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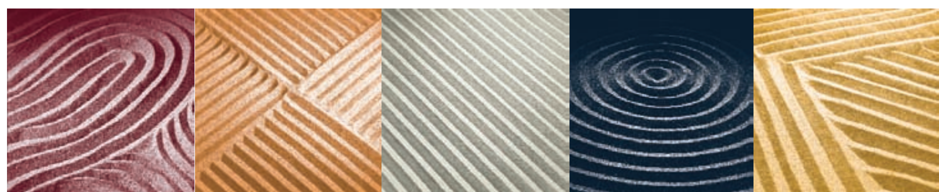

2010 FEDERAL BUDGET

March 4, 2010

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Introduction

Minister of Finance Jim Flaherty today tabled the 2010 Federal Budget entitled "Leading the Way on Jobs and Growth".

We are pleased to provide our summary of tax measures contained in the Budget. While the Budget contains no general income tax increases or decreases for individuals or businesses, there are a number of specific tax measures of note which are proposed to take immediate effect and many tax proposals for future implementation. Some of the proposals are of a relieving nature, while others address planning that is considered by the Department of Finance to be of an inappropriate nature.

From a fiscal policy perspective, there is an overall focus on addressing the federal deficit largely through expenditure reductions.

Our summary of the tax highlights contained in the 2010 Federal Budget follows.

Business Tax Measures

Accelerated Capital Cost Allowance for Clean Energy Generation

The 2010 Federal Budget proposes tax incentives for businesses by amending the capital cost allowance (CCA) system in two categories: (i) clean energy generation and conservation equipment; and (ii) television set-top boxes.

Clean Energy Generation and Conservation Equipment

Heat Recovery Equipment

The 2010 Federal Budget proposes to broaden the range of heat recovery equipment eligible for accelerated CCA in Class 43.2 (50% per year on a declining balance basis). Currently, the heat recovered by Class 43.2 heat recovery equipment must be reused in the same type of process that generated it. The proposed removal of this reuse restriction will allow recovered heat to offset energy otherwise used for other productive purposes.

Distribution Equipment of a District Energy System

The Budget proposes to broaden Class 43.1 and Class 43.2 to include specified distribution equipment that is part of a district energy system that uses thermal energy provided primarily by a ground source heat pump system, an active solar system, heat recovery equipment, or a combination of these energy sources. This measure will apply to eligible assets acquired on or after March 4, 2010.

Canadian Renewable and Conservation Expenses – Principal-Business Corporations

Canadian Renewable and Conservation Expenses can be fully deducted in the year incurred or transferred to investors using flow-through shares. In order to renounce such expenses to flow-through share investors, the corporation must be a “principal-business corporation” (PBC). The Budget proposes to amend the PBC definition to clarify that flow-through share eligibility extends to corporations with a principal business that uses Class 43.1 or Class 43.2 property in fuel production, energy generation or energy distribution (or any combination thereof), effective for taxation years ending after 2004.

Television Set-top Boxes (STBs)

Currently, satellite STBs used to decode digital television signals are eligible for a declining-balance CCA rate of 20% under Class 8, while cable STBs are eligible for a declining-balance rate of 30% under Class 10. The Budget proposes that both types of STBs, acquired after March 4, 2010, be eligible for a declining-balance CCA rate of 40%, to better reflect the useful life of these assets.

Interest on Overpaid Taxes

The 2010 Federal Budget proposes to eliminate the 2% premium above the benchmark calculation on interest paid by the Government in respect of overpayments of most taxes paid by corporations, including income tax, GST/HST, EI premiums and CPP contributions. Effective July 1, 2010, the interest rate payable by the Minister of National Revenue to corporations will be set at the average yield of three-month Government of Canada Treasury Bills sold in the first month of the preceding quarter, rounded to the nearest percentage point.

The interest rate calculations for non-corporate taxpayers will not change.

Federal Credit Unions

As a result of the proposal in the Budget to allow for the establishment of federal credit unions, it is anticipated that amendments to the *Income Tax Act* (ITA) may be needed to ensure that federal credit unions that satisfy the definition of “credit union” will be subject to the same tax rules as other credit unions. The details of such amendments have yet to be provided.

SIFT Conversions and Loss Trading (Income Trusts and Partnerships)

The Budget proposes to amend the acquisition of control rules to clamp down on the use of income trust conversion rules as a means to trade in tax losses that would not otherwise be allowed as between two corporations. The Federal Government is targeting "aggressive schemes" that have been implemented by certain income trusts or partnerships as part of a conversion transaction into corporate form on a tax-deferred basis.

