

MARCH 4, 2010

FEDERAL BUDGET COMMENTARY

10

Among proposed and continued spending programs aimed at stimulating and maintaining economic recovery are \$3.2 billion in personal income tax relief including upgrading the basic personal tax credit and raising child benefits; over \$4 billion in unemployment benefits including some EI premium relief; and \$7.7 billion to stimulate infrastructure and housing construction. The Budget also proposes investment of \$1.9 billion to "create the economy of tomorrow," including \$600 million to strengthen research and development efforts in Canada.

The Minister pledged increased restraint on government spending, most notably by slowing the projected growth of spending on defense and foreign aid. There are, however, few proposed cuts to program spending. He also promised to freeze the total amount spent on government salaries, administration and overhead. This includes freezing the salaries of the Prime Minister, other ministers, members of parliament and senators, as well as the budgets of ministers' offices.

While the Budget does not propose major fiscal policy shifts, it contains a number of fairly significant tax-related measures. For example, the CICA welcomed the government's continued commitment to cut the corporate tax rate to 15 percent by 2012, which the Minister noted will be the lowest corporate tax rate in the G7. However, the CICA urged the government to further reduce the corporate tax rate to the small-business level, currently 11 percent, as improving finances permit. "Moving to a single rate would reduce the complexity of the tax system while lowering compliance costs," said Dancey.

Other noteworthy tax-related proposals include closing some perceived tax loopholes to promote fairness, and the elimination of remaining tariffs on imported machinery and equipment. These and other provisions are discussed below.

addition, these proposals will not apply to options granted before 2011 pursuant to an agreement in writing entered into before 4:00 pm EST on March 4, 2010 where the agreement included restrictions on the disposition of the optioned shares.

SPECIAL RELIEF FOR TAX DEFERRAL ELECTIONS

Where a taxpayer disposes of securities of a non-CCPC before 2015 and the related stock option benefit was deferred upon the exercise of the option, special tax relief will be provided by the Budget. This special relief will ensure that the tax liability on a deferred stock option benefit will not exceed the sale proceeds from the optioned securities after taking into account the tax relief resulting from the use of the capital loss on the optioned securities against capital gains from other sources.

A taxpayer may elect to pay a special tax for the year equal to the proceeds from the sale of the optioned shares. This tax election will allow the taxpayer to claim an offsetting deduction equal to the amount of the stock option benefit. In addition, a capital gain equal to one-half of the lesser of the stock option benefit and the capital loss on the optioned shares will be included in income. This capital gain may be offset by the capital loss on the optioned shares, provided that this loss has not otherwise been utilized.

Individuals who disposed of their optioned securities before 2010 will have to make an election for this special tax treatment on or before the filing due-date for their 2010 tax return. In addition, individuals who have not disposed of their optioned shares before 2010 must do so before 2015 in order to qualify for this special tax treatment. The tax election will be required by the filing due-date for the year of disposition.

This special tax treatment will provide relief for federal income tax liabilities and for provincial and territorial income tax liabilities on those benefits for residents of provinces and territories participating in a Tax Collection Agreement.

MEASURES FOR DISABLED TAXPAYERS

RRSP TAX-DEFERRED TRANSFERS ON DEATH

Under current legislation, where the balance in a deceased annuitant's Registered Retirement Savings Plan (RRSP) is payable to a surviving spouse or partner or an infirm financially dependent child or grandchild, the amount may be transferred to the beneficiary's RRSP and tax thereby deferred. The Budget proposes to extend this "rollover" treatment where the RRSP proceeds are transferred to a Registered Disability Savings Plan (RDSP) for the benefit of an infirm dependent child or grandchild, effective for deaths after March 4, 2010. The child or grandchild is

July, 2011, these payments may be shared equally between two individuals who live separately where the child lives approximately equally with each of them. Each will receive one-half of the amount to which they would be entitled if they were the sole recipient. These credits will still be able to be received by one individual if the two parties so agree.

