



# FLASH

## Taxation Measures in the 2010 Federal Budget

March 4, 2010

Finance Minister Jim Flaherty delivered the Federal Budget on March 4, 2010. The Budget leaves untouched previously-enacted reductions in corporate income tax rates through 2012. The Budget proposes a number of narrowly-targeted measures in discrete areas including, among other things, employee stock options, the definition of "taxable Canadian property", disclosure of tax avoidance transactions, the purchase of losses in connection with income trust conversions and certain foreign tax credit transactions. The Budget also promises revised proposals dealing with foreign investment entities and non-resident trusts. Highlights of these measures are provided below.

### **Employee Stock Options**

#### *Stock Option Cash-Outs*

Upon the exercise or disposition of an employee stock option, a Canadian resident employee is generally required to include in income an employment benefit. Where the necessary conditions are satisfied, the employee is entitled to a deduction equal to one-half of such employment benefit (the "50% Deduction").

The Budget proposes that where an employer makes a cash payment on the cash-out of an employee's stock options, the employee will no longer be entitled to claim the 50% Deduction (assuming that the employee otherwise qualifies) unless the employer makes an election to not claim a deduction in respect of the cash-out payment.

#### *Elimination of Deferral Election*

As noted above, where an employee exercises a stock option to acquire shares, the employee is generally taxed on the employment benefit at the time of such exercise. In certain circumstances, an employee who on exercise of the option acquires shares listed on a stock exchange may jointly elect with his or her employer to defer recognition of the employment benefit from the time of exercise to the time the share is disposed of.

The Budget papers state that when an employee makes the deferral election, the employee may not be able to meet his or her tax obligation where there is a subsequent decrease in the value of the shares. For this reason, the Budget proposes to remove the ability to make

the deferral election in respect of stock options issued after 4:00 p.m. (EST) on March 4, 2010.

For employees that previously made a tax deferral election, the Budget proposes special elective tax relief which is intended to provide that the tax liability on the deferred stock option benefit does not exceed the proceeds of disposition of the shares acquired on the exercise of the stock options.

#### *Withholding & Remittance on the Exercise of Stock Options*

The Budget includes proposals effective after 2010 that ensure the withholding and remittance obligations for ordinary employment compensation also applies to the employment benefit in respect of the exercise of stock options to acquire shares (other than, in certain circumstances, stock options issued by Canadian controlled private corporations). Accordingly, the required remittance will have to be made for the period that includes the date on which the stock options are exercised.

#### **Taxable Canadian Property**

Non-residents of Canada are liable to Canadian taxation on gains from the disposition of "taxable Canadian property" (TCP), including shares of private corporations resident in Canada, whether or not their value is derived from Canadian real property. In addition, the withholding and certification rules in section 116 of the *Income Tax Act* (Canada) are applicable to a disposition by a non-resident of TCP (other than certain excluded property).

The Budget proposes that the definition of TCP be amended, effective on March 4, 2010, to exclude shares of corporations (and certain other interests) that do not derive their value principally from real property situated in Canada, Canadian resource property, or timber resource property. If such interests derived more than 50% of their value from these types of property at any time during the 60-month period that ends upon the disposition, such interests would be TCP.

Note that unlike other Canadian provinces, Québec has rules for taxable Québec property that are similar to the ones under the *Income Tax Act* (Canada) for TCP. No announcement has been made yet whether Québec will harmonize its rules with the TCP proposals in the Budget.

#### **Reporting of Tax Avoidance Transactions**

The Budget proposes, subject to public consultation, provisions which would require the reporting of "reportable transactions" to the Canada Revenue Agency ("CRA"). A reportable transaction would be an "avoidance transaction" (in approximate terms, one entered into primarily for the purposes of avoiding or deferring tax) where the transaction had at least two of the following three characteristics:

1. A promoter or tax advisor in respect of the transaction is entitled to fees in respect of the transaction that are to any extent contingent upon the obtaining of the tax benefit or based on its amount or the number of taxpayers who participate in the transaction or receive advice of the promoter or advisor of the tax consequences.
2. The promoter or tax advisor requires "confidential protection" (not yet defined) about the transaction.

3. The taxpayer obtains "contractual protection" (also not defined) in respect of the transaction.

If a reportable transaction has not been reported on a timely basis, the CRA would be able to deny the tax benefit - unless the taxpayer files with the CRA any required information and pays a penalty.

These proposals, as modified to take into account the consultation process, would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

Transactions that were tax shelters or flow through share arrangements (which are already subject to an existing set of disclosure rules) would not be affected by these proposals.

### **Income Trust Conversions**

Canadian income tax changes first announced in 2006, will subject most income trusts (other than certain real estate investment trusts) to entity-level taxation on January 1, 2011, and the traditional tax benefits of conducting business through a Canadian income trust structure will be eliminated. Many income trusts have already converted to corporations. Some of these income trust conversions have been structured to include loss companies in an effort to allow the successor corporations to continue to distribute cash flows without the incurrence of entity level taxation for a period of time.

The *Income Tax Act* (Canada) deems control of a corporation to have been acquired in certain circumstances, including in the case of a so-called "reverse takeover" of a public corporation. This rule will be extended to apply to the conversion of income trusts into corporations. As a result, the ability to use a loss company's tax losses following the conversion of an income trust will be constrained. These changes apply to income trust conversions after 4:00 p.m. EST on March 4, 2010, other than conversions that must be completed pursuant to an agreement in writing entered into before that time (for these purposes, there is no such obligation if a party may be excused from completing the transaction as a result of changes to the *Income Tax Act* (Canada)).