The Federal Government proposes to extend the acquisition of control rule that applies to a "reverse takeover" of a public corporation to specified investment flow-through (SIFT) trusts and partnerships and real estate investment trusts (REITs) where units of such entities are exchanged for shares of a corporation. Under this proposed amendment, the use of losses will be restricted where units of a SIFT trust or partnership are exchanged for shares of a corporation.

It is also proposed that the acquisition of control rules be amended to ensure that they do not inappropriately restrict the use of losses where a SIFT trust is wound-up and distributes the shares of a corporation it holds to another corporation that is the sole beneficiary of the SIFT.

These amendments will apply to transactions undertaken after 4:00 p.m. EST on March 4, 2010. Transactions that the parties are obligated (and not excused by reason of changes to the ITA) to complete pursuant to the terms of an agreement in writing between the parties entered into before that time will be excluded from the application of these amendments. These amendments will also apply to other SIFT conversion transactions if the parties so elect.

International Taxation

Section 116 and Taxable Canadian Property

Non-residents of Canada are, subject to tax treaty relief, taxable on gains from the disposition of "taxable Canadian property" (TCP). A non-resident must generally notify the Canada Revenue Agency (CRA) under section 116 of the ITA if the non-resident sells TCP. The non-resident must either remit an amount in respect of Canadian taxes, post security, or satisfy CRA that no Canadian taxes are payable to obtain a section 116 clearance certificate.

Under current legislation, shares of Canadian resident private corporations and shares listed on a designated stock exchange where the taxpayer and/or persons with whom the taxpayer does not deal at arm's length owned 25% or more of the shares of any class at any time in the preceding 60 months are TCP.

The Budget proposes to amend the definition of TCP under the ITA to exclude shares of corporations and interests in partnerships or trusts (other than an income interest in a trust resident in Canada) if such shares or interests do not derive more than 50% of their fair market value (FMV) from real or immovable property situated in Canada, Canadian resource or timber resource property, and options in respect of or interests in the foregoing, at any time during the 60-month period prior to the relevant time (usually the time of disposition).

This measure aligns Canada's domestic tax rules with Canada's tax treaties, so that generally exempt shares and interests in partnerships or trusts will be excluded from the definition of TCP, from Canadian taxation, and from the section 116 clearance certificate procedures, for dispositions of TCP after March 4, 2010.

Refunds under Regulation 105 and Section 116

Regulation 105 requires every person paying a fee, commission or other amount to a non-resident person for services rendered in Canada to withhold and remit 15% of such amount on account of the non-resident person's Canadian tax. For its part, section 116 imposes a Canadian withholding tax obligation on a purchaser of TCP from a non-resident vendor at a rate of 25% or 50% depending on the type of property, if the purchaser

does not receive a clearance certificate. These Canadian withholding taxes are effectively instalments on account of Canadian tax payable by a non-resident person in respect of the services performed or the TCP sold.

Under the current provisions, a non-resident person may not be able to recoup Canadian taxes withheld under regulation 105 or section 116 if the payor or purchaser is assessed for the withholding tax after the non-resident person's time limit for filing an income tax return to claim a refund. To correct this anomaly, the Budget proposals will allow a non-resident person to obtain a refund of the overpayment of Canadian taxes as a result of an assessment of the payor or purchaser, if the non-resident files an income tax return within two years after the date of such an assessment. This measure will be effective for refund claims in returns filed after March 4, 2010.

Foreign Tax Credit Generators

The Budget proposes measures to deny claims of foreign tax credits, foreign accrual tax and underlying foreign tax in respect of certain transactions entered into between a Canadian corporation and a corporation resident in a foreign jurisdiction which are perceived by the Federal Government as schemes to artificially generate foreign taxes to offset Canadian tax otherwise payable.

These measures target two main categories of schemes and their variations. The first category involves the use of a foreign partnership while the second category involves the use of a foreign corporation intended to qualify as a foreign affiliate. These schemes rely on the asymmetry between the characterization of the direct or indirect investment made by the Canadian corporation under Canadian and foreign laws.

These measures in the 2010 Federal Budget appear to target certain financing structures that were implemented as an alternative to double-dip financing structures commonly referred to as "tower structures" in anticipation of the enactment of the double-dip financing denial rules which have since been repealed as announced in the 2009 Federal Budget.

The measures are proposed to apply to foreign taxes incurred in respect of taxation years ending after March 4, 2010.

Foreign Investment Entities and Non-Resident Trusts

The Federal Government announced in the 2009 Federal Budget that it would review the proposals regarding foreign investment entities (FIEs) and non-resident trusts (NRTs) first proposed in the 1999 Federal Budget, in light of the December, 2008 recommendations of the Advisory Panel on Canada's System of International Taxation and other submissions. The 2010 Federal Budget includes substantial changes to the proposals for NRTs and shelves the previous FIE proposals.

