative.

Employee Stock Options

Employers often grant options to their employees to buy stock of the employer (or a related entity) as a form of compensation. Employee stock options are favorably taxed under the ITA.

When a corporation grants an employee the right to buy its shares, most typically the price at which the employee is entitled to buy the shares (the exercise

[5]*See, e.g.*, Steve Suarez and Susan Wooles, ''Multinational Groups With Canadian Members in Hard Times,'' *Tax Notes Int'l*, July 20, 2009, p. 225, *Doc 2009-10831*, or *2009 WTD 136-11*.

price) is equal to the fair market value of the employer's shares at the date the option is granted. No taxable event occurs on the grant of the option. If the value of those shares subsequently rises, the employee will typically exercise the option, pay the exercise price, acquire the shares, and enjoy a benefit equal to the difference between the value of the shares on the date of exercise and the exercise price (known as the in-the-money amount).

For tax purposes, the in-the-money amount is reported as a taxable benefit and included in the employee's income when the option is exercised. (In limited circumstances, inclusion is deferred until the shares are sold.) In most cases the employee is entitled to deduct 50 percent of the benefit in computing his taxable income under a deduction for qualifying stock options. Thus, the employee usually receives a benefit of which only half is taxable. The employer cannot claim a deduction in its income for any part of the value of the shares issued to the employee.

Tax Deferral Election

Once the employee exercises the stock option and acquires the shares, the amount of the taxable benefit is fixed based on the value of the shares at that time. Any increase or decrease in the value of the share from that point onward will generally be treated as a capital gain or loss. Because capital losses can be used only against capital gains and not against employment income, the employee takes a risk in continuing to hold the shares: If the shares decrease in value, he will only get recognition for the loss when he sells the shares, and even then, only as a capital loss that cannot be used to reduce the previously recognized employment income from exercising the option.[6]

Under certain conditions, employees of publicly traded companies can defer some or all of the employment benefit created by the exercise of employee stock options until the time the shares acquired on the exercise of the options are sold. The budget announces the government's intention to eliminate this deferral election, applicable to employee stock options exercised after 4 p.m. on March 4, 2010. A special rule is also being proposed to offer relief to employees who have previously availed themselves of this deferral to ensure that the taxable benefit from exercising the options does not exceed the proceeds from the sale of the underlying shares (taking the benefit of any capital loss on the shares into account).

Withholding Obligations

There has been some uncertainty under the CRA's administrative policy to date about whether any withholding from the employee's earnings should be made when an employee exercises a stock option and thereby receives shares, as the option exercise for shares does not produce any cash from which the employer can withhold. The result has been that many employers have not withheld and remitted to the CRA any amount relating to the tax due on the employee's taxable benefit from exercising the options.

The budget also proposes to clarify this uncertainty by requiring that for employee stock options exercised after 2010 (subject to certain transitional rules), the employee's taxable benefit (taking the 50 percent deduction for qualifying stock options into account) should be treated as if it had been paid in cash, necessitating increased withholding and remittance from the employee's other cash compensation. This will require employees to consider the cash flow implications of a significant exercise of employee stock options. In particular, employees exercising options may need to sell some of the shares they acquire immediately in order to generate cash for the withholding obligation.

Option Cash-Outs

In some cases, the option plan may be structured in such a way that instead of issuing shares to the employee on the exercise of the option, the employee can choose to receive a cash payment equal to the in-the-money amount (often called a cash out). Done properly, the employee still gets the advantageous 50 percent deduction of the benefit, and the employer can claim a deduction in its income for the cash paid. In effect, this result produces the best of both worlds.

The budget will eliminate this possibility on cash outs occurring after 4 p.m. on March 4, 2010, by denying the employee the favorable 50 percent deduction from taxable income unless the employer elects not to deduct the payment. This development will have consequences on how employee stock option plans are structured and operated. While in some cases employers seeking to avoid equity dilution or employees seeking convenience and immediate cash may prefer that options be cashed out rather than exercised for shares, the cost of cashing out options will be significantly greater if there is either no tax deduction to the employer or the loss of the 50 percent taxable benefit deduction to the employee. Employees will be alarmed at the prospect of not receiving the favorable 50 percent deduction of the taxable benefit (something that has come to be viewed as an entitlement). If their employers are not willing to forego the deductibility of cash out payments, employees wanting the 50 percent benefit inclusion rate will be forced to actually exercise their options and acquire shares rather than choose to have their options cashed out. It would not be surprising to see employers try to steer their option holders in that

[6]For a discussion of the perilous results that can occur when shares go down in value in such circumstances, see Steve Suarez, ''Canada's Taxation of Stock Option Benefits: Could the SDL Remission Order Benefit Others?'' *Doc 2008-3358* or *2008 WTD 46-8*.