### **Foreign Investment Entities and Non-Resident Trusts**

Complex proposals with respect to non-resident trusts and foreign investment entities were first introduced in the 1999 Budget. In response to concerns from the tax community regarding the complexity of these provisions, combined with numerous technical problems, the 2009 Budget announced that the proposals would be reviewed before the government proceeded with legislative amendments. The Budget contains revised proposals with respect to foreign investment entities and non-resident trusts, which will be subject to a consultation process with a view to releasing revised legislation for comment.

The Budget proposes to retain the foreign investment entity provisions which are currently in force, with limited enhancements. The currently enacted provisions require an income inclusion with respect to an interest in an "offshore investment fund property" in certain circumstances. The 2010 proposals increase the prescribed rate applicable in computing this income inclusion to the three-month average Treasury Bill rate plus two percentage points. They also broaden the existing rules to apply to interests in certain trusts that are not subject to the non-resident trust rules described below, and extend the normal

reassessment period in respect of these interests by three years. The former proposals were vastly more complex than the currently enacted foreign investment entity rules, and the Budget proposals represent a significant improvement in this respect.

The Budget changes to the proposals in respect of non-resident trusts are generally relieving in nature. The former proposals imposed Canadian tax on the worldwide income of a non-resident trust where there was a resident beneficiary or a resident contributor to the trust, for which such beneficiaries and contributors were jointly and severally liable. The revised proposals contain a carve-out for investments in non-resident trusts by tax-exempt entities, which will address concerns over the inappropriate application of the rules in this context. They also expand the carve-outs from the application of the proposed rules for commercial trusts, in recognition that the former proposals were overly broad.

The revised non-resident trust proposals generally exclude from the trust's income for purposes of these rules any income arising from property contributed to the trust by non-residents of Canada (with the exception of certain former residents), other than Canadian-source income otherwise subject to tax. In addition, the trust's income is attributed to its resident contributors in proportion to their relative contributions to the trust. The trust is entitled to a deduction for the amount of its income payable to its beneficiaries in the year and for amounts attributed to resident contributors. These measures are generally proposed to apply in respect of the 2007 and subsequent taxation years, with the attribution of trust income to resident contributors applicable in respect of taxation years ending after March 4, 2010.

Countering arguments that Canada's income tax treaties can effectively override the non-resident trust rules, the Budget further proposes to amend the *Income Tax Conventions Interpretation Act* to provide that a trust that is deemed to be resident in Canada under these rules will be considered a resident of Canada for tax treaty purposes.

### **Mineral Exploration Tax Credit**

The sunset provisions for the federal mineral exploration tax credit of 15% have been extended by a further year. The related flow-through share agreement must now be entered into on or before March 31, 2011.

### **Foreign Tax Credits**

The Budget includes proposals to target transactions that are referred to in the Budget documents as "foreign tax credit generators" (generally certain transactions that allow tax credits or other tax relief to both Canadian and foreign participants for the same foreign tax). These proposals are intended to eliminate the Canadian tax benefits of participating in certain of these transactions.

### **Interest on Corporate Tax Overpayments**

The interest rate payable by the Canadian Government on corporate tax overpayments will be reduced effective July 1, 2010 by two percentage points. This is in response to a concern raised by the Auditor General that corporations were voluntarily overpaying their taxes to benefit from above-market interest rates.

## Taxation of Corporate Groups

The Government announced that it will again explore the possibility of introducing a formal system of loss transfers or consolidated reporting for corporate groups and will seek taxpayers' views in that respect. In 1985, the Department of Finance had released a discussion paper recommending the use of losses within a group but these recommendations were never adopted. As a result, the *Income Tax Act* (Canada) contains no comprehensive loss consolidation regime and taxpayers often undertake complicated transactions (generally relying on the administrative practices of the CRA) to achieve such results.

## GST on Investment Management Services

The Budget contains draft legislation to implement a proposal previously announced on December 14, 2009, to narrow the types of services that qualify as exempt financial services. Among other provisions, the draft legislation provides that asset management fees will be subject to GST (or HST, as the case may be). This term will refer to a service of:

- a. managing or administering the assets or liabilities of another, irrespective of the level of discretionary authority of the service provider [this responds to a court decision which found discretionary investment management services to be exempt];
- b. providing research, analysis, advice or reports in respect of the assets or liabilities;
- c. determining which assets or liabilities are to be acquired or disposed of; or
- d. acting to realize performance targets or other objectives in respect of the assets or liabilities.

This change (and other proposals "clarifying" that various facilitatory services and credit management services are taxable) will be retroactive to the introduction of the GST in 1990, except that they will not apply to transactions where (in general terms) the supplier did not charge GST and was paid on or before December 14, 2009. Accordingly, refund claims based on the loss of the Government in the relevant court cases have been cut off.

*If you have any questions regarding the foregoing, please contact [Ian Crosbie](#), [John Ulmer](#), [Elie Roth](#), [Raj Juneja](#), [Neal Armstrong](#) or [Colin Campbell](#) in our Toronto office (416.863.0900) or [Brian Bloom](#), [Michael Kandev](#) or [Marie-Emmanuelle Vaillancourt](#) in our Montréal office (514.841.6400).*

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