FIEs

The previously proposed FIE rules have been subject to criticism for their complexity and for imposing Canadian tax in a number of arguably inappropriate circumstances. The 2010 Federal Budget pulls back entirely from the previous proposals. Instead, the Budget proposes relatively minor amendments to the existing section 94.1 of the ITA (which was in place prior to the 1999 Federal Budget proposals, but rarely invoked).

Imputed Income

The existing section 94.1 imputes income to a taxpayer holding an "offshore investment fund property" by applying a prescribed interest rate to the taxpayer's designated cost. The prescribed rate will be increased to the three-month average Treasury Bill rate plus 2%.

NRTs

It is also proposed to broaden the existing rate for beneficiaries of an NRT not otherwise deemed to be a

resident of Canada. A beneficiary of such an NRT will have to report a certain share of the NRT's foreign accrual property income if the FMV of the interests in the NRT of the beneficiary and persons not dealing at arm's length with the beneficiary represent 10% or more of any class of interests in the NRT by FMV. This rule will also apply to Canadian residents who have contributed restricted property to the NRT.

Reassessment Period

The normal reassessment period "for income from an offshore investment fund property" or NRT as described above will be extended by 3 years.

Correcting Overreporting

A taxpayer who voluntarily complied with the outstanding proposals in previous years will be able to opt to have these taxation years reassessed. If a taxpayer does not opt for a reassessment, and has more income than would otherwise have been the case under the existing rules, the taxpayer will be entitled to a deduction in the current year for the excess income.

Reporting Requirements

The existing reporting requirements with respect to "specified foreign property" within the meaning of subsection 233.3(1) of the ITA will be expanded so that more detailed information is available for audit use.

It is proposed that the revised measures regarding FIEs apply to taxation years ending after March 4, 2010.

NRTs

The proposed rules applicable to NRTs have been substantially revised. According to the Federal Government, these substantial modifications are meant to simplify the outstanding proposals and to better target arrangements that seek to avoid paying the appropriate amount of Canadian taxes.

Some of the more significant changes are:

- Tax Exempt Entities – Charities, pension funds, Crown corporations and others exempt from tax under section 149 of the ITA will be specifically excluded from taxation under the NRT rules unless used as a conduit for a taxable Canadian resident's contribution to an NRT.
- Commercial Trusts – Non-resident commercial trusts will be excluded from taxation under the NRT rules if:
  - each beneficiary is entitled to both income and capital of the trust,
  - interests in the trust cannot cease to exist except by way of redemption or cancellation where the beneficiary is entitled to receive the fair market value of the beneficiary's interest,
  - any transfer of an interest in the trust by a beneficiary is a disposition for Canadian income tax purposes,
  - the income or capital payable to a beneficiary does not depend on the exercise of, or failure to exercise, discretion (except discretion as to timing of distributions),
  - interests in the trust are listed and regularly traded on a designated stock exchange or, if the trust has at least 150 investors, are available to the public in an open market,
  - the terms of the trust cannot be varied without the consent of all the beneficiaries, or of a majority of the beneficiaries for a widely held trust, and
  - the trust is not a personal trust.
- Loans from a Canadian Financial Institution – A loan from a Canadian financial institution to an NRT

will not cause the financial institution to be a resident contributor, and so will not by itself cause the NRT to be deemed resident in Canada, if the loan is made in the ordinary course of the financial institution's business.

- Taxation of a Deemed Resident Trust – Where the NRT rules apply, the NRT will only be taxable on: (i) income attributable to property acquired by the trust from Canadian residents or certain non-residents or property substituted therefor, and (ii) Canadian source income under normal rules (collectively the "Resident Portion"). Income from the trust's other property (the "Non-resident Portion") will not be taxable in Canada. Distributions to resident beneficiaries will come first out of the Resident Portion of the trust's income. Distributions to non-resident beneficiaries will come first out of the Non-resident Portion. Distributions to non-resident beneficiaries out of the Resident Portion of the trust's income will be subject to withholding tax. Distributions to non-resident beneficiaries out of the Non-resident Portion will not be subject to withholding tax.
- Liability of Resident Contributors – The previous proposals made resident contributors jointly and severally liable for the trust's tax. The 2010 Federal Budget proposes that a portion of the income of a trust deemed to be resident in Canada by the NRT rules be attributed to the trust's resident contributors, effectively limiting the resident contributor's liability to the tax on this portion of the trust's income. The trust income attributed to the resident contributor will be proportionate to the FMV of the property contributed by the resident contributor compared to the FMV of all property contributed by all connected contributors. The income so attributed to the resident contributor will be reduced by losses of the trust from other years and the trust may allocate a share of its foreign tax credit to the resident contributor. The normal reassessment period will be extended by three years for income attributed from a deemed resident NRT.
- Treaty Residence – The *Income Tax Conventions Interpretation Act* will be amended to provide that a trust deemed to be a resident of Canada under the NRT rules will be deemed to be a resident of Canada for tax treaty purposes. This responds to recent court decisions which suggest the opposite.