Table 2. Taxation of Employee Stock Options

	Pre-2010 Budget	Post-2010 Budget
Options exercised: timing of employee benefit recognition	Generally when option exercised, subject to deferral for shares of Canadian controlled private corporations and potential elective deferral for publicly listed shares	Generally when option exercised, subject to deferral for shares of Canadian controlled private corporations
Options exercised: computation of employee taxable benefit	Employee includes in-the-money amount as taxable benefit, subject to 50% deduction for qualifying options	Employee includes in-the-money amount as taxable benefit, subject to 50% deduction for qualifying options
Options exercised: expense deduction for share issuer	None	None
Options exercised: withholding obligation	CRA administrative policy unclear whether employer required to withhold tax on taxable benefit by increasing withholding on cash compensation	Cash withholding from other sources now required for tax on taxable benefit
Options cashed out: computation of employee taxable benefit and employer deductibility	Employee includes in-the-money amount as taxable benefit, subject to 50% deduction for qualifying options; deduction to employer for cash payment	Employee includes in-the-money amount as taxable benefit; can take 50% deduction for qualifying options only if employer elects to forego deduction for cash payment

direction, and make it easier for them to exercise their stock options by setting up mechanisms that reduce the cost and inconvenience of exercising options (and selling shares, given the withholding clarification described above). With cash-out rights now creating a tension between employers and their employees in terms of one but not both getting favorable tax treatment, employers are less likely to want to give employees the right to elect to be cashed out and may want to amend existing stock option plans accordingly (or create new stock option plans for future awards).

Table 2 compares the pre- and post-budget taxation of employee stock options.

Foreign Tax Credit Generators

Canada taxes Canadian residents on worldwide income but generally offers some form of tax relief (for example, a foreign tax credit) for foreign taxes paid on foreign-source income in order to prevent double taxation. Conceptually, similar relief is provided on foreign-source income earned indirectly through a foreign affiliate and ultimately taxed in the hands of its Canadian corporate shareholder.

The budget identifies as objectionable schemes designed to ''exploit asymmetry, as between the tax laws of Canada and those of a foreign country, in the characterization of the Canadian corporation's direct or indirect investment in a foreign entity earning the income that is subject to foreign tax.'' Such schemes are identified in the budget as typically involving the use of a foreign partnership or foreign corporation, whereby the Canadian corporation makes an investment that is in substance a loan to a foreign corporation in a jurisdiction that taxes on a substance-over-form basis. By taxing the arrangement based on its legal form, Canada treats the Canadian taxpayer as having generated an FTC (or its equivalent in a foreign affiliate) for foreign taxes paid, even though the relevant foreign jurisdiction may allow an offsetting reduction in taxes payable elsewhere in the foreign corporation's group.

To thwart such schemes, the budget introduces a proposal to deny credits for foreign taxes paid by a Canadian taxpayer, either as a member of a partnership or indirectly through an interest in a foreign affiliate, when certain conditions apply. For income earned through a partnership, the denial applies if the Canadian taxpayer's share of the partnership's income under the relevant foreign country's tax laws is less than its share of the partnership's income for Canadian tax purposes. There is no tax avoidance purpose test: The test is simply a comparison of the foreign country's tax laws with Canada's. Recognition for foreign taxes paid by a foreign affiliate of a Canadian taxpayer is denied if, under the relevant foreign law, the taxpayer is considered to own a smaller equity interest in the relevant entity than it is considered to own for Canadian purposes.

In concept, this initiative reportedly is intended to put the Canadian corporation in the same position as if it had simply made a loan to the foreign corporation. In practice, however, these proposals (effective for tax years ending after March 4, 2010) may have broader application than the particular result that the Department of Finance is targeting. Clearly, taxpayers seeking Canadian tax relief for foreign taxes paid through a partnership or indirectly through a foreign affiliate will have to carefully consider the potential application of these rules. The Department of Finance is accepting comments on this proposal until May 4. While the budget expresses the view that foreign tax credit generators can be challenged under existing rules, the strength of that position remains to be seen, as Canadian tax law strongly emphasizes the legal form of a transaction and permits a transaction to be recharacterized only in very limited circumstances.