UNIVERSAL CHILD CARE BENEFIT (UCCB)

In a two-parent family, the \$100 monthly UCCB for each child age five or under is included in the income of the lower income spouse. This disadvantages a single parent in that the tax on the UCCB could be significantly higher than for a two-parent family. Accordingly, for 2010 and subsequent years, a single parent receiving the UCCB will have the option of including the UCCB for all children in the income of the child for whom the eligible dependant (equivalent-to-married) credit is claimed. If no eligible dependant claim can be made, for example if the children's income is too high, the parent will have the option of including the UCCB for all children in the income of one of the children for whom it is paid.

SCHOLARSHIP EXEMPTION AND EDUCATION TAX CREDIT

For 2010 and subsequent years, the tax-free portion of a scholarship will be limited to the total of the fees paid to a designated educational institution for tuition and the cost of program-related materials where the taxpayer is enrolled in a part-time qualifying educational program. Scholarships awarded to disabled or infirm students enrolled in a part-time qualifying program will continue to be fully tax exempt. In addition, an amount will be eligible for the scholarship exemption only to the extent that it can reasonably be considered to be received in connection with enrollment in an eligible educational program for the duration of the period of study related to the scholarship.

6

A qualifying post-secondary school program, for the purpose of the education tax credit and the scholarship exemption, will not include a program which consists primarily of research unless the program leads to a diploma from a college or CEGEP or a bachelor, masters or doctoral degree or equivalent degree. Consequently, post-doctoral fellowships will be taxable.

BUSINESS

CAPITAL COST ALLOWANCE (CCA)

TELEVISION SET-TOP BOXES

To better reflect their estimated useful life, satellite set-top boxes and cable set-top boxes that are currently governed by Class 8 (20% declining balance CCA rate) and Class 10 (30% declining balance CCA rate), respectively, will be eligible for a higher declining balance CCA rate of 40%. The Budget proposes to make this higher CCA rate available for such assets acquired after March 4, 2010 and that have not been used or acquired for use before March 5, 2010.

CLEAN ENERGY EQUIPMENT

Taxpayers who acquire specified clean energy generation and conservation equipment after February 22, 2005 and before 2020 are permitted to treat these assets as Class 43.2 (50% declining balance CCA rate) property. Generally, such assets acquired before February 23, 2005 are classified as Class 43.1 (30% declining balance CCA rate) property. With a view to further encouraging taxpayers to invest in energy generation equipment with low or zero emission levels, the Budget proposes to broaden the definition of Class 43.2 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. Lower-efficiency fossil-fuel-based distribution equipment will now be included in Class 43.1. These measures will apply to eligible assets acquired on or after March 4, 2010 that have not been used or acquired for use before that date.

CANADIAN RENEWABLE AND CONSERVATION EXPENSES

If the majority of a project's tangible property qualifies for inclusion in Class 43.2, then certain project start-up expenses (for example, feasibility studies and engineering and design work) qualify as Canadian Renewable and Conservation Expenses. Canadian Renewable and Conservation Expenses can be fully deducted in the year incurred or transferred to investors using flow-through shares. A corporation must be a "principal business corporation" in order to transfer or "renounce" Canadian Renewable and Conservation Expenses to an investor using flow-through shares. Accordingly, to enhance investment in this sector, the "principal business corporation" definition has been expanded, effective for taxation years ending after

where an acquiring corporation's tax attributes, including its loss carryovers, are available without restriction to shelter future income earned by the acquired SIFT trust. Existing tax rules prohibit such loss trading if the acquired entity was instead a corporation. The Budget proposes to extend these existing rules to situations where units of a SIFT trust or SIFT partnership are exchanged for shares of a corporation.

Measures have also been introduced to facilitate the wind-up of SIFT trusts with corporate investments.

These measures will generally be applicable to transactions undertaken after 4:00 pm EST on March 4, 2010.

SPECIFIED LEASING PROPERTY RULES

The Budget proposes, for leases entered into after 4:00 pm EST on March 4, 2010, to expand the scope of existing specified leasing property rules to otherwise exempt property that is the subject of a lease to a non-resident or to a government or tax-exempt entity. However, there is an exception if the total value of the leased property is less than \$1 million, subject to an anti-avoidance rule.