It is proposed that the revised measures for NRTs be applicable to the 2007 and subsequent taxation years. A trust will be able to elect to be deemed resident in Canada for the 2001 and subsequent taxation years. The attribution of trust income to resident contributors will only apply to taxation years ending after March 4, 2010.

The revised proposed measures for FIEs and NRTs will be subject to a consultation process before being tabled in Parliament. The public is invited to make submissions regarding these revised proposals before May 4, 2010.

Sales Tax Measures

GST/HST on Purely Cosmetic Procedures

Currently, basic health care services are exempt from the GST/HST, while purely cosmetic procedures and goods and services related to cosmetic procedures are subject to tax. The 2010 Federal Budget proposes to clarify that all purely cosmetic procedures, goods used or provided with such procedures and services related to such procedures are subject to GST/HST. Cosmetic procedures required for medical or reconstructive purposes will continue to be exempt from GST/HST.

Simplification of the GST/HST for the Direct Selling Industry

The 2009 Federal Budget introduced a significant change in the GST/HST as it relates to the direct selling industry. To simplify the operation of the GST/HST for network sellers employing a commission-based model, the 2009 Federal Budget proposed allowing network sellers that met certain criteria to apply to use a special GST/HST accounting method (for details of this proposal see Miller Thomson LLP's 2009 Federal Budget

publication at http://www.millerthomson.com/docs/Tax_Notes_January_2009.pdf). The 2010 Federal Budget proposes further clarifications and enhancements to the previously announced measures. The most noteworthy of these is a “safety mechanism” for network sellers that do not meet certain qualification criteria relating to commissions paid to sales representatives in a particular fiscal year. No adjustment to the GST/HST net tax of a network seller would be required in respect of:

- the first fiscal year that the network seller fails to meet the requirement that all or substantially all (interpreted by CRA to mean 90% or more) of its sales representatives have annual commissions not exceeding $30,000, provided that at least 80% of the sales representatives have annual commissions from the network seller not exceeding $30,000 in that first fiscal year; or
- the second fiscal year that the network seller fails to meet the above requirement, provided that the network seller requests in writing, within the first 6 months of that second fiscal year, that the Minister revoke its approval to use the special GST/HST accounting method and provided that at least 80% of the sales representatives have annual commissions from the network seller not exceeding $30,000 in that second fiscal year.

These enhanced measures are proposed to apply for fiscal years of a network seller that begin after 2009.

Financial Services

The 2010 Federal Budget proposes to amend the definition of “financial service” in the *Excise Tax Act* (ETA) to exclude certain services such as asset management services, preparatory services and credit management services. As a result of the proposed changes, the concept of “arranging for” financial services will be much narrower than before.

Customs Measures

Tariff Reductions on Manufacturing Inputs and Machinery and Equipment

The 2009 Federal Budget proposed to eliminate customs duties on most categories of machinery and equipment used as inputs for manufacturing. The 2010 Federal Budget proposes to eliminate the remaining tariffs on such goods either immediately or in stages. Customs duty will be eliminated on 1,160 tariff items as of March 5, 2010 and gradually reduced and eliminated on an additional 381 tariff items beginning on March 5, 2010 and ending on or before January 1, 2015.

Personal Tax Measures

Benefits Entitlement – Shared Custody

To improve the allocation of child benefits between parents sharing custody of a child, the 2010 Federal Budget proposes that both eligible individuals (as opposed to only one, which is presently the case) receive Canada Child Tax Benefit and Universal Child Care Benefit amounts and the corresponding GST/HST credit if the recipients would be eligible to receive amounts under the existing shared eligibility policy of CRA. This policy applies when a child lives more or less equally with two individuals who live separately. The Canada Child Tax Benefit and Universal Child Care Benefit payments will be equivalent to each eligible individual receiving one-half of the annual entitlement that they would receive if they were the sole eligible individual. This measure will apply to benefits payable commencing July, 2011.

Universal Child Care Benefit for Single Parents

Under the current legislation, a single parent can pay more tax on Universal Child Care Benefit amounts than a single-earner couple, with the same income, receiving the same Universal Child Care Benefit.