Income Trust/SIFT Conversions

Partnerships are treated as flow-through entities for Canadian tax purposes (that is, income earned by the partnership is taxed in the hands of its partners), and trusts can be structured to produce essentially the same flow-through result. This allows partnerships and trusts to hold operating businesses without incurring entity-level taxation, giving them a structural advantage over corporations. Numerous Canadian corporations have been effectively converted into flow-through entities (typically trusts) in recent years to reduce taxation on the businesses they held, as investors (including tax-exempts and nonresidents) flocked to invest in such income trusts.

The party ended on October 31, 2006, when Flaherty announced that new specified investment flow-through (SIFT) partnerships and trusts would cease to enjoy this structural tax advantage relative to corporations as regards such income, and that existing SIFTs would enjoy only an additional four years of those benefits before new taxes would be imposed, starting in 2011. The legislation dealing with SIFTs allowed them to convert back into corporations on a tax-deferred basis, which many such entities have been doing.

In some cases, the conversion has been structured as a reverse takeover of the SIFT by a corporation with significant accrued losses or similar tax attributes, with SIFT investors exchanging their interests in the SIFT for shares of the corporation. Even though the SIFT investors as a whole typically acquire most of the equity in the acquiring corporation as a result (hence the term ''reverse takeover''), because the SIFT is widely held, its investors do not constitute a group for purposes of the rules in the ITA that restrict the corporation's ability to use its losses after it has been the subject of an acquisition of control by a person or group of persons.

The budget introduces a new rule designed to deem an acquisition of control to have occurred in such circumstances, restricting or eliminating the corporation's ability to use its losses following the deemed acquisition of control. (An existing rule already produces this result when the investors are shareholders of a corporation rather than holders of SIFT interests.) This rule will apply to transactions occurring after March 4, 2010, unless they are the subject of a binding written agreement before that time. As such, it does not apply to SIFT conversions that have already been completed, and interestingly, the budget does not assert that such conversions are susceptible to challenge under existing legislation (unlike the foreign tax credit generators).

Foreign Investment Entities

In 1999 the Department of Finance announced a major proposed revision to Canada's outbound taxation system. The existing rule governing investments by Canadian residents in foreign entities earning passive income was deemed insufficient to deter Canadians seeking to defer the taxation of investment income by earning it through a foreign entity rather than earning it directly. Paraphrased, this rule applied when a taxpayer held an interest in an offshore investment fund property (OIFP) deriving its value primarily from portfolio investments, and it could reasonably be concluded that one of the main reasons for the taxpayer holding such investment was to reduce the amount of Canadian tax otherwise payable relative to the tax that would have been payable if the taxpayer had earned the income directly.

In place of this rule, a complex regime dealing with interests in foreign investment entities (FIEs) was proposed. The FIE regime was highly controversial because of its breadth, its unprecedented complexity, and the widespread perception that the amount of tax revenue involved did not warrant the legislative response being proposed. Multiple revisions of the draft FIE rules were released, but the essential concepts remained the same.[7] The finance minister's advisory committee (and others) recommended a reconsideration of these rules in its report.[8]

Thankfully, the budget proposes to scrap the FIE regime (effective for tax years ending after March 4, 2010) and revert back to the existing OIFP rule with some relatively simple modifications.

If the existing OIFP rule applies, the taxpayer has a periodic income inclusion equal to the cost of the OIFP multiplied by a rate equal to the three-month Treasury bill rate plus 2 percentage points (an increase in the old rate). The government (which intends to seek public consultation before proceeding with legislation) is to be commended for listening to the tax community's concerns and reverting to a relatively simple rule that should catch most situations that would be considered offensive without creating undue complexity.

---

[7]For a history of the FIE/NRT rules, see Patrick Marley, Sabrina W.Y. Wong, and Peter Macdonald, ''Canada Considering Tax Changes for Foreign Investment Entities, Nonresident Trusts,'' *Doc 2005-16307* or *2005 WTD 148-2.*

[8]Advisory Report at para. 4.101-103, and Recommendation 4.5.

The FIE proposals from 10 years ago were accompanied by proposed rules dealing with nonresident trusts (NRTs). In general terms, these rules deemed to be resident in Canada (and hence subject to Canadian tax) certain trusts that had received property from a Canadian contributor or in some cases had a Canadian beneficiary. Essentially these rules would have resulted in the NRT being deemed resident in Canada and would have made resident contributors or beneficiaries jointly and severally liable for the NRT's Canadian taxes.