CHARITIES

DISBURSEMENT QUOTA REFORM

Currently, the disbursement quota rules require that the amount that a charity spends annually on charitable activities be at least the sum of:

- 80% of the previous year's tax-receipted donations plus other amounts relating to enduring property and transfers between charities (the "charitable expenditure rule")
- 3.5% of all assets not used in charitable programs or administration, if these assets exceed \$25,000 (the "capital accumulation rule")

The Budget proposes to reform the disbursement quota for fiscal years that end on or after March 4, 2010 by the following measures:

- repeal of the charitable expenditure rule
- modification of the capital accumulation rule
- strengthening of related anti-avoidance rules

INTERNATIONAL TAXATION

SECTION 116 AND TAXABLE CANADIAN PROPERTY

Pursuant to Canadian tax rules, non-residents of Canada are subject to income tax in Canada on gains arising from the disposition of "taxable Canadian property". However, many of Canada's tax treaties with other countries contain an exemption from such tax in respect of taxable Canadian property, except for taxable Canadian property that is real estate or shares that derive their value principally from real estate.

The Budget proposes a relieving measure to amend the definition of "taxable Canadian property" to exclude shares of corporations (and certain other interests) that do not derive their value principally from real estate situated in Canada, Canadian resource property and timber resource property in order to reduce deterrents to foreign investors to invest in Canada. This measure will eliminate, in most cases, purchaser withholding and section 116 certificate compliance obligations for these types of properties. It will also eliminate the existing requirement of a vendor to file a related Canadian tax return in instances where no Canadian tax liability exists in respect of the sale.

This measure will apply for determinations after March 4, 2010 of whether property owned by a taxpayer constitutes taxable Canadian property.

REFUNDS UNDER REGULATION 105 AND SECTION 116

Regulation 105 imposes a withholding tax requirement on payors on amounts paid to a non-resident of Canada who renders services in Canada. Also, section 116 imposes a withholding tax requirement on a purchaser of taxable Canadian property from a non-resident. In each case, the amounts are to be withheld and remitted to the CRA on account of a non-resident's potential Canadian tax liability. The responsibility of the payor to withhold and remit the subject taxes may exist notwithstanding that a non-resident is exempt from tax in Canada due to a tax treaty.

The ability of the non-resident to file a Canadian income tax return and claim a refund of any such excess amount withheld is subject to certain time limits. The Budget proposes to correct a technical anomaly that otherwise prevents a non-resident from recovering any such excess amount withheld and remitted to the CRA. The tax return is required to be filed within two years of the assessment of the withholding tax. It is proposed that this measure is to be effective for refunds claimed in tax returns filed after March 4, 2010.

mechanism will eliminate the need for network sellers to make GST/HST adjustments in a particular period where the qualification criteria to use the simplified accounting method are not met.

CUSTOMS TARIFF REDUCTIONS ON MANUFACTURING INPUTS AND MACHINERY AND EQUIPMENT

This Budget proposes to make Canada a tariff-free zone for industrial manufacturers by eliminating all remaining tariffs on machinery and equipment and goods imported for further manufacturing. 1160 tariff items will have the Most Favoured Nation (MFN) rates of duty reduced to “free” for imports on or after March 5, 2010. Another 381 tariff items will have the MFN rates of duty gradually reduced as of March 5, 2010 and becoming “free” no later than January 1, 2015. When fully implemented this measure will result in \$300 million in annual duty savings for Canadian business.

OTHER MEASURES

TAX AVOIDANCE TRANSACTIONS

The government intends to hold public consultations on proposals for a formal reporting process for certain so-called tax avoidance transactions. Details of the proposals and the consultation process will be released at the “earliest opportunity.”

The purpose of the eventual legislation will be to institute a reporting mechanism in respect of potentially abusive transactions to enable the CRA to identify aggressive tax planning on a timely basis in order that existing anti-avoidance rules, such as the General Anti-Avoidance Rule (GAAR), can be applied, if warranted.

Reportable transactions will be avoidance transactions, as currently defined in the *Income Tax Act*, that meet at least two of the following three criteria:

1. A promoter or tax advisor is entitled to fees that are to any extent based on the amount of tax benefit from the transaction, contingent on obtaining the tax benefit or attributable to the number of taxpayers who participate in the transaction.
2. A promoter or advisor in respect of the transaction requires “confidential protection” about the transaction.
3. The taxpayer obtains “contractual protection” in respect of the transaction.

Tax shelters and flow-through share arrangements will be exempted as they have existing reporting mechanisms.