The Budget proposes to allow a single parent the option of including the aggregate Universal Child Care Benefit amount received, in respect of all of his or her children, in the parent’s income or in the income of the

dependant for whom an Eligible Dependant Credit is claimed. If a single parent is unable to claim an Eligible Dependant Credit, he or she will have the option of including the aggregate Universal Child Care Benefit amount in the income of one of the children for whom the Universal Child Care Benefit is paid.

This measure will apply to the 2010 and subsequent taxation years.

Medical Expense Tax Credit – Purely Cosmetic Procedures

The Medical Expense Tax Credit (METC) provides tax recognition for above-average medical and disability-related expenses incurred by individuals. An expense is generally eligible to be claimed under the METC if it is directly related to a disability or a medical condition. By contrast, an expense is not generally intended to be eligible if it is ordinarily incurred by persons without a disability or a medical condition or has a substantial element of personal consumption and choice.

The 2010 Federal Budget proposes to exclude expenses incurred for purely cosmetic procedures (including related services and other expenses such as travel) from eligibility for the METC. Such procedures include surgical and non-surgical procedures purely aimed at enhancing one's appearance such as liposuction, hair replacement procedures, botulinum toxin injections and teeth whitening. However, a cosmetic procedure will continue to qualify for the METC if it is required for medical or reconstructive purposes, such as surgery to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma or a disfiguring disease.

This measure will apply to expenses incurred after March 4, 2010.

Rollover of RRSP Proceeds to an RDSP

The Budget proposes to extend the existing Registered Retirement Savings Plan (RRSP) rollover rules to allow a rollover of a deceased individual's RRSP proceeds to the Registered Disability Savings Plan (RDSP) of a financially dependent infirm child or grandchild. The rollover rules provide for preferential tax treatment on RRSP distributions made after death to the deceased's surviving spouse or common-law partner, or to children or grandchildren who were financially dependent on the deceased RRSP annuitant. Similar rules also apply in respect of Registered Retirement Income Fund (RRIF) proceeds and certain lump-sum amounts paid from Registered Pension Plans (RPPs).

An individual who qualifies to be an RDSP beneficiary and who meets the age and residency requirements for RDSP contributions will be eligible to roll over RRSP proceeds received as a result of the death of their parent or grandparent to their RDSP if the requirements under the existing RRSP rollover rules are satisfied (that is, if the RDSP beneficiary was financially dependent on the deceased individual by reason of physical or mental infirmity).

The amount of RRSP proceeds rolled over into an RDSP cannot exceed the beneficiary's available RDSP contribution room. The lifetime contribution limit for RDSPs is $200,000. The rolled-over proceeds will reduce the beneficiary's RDSP contribution room, but will not attract Canada Disability Savings Grants. These proceeds will be considered private contributions for the purpose of determining whether an RDSP is a primarily government-assisted plan (a plan where Canada Disability Savings Grants and Canada Disability Savings Bonds paid to the plan exceed private contributions made to the plan, and which is consequentially subject to a number of additional requirements). Since the amount of RRSP proceeds rolled over to an RDSP will not have been subject to income tax, the amount will form part of the portion of a disability assistance payment that is included in the beneficiary's income when withdrawn from the RDSP.

The RDSP beneficiary or his or her legal representative will be required to make an election in prescribed form to transfer the RRSP proceeds to the RDSP on a rollover basis. The election would be made at the time of the RDSP contribution and filed with both CRA and Human Resources and Skills Development Canada by the RDSP issuer.

These measures will be effective for deaths occurring on or after March 4, 2010.

Transitional Rules

Where the death of an RRSP annuitant occurs after 2007 and before 2011, special transitional rules will allow a contribution to be made to the RDSP of a financially dependent infirm child or grandchild of the annuitant that would provide a result that is generally equivalent to the proposed measures.

To allow time for financial institutions and Human Resources and Skills Development Canada to adjust their RDSP systems, RDSP contributions benefiting from the proposed rollover measure cannot be made before July 2011.

Carry Forward of RDSP Grants and Bonds

Annual RDSP contributions attract Canada Disability Savings Grants (CDSGs) of up to $3,500, depending on the beneficiary's family income and the amount contributed, up to a lifetime limit of $70,000. In addition, Canada Disability Savings Bonds (CDSBs) of up to $1,000 annually are provided to RDSPs established by low- and modest-income families, based on a beneficiary's family income, up to a lifetime limit of $20,000. The amount of the CDSB begins to be phased out for incomes above $23,855 and is fully phased-out at $40,970 (for 2010). Beneficiaries are currently unable to carry forward unused CDSG and CDSB entitlements to future years.