The budget announces numerous revisions to the NRT rules in response to concerns expressed that the rules are broader and more complex than they have to be. The changes proposed include the following:

- To address the concern that a Canadian tax-exempt entity such as a pension fund or charity could become liable for the trust's tax despite being tax-exempt on its own income, an exemption from resident-beneficiary and resident-contributor status is proposed for various such tax-exempt entities.
- Exemptions from the NRT rules for bona fide commercial trusts would be expanded to avoid deterring genuine commercial investments.
- Loans made to a trust by a Canadian financial institution in the ordinary course of the financial institution's business would not result in the financial institution being a resident contributor to the trust.

If the NRT rules do apply, amendments to the taxation of the trust (particularly the calculation of its income) and its beneficiaries/contributors are also being proposed (for example, to limit the amount of the trust's property that is subject to Canadian income tax to the portion attributable to property contributed by Canadian residents or former residents).

In general, these changes to the NRT rules are effective for 2007 and subsequent tax years. While the new NRT rules will not significantly simplify the regime (which remains potentially overbroad in some cases), they are a step in the right direction, and to that extent they are welcome. While a full discussion of the NRT regime and the proposed changes is beyond the scope of the present discussion, those involved with non-Canadian trusts that have a Canadian connection will want to examine these proposed amendments closely.

Other Business Tax Measures

The budget also contains some less important business tax measures that are nonetheless worthy of note.

Overpayments by Nonresidents

In various situations payers of amounts to nonresidents are obliged to withhold and remit to the CRA a portion of the payment as a prepayment toward the nonresident's Canadian tax liability, if any. The principal examples of this obligation occur under the s. 116 system on an acquisition of TCP from a nonresident vendor, and under regulation 105 when an amount is paid to a nonresident for services rendered in Canada. In many cases, no tax is owed by the nonresident (for example, because of a treaty exemption), meaning that the nonresident is entitled to a refund on filing a Canadian tax return. However, to be entitled to a refund, the nonresident must file a Canadian tax return within a prescribed time.

Because there is no time limit for the CRA to assess the payer for a failure to withhold and remit, it is possible that the situation could arise when the overpayment of the nonresident's tax occurs after the time has expired for the nonresident to file a Canadian income tax return for the relevant year. This could leave the nonresident unable to recoup the overpayment of tax.

The budget proposes to alleviate this on overpayments of tax related to an assessment of the payer (under regulation 105) or the purchaser (under section 116), effective for refund applications claimed in returns filed after March 4, 2010. This will be achieved by amending the rules to allow a refund to be made to the nonresident if the nonresident files the requisite Canadian tax return within two years of the CRA's assessment.

Clean Energy Allowance

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. Different types of property fall into different classes for CCA purposes, each with a different rate of depreciation.

Class 43.2 provides for accelerated CCA (a 50 percent rate) for specified clean energy generation and conservation equipment. The budget will expand the list of assets eligible for Class 43.2 (effective for assets acquired after March 4, 2010) to include heat recovery equipment used in a broader range of applications and distribution equipment used in district energy systems that rely primarily on ground source heat pumps, active solar systems, or heat recovery equipment.

Moreover, for tax years ending after 2004, the range of corporations (principal business corporations) entitled to transfer Canadian renewable and conservation expenses to investors via flow-through shares (see below) is being expanded to include corporations whose principal business is using Class 43.1 or 43.2 property to produce fuel or to generate or distribute energy.

Specified Leasing Property

The specified leasing property rules were originally introduced to eliminate the after-tax advantages of leasing as a source of financing relative to a loan. They accomplish this by recharacterizing a lease as a loan and limiting the lessor's CCA deductions to deemed repayments on the loan. Property commonly leased for operational purposes and whose CCA rate approximates its economic depreciation (exempt property) is excluded from these rules.

The Department of Finance perceives the exempt property rules as having been exploited when exempt property is leased to a lessee who cannot make use of the CCA by virtue of not being taxable in Canada (that is, a nonresident or a tax-exempt). Effective for leases entered into after 4 p.m. EST on March 4, the budget will extend the specified leasing property rules on leases of exempt property to a tax-exempt entity or a nonresident, unless the value of the property is less than $1 million (an antiavoidance rule applies when multiple leases are used to stay below the dollar limit).

Mineral Exploration Tax Credit

Finally, the 15 percent mineral exploration tax credit available to individuals who invest in flow-through shares of mining exploration companies (shares that effectively allow the exploration company to ''flow out'' the exploration deductions to the shareholder) is being extended for another year for flow-through share agreements entered into by March 31, 2011. ◆