In recognition of the fact that families of children with disabilities may not be able to contribute regularly to their plans, the Budget proposes to amend the *Canada Disability Savings Act* to allow a 10-year carry forward of CDSG and CDSB entitlements. Upon opening an RDSP, CDSB entitlements will be determined and paid into the plan for the preceding 10 years (not before 2008, the year RDSPs became available), based on the beneficiary's family income in those years. Balances of unused CDSG entitlements will also be determined and maintained for the same period. CDSGs will be paid on unused entitlements, up to an annual maximum of $10,500.

The matching rate on unused CDSG entitlements will be the same as that which would have applied had the contribution been made in the year in which the entitlement was earned. Matching rates on RDSP contributions will be paid in descending order, with contributions using up any grant entitlements at the highest available matching rate first, followed by any grant entitlements at lower rates. Plan holders will receive annual statements of CDSG entitlements.

The carry forward will be available starting in 2011.

Provincial Payments into RESPs and RDSPs

The Budget proposes to clarify that all payments made to a Registered Education Savings Plan (RESP) or an RDSP through a program funded, directly or indirectly, by a province or administered by a province will be treated the same way as federal grants and bonds and will therefore not themselves attract or reduce federal grants and bonds. In the case of programs that are administered by a province, this measure will apply to payments made after 2006. In the case of programs that are not administered by a province, this measure will apply to payments made after 2008.

Under the current rules, provincial initiatives that are not administered by the Federal Government have to be prescribed in order to be treated as provincial programs, which can create uncertainty about the status of payments from these programs.

Scholarship Exemption and Education Tax Credit

Currently, post-secondary scholarships, fellowships and bursaries are fully exempt from tax. The scholarship exemption applies to amounts received in connection with the student's enrolment in an educational program that entitles the student to the Education Tax Credit. The Education Tax Credit is generally available in

respect of programs at the post-secondary level, and programs at educational institutions that are certified by the Minister of Human Resources and Skills Development as providing skills in an occupation.

The Budget proposes to clarify that a post-secondary program that consists principally of research will be eligible for the Education Tax Credit, and the scholarship exemption, only if it leads to a college or CEGEP diploma, or a bachelor, masters or doctoral degree (or an equivalent degree). Accordingly, post-doctoral fellowships will be taxable.

Occupational training programs certified by the Minister of Human Resources and Skills Development will continue to qualify for the Education Tax Credit.

The Budget also proposes that an amount will be eligible for the scholarship exemption only to the extent it can reasonably be considered to be received in connection with enrolment in an eligible educational program for the duration of the period of study related to the scholarship.

If a scholarship, fellowship or bursary amount is provided in connection with a part-time program, it is proposed that the scholarship exemption be limited to the amount of tuition paid for the program plus the costs of program-related materials, except if the part-time program is undertaken by a student entitled to the Disability Tax Credit or a student who cannot be enrolled on a full-time basis because of a mental or physical impairment.

The measures will apply to the 2010 and subsequent taxation years.

Employee Stock Options

Overview of Taxation of Employee Stock Options

Generally, where an employer has agreed to sell securities of its capital stock to an employee pursuant to a stock option agreement, the employee is deemed to have received a taxable benefit from employment equal to the value of the securities at the time the employee acquired them, minus the total of the amount paid by the employee for the securities. In a non Canadian-controlled private corporation (CCPC) situation, this benefit has to be included in employment income by the employee in the taxation year in which the securities are acquired. However, an employee who is deemed to have received such a benefit may be entitled to an offsetting deduction equal to one-half of the benefit provided certain conditions are met. This, in effect, taxes the benefit at capital gains tax rates.

In addition, an employee of a publicly traded corporation can, in certain circumstances, elect to defer the inclusion of the benefit until such time that the securities are disposed of (as opposed to an inclusion in income by the employee at the time the securities are acquired).

In the past, employees have experienced significant financial difficulties when they have made the Election. Where the value of the securities decreases, this may result in the employees not having sufficient proceeds to satisfy their tax liability arising from the inclusion in income of the benefit.

Budget 2010 Proposed Measures

Stock Option Cash Outs

An employer who has agreed to sell securities of its capital stock to an employee pursuant to a stock option agreement is not allowed a deduction for the issuance of the securities. However, if an employee disposes of his or her stock option right to the employer for cash, the benefit arising from this disposition will be eligible for the offsetting deduction while the employer is entitled to a deduction equal to the cash payment.

The 2010 Federal Budget proposes amendments whereby in order to qualify for the deduction, the employee has to acquire the securities of the employer or the employer must make the Election to forgo the deduction for the cash payment. This eliminates the situation where the employee can take advantage of the offsetting deduction while the corporation is also entitled to a deduction for corporate tax purposes.

Additionally, the Budget clarifies that where the employee disposes of his or her rights under the stock option agreement to a non-arm's length person, the employee is deemed to have received the taxable benefit at the time of the disposition.

These measures will apply to a disposition of employee stock options that occur after 4:00 p.m. EST on March 4, 2010.

Repeal of Election and Withholding/Remitting Requirement

In an attempt to alleviate the financial difficulties that could arise when an employee has made the Election and the value of the securities subsequently decreases, the 2010 Federal Budget proposes to repeal the Election and to require a non-CCPC employer to withhold and remit tax on the value of the benefit.

The repeal of the Election will take effect for employee stock options exercised after 4:00 p.m. EST on March 4, 2010 and the withholding and remitting requirement will take effect on the issuance of securities on and after January 1, 2011, in order to give the employer the opportunity to adjust its payroll systems.

Special Relief for Tax Deferral Elections

Generally, in order to provide relief to taxpayers who have taken advantage of the Election but hold optioned securities that have a FMV that is less than their deferred tax liability, the 2010 Federal Budget provides for a special elective tax treatment. Only stock options for which an Election has been made will qualify for the special elective tax treatment. Individuals who have disposed of optioned securities before 2010 will have until April 30, 2011 to claim the special elective tax treatment. Individuals who have not disposed of their optioned securities must do so before 2015 in order to qualify.

The Budget proposes to limit the employee's tax liability on the taxable benefit to the proceeds of disposition of the securities, taking into account any capital losses on the optioned securities against capital gains from other sources.

U.S. Social Security Benefits

Prior to 1996, pursuant to the *Canada-United States Tax Convention (1980)* (the Treaty), Canadian residents receiving certain U.S. Social Security benefits, were required to include only 50% of those benefits in computing income. Changes made to the Treaty effective beginning in 1996 increased the inclusion rate for U.S. Social Security benefits to 85% from 50%.

The Budget proposes to reinstate the 50% inclusion rate for Canadian residents who have been in receipt of U.S. Social Security benefits prior to January 1, 1996 and for their spouses and common-law partners who are eligible to receive survivor benefits. This measure will apply to U.S. Social Security benefits received on or after January 1, 2010.

Mineral Exploration Tax Credit

The Mineral Exploration Tax Credit is an additional benefit, available to individuals who invest in flow-through shares, equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

The Budget proposes to extend eligibility for this credit for one year, to flow-through share agreements entered into on or before March 31, 2011. Under the existing "look-back" rule, funds raised in one calendar year with the benefit of the credit can be spent on eligible exploration up to the end of the following calendar year.

Other Tax Measures

Charities: Distribution Quota Reform

In response to proposals from Imagine Canada, the Canadian Bar Association and others in the voluntary

sector, the 2010 Federal Budget proposes to repeal the 80/20 rule, which, in substance, means most aspects of the charitable expenditure requirements in the disbursement quota. Charities will no longer be subject to a requirement to disburse 80% of receipted donations received in the previous taxation year. The only expenditure requirement that will remain is that relating to property held by a charity that is not used directly in charitable activities or for administration. Charities will still be required to disburse a minimum of 3.5% of such accumulated property on their charitable activities or by granting to qualified donees.

As a consequence of these changes, several concepts which have been fundamental to the calculation of the disbursement quota will be eliminated. These will include enduring property, the capital gains reduction and capital gains pool. The concept of "specified gift" will be replaced by a new concept of "designated gift", which affects the calculation of the disbursement requirement on transfers between related charities (described below).

The Budget proposes to modify the capital accumulation exemption in the ITA so as to allow small charities greater flexibility to accumulate capital without being subject to the 3.5% rule. Under the current disbursement quota rules, charities are exempt from the 3.5% rule if the charity holds $25,000 or less in assets that are not used directly in charitable activities or administration. The 2010 Federal Budget proposes to increase this threshold to $100,000 for charitable organizations (the exemption will remain at $25,000 for charitable foundations).

The Budget also proposes to strengthen the existing anti-avoidance rules related to gifts between related charities. Where a registered charity receives a gift from a non-arm's length charity, it is proposed that the recipient charity be required to spend the full amount of the gift on its own charitable activities, or to transfer the amount to another arm's length qualified donee, within the current or subsequent year. However, if the donor charity designates all or a portion of the gift as a "designated gift", this designated portion will not be subject to the immediate disbursement requirement. Where the recipient charity fails to meet this disbursement requirement, it can lose its charitable status and/or it will be subject to a penalty equal to 110% of the amount by which the FMV of the gift exceeds the amount required to be expended.

Finally, the 2010 Federal Budget proposes technical amendments to the existing rules that provide CRA with discretion to allow charities to accumulate property for a particular purpose (such as capital building projects). Whereas the current rules provide that CRA has discretion to deem accumulated amounts as having been spent on charitable activities, as a consequence of the elimination of the charitable expenditure rule, CRA will now be provided with discretion to exclude accumulated property from the 3.5% rule calculation.

These amendments will take effect for taxation years ending on or after March 4, 2010.

Specified Leasing Property Rules

The 2010 Federal Budget proposes to extend the application of the specified leasing property rules to otherwise exempt property that is leased to a government or other tax-exempt entity, or to a non-resident. However, certain leases will continue to be exempt if the total value of the underlying property is less than $1 million. An anti-avoidance rule will apply if it is reasonable to conclude that one of the purposes of dividing property (or a class of property) among separate leases is to meet the $1 million exception. These measures will apply to leases entered into after 4:00 p.m. EST on March 4, 2010.

Information Reporting of Tax Avoidance Transactions – Public Consultation

Public consultation on proposals to require the reporting of certain tax avoidance transactions has been announced in the Budget. Stakeholders will be consulted on these proposals. The Federal Government seeks to build on the existing information reporting regime for tax shelters to assist the CRA in effectively applying the substantive rules in the ITA intended to counter aggressive tax planning. The Budget proposes a regime under which a tax "avoidance transaction" that features at least two of three "hallmarks" would be a

"reportable transaction" that must be reported to CRA. These hallmarks include:

1. A promoter or tax advisor in respect of the transaction is entitled to fees that are to any extent:
    - attributable to the amount of the tax benefit from the transaction,
    - contingent upon the obtaining of a tax benefit from the transaction, or
    - attributable to the number of taxpayers who participate in the transaction or who have been provided access to advice given by the promoter or advisor regarding the tax consequences from the transaction.
2. A promoter or tax advisor in respect of the transaction requires "confidential protection" about the transaction.
3. The taxpayer or the person who entered into the transaction for the benefit of the taxpayer obtains "contractual protection" in respect of the transaction (otherwise than as a result of a fee described in the first hallmark).

Tax shelters and flow-through arrangements will not be impacted by these proposals as existing requirements will continue to be in place.

Discovery of an unreported reportable transaction may result in the denial of the resulting tax benefit. In order to claim the denied tax benefit, information would have to be provided to CRA and a penalty would apply. Disclosure under the proposed regime would have no bearing on the legal determination of whether the benefit is legitimate and would not be an admission that GAAR applies to the transaction.

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

Online Notices

It is proposed to amend the ITA, ETA, *Excise Act*, *2001* (EA), *Air Travellers Security Charge Act*, *Canada Pension Plan Act* and *Employment Insurance Act* to allow for the electronic issuance of those notices that can currently be sent by ordinary mail, provided a taxpayer authorizes CRA to do so. CRA intends to provide this service in respect of notices of assessment and reassessment under Part I of the ITA, notices of determination and re-determination in respect of GST/HST credit and the Canada Child Tax Benefit and notices for GST/HST, excise tax duty (other than the duty on beer) and the Air Travellers Security Charge.

Although legislative amendments will be effective as of the date of Royal Assent of the implementing legislation, the Minister of National Revenue announced the application of these measures before that time.

Specific notices that must be served personally, by registered mail or certified mail, will not be eligible for electronic transmission.

Tax Evasion and the Proceeds of Crime and Money Laundering Regime

The Budget proposes to amend the ITA and ETA (among other legislation) to enable the Crown to prosecute certain tax offences by using the proceeds of crime and money laundering regime in the *Criminal Code*, regardless of whether prosecuted under the *Criminal Code* fraud provisions or the tax statutes. Moreover, consequential amendments to the *Proceeds of Crime* (*Money Laundering*) and *Terrorist Financing Act* are proposed to ensure consistency.

Taxation of Corporate Groups

In a continuing effort to improve the competitiveness of the tax system for Canadian businesses, the Federal Government is considering whether the introduction of new rules for the taxation of corporate groups (such

as a formal system of loss transfers or consolidated reporting) would be beneficial. The views of stakeholders will be sought prior to introducing any changes.

Aboriginal Tax Policy

Building on existing arrangements, the Federal Government will continue to discuss, promote and implement direct taxation systems with interested Aboriginal governments in respect of reserves and settlement lands. Such arrangements between provinces or territories and Aboriginal governments are also supported and encouraged.

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