

Blakes Bulletin

Tax

2010 Federal Budget

While the lead-up to and the media coverage of the federal budget introduced on March 4, 2010 (the Budget) was heavily skewed towards deficit control, there was no shortage of significant tax proposals in the Budget, including the following:

- effective immediately, unless an employer elects to forgo its deduction, employee stock option holders will be disqualified from capital gains rate taxation if their options are cashed out instead of being exercised, and the deferral rules for public company stock options introduced in the 2000 budget will be repealed;
- effective immediately, foreign investors will no longer be subject to potential tax and compliance requirements on sales of Canadian shares that do not constitute a real property interest;
- the proposed "foreign investment entity" regime, first announced in 1999 but never enacted, will be abandoned, and the related proposed "non-resident trust" rules will be relaxed; and
- new rules will be enacted to curb loss transfer transactions achieved on conversion of income trusts and foreign tax credit planning schemes.

The Minister of Finance also announced a public consultation on proposals to require reporting of certain types of "aggressive" transactions, similar in some respects to measures previously proposed in Quebec.

Despite the fact that the government faces a significant budgetary deficit, no changes were made to the planned phased reductions in corporate tax rates nor were any changes proposed to personal tax rates.

In the remainder of this bulletin, we discuss these and other business tax measures contained in the Budget.

EMPLOYEE STOCK OPTION RULES

No deduction for cash-out

Generally, the *Income Tax Act* (the Tax Act) provides that the grant of an employee stock option is a non-event. At the time of exercise, the employee is taxed on the in-the-money value of the option. This deemed

benefit is treated as employment income. Provided certain conditions are met, the option benefit is eligible for a 50% deduction – effectively resulting in the option benefit being taxed at capital gains rates.

Capital gains rate taxation is generally available upon crystallization of the option benefit, whether by actual exercise of the option into underlying shares, or by the "cash-out" of the option pursuant to the exercise by the holder of a right to be paid the in-the-money value in cash. A well-known opportunity existed for an employer to claim a deduction on the cash-out of its employees' options. It is understood that the availability of such a deduction in the context of a change of control of the employer is the subject of ongoing litigation. However, even the Canada Revenue Agency (CRA) has acknowledged that the deduction was available where options are cashed out in the ordinary course.

The Budget ends this opportunity by generally denying option holders the right to capital gains rate taxation where their options are cashed out unless the employer elects to forgo a deduction in respect of the cash-out payment. Thus, either the employer can claim a deduction or the employee can be entitled to capital gains rate taxation on the payment, but not both.

In many public M&A transactions completed through plans of arrangement, it has been customary for the options to be cashed out by the target. While this may still be a viable approach, there will now be a need to determine, as a business matter, whether the employer will agree to forgo a deduction so that option holders will choose to cash out options rather than exercise options in advance of the transaction.

End of deferral

In 2000, the stock option rules were amended to permit an employee to defer the employment income inclusion on the exercise of up to C\$100,000 of qualifying public company options until the year of sale of the underlying shares. This measure was intended to allow employees to exercise options without having to then sell their shares on the market in order to fund the resulting tax liability. Effective immediately, this deferral rule is being repealed.

CONT'D ON PAGE 2

CONT'D FROM PAGE 1

No doubt this change was intended to address the all-too-common circumstance of employees who elected to defer the taxation of employment benefits on the exercise of options and continued to hold securities that ultimately dropped in value. The stock option employment benefit and corresponding tax is crystallized on the date of option exercise and any subsequent loss on the securities is, typically, a capital loss to the employee and cannot offset any portion of the stock option employment benefit. Some employees found themselves in a situation where the ultimate proceeds of disposition of the acquired securities were insufficient to pay the tax on the stock option employment benefit.

The Budget proposes to offer relief to those who have elected to defer the inclusion of public company employee stock option benefits and find themselves in that situation. Qualifying employees can elect to pay a special tax equal to the full proceeds of disposition of such securities (2/3 of such proceeds for Quebec residents) instead of the tax otherwise payable in connection with the corresponding stock option employment benefit. This special election is proposed to apply to all such securities sold before 2015, including sales in past years where a public company option deferral election has been made.

Withholdings

The Budget also purports to "clarify" the rules surrounding an employer's obligation to withhold and remit amounts in connection with the exercise of options to acquire securities that are not shares of a Canadian-controlled private corporation by amending the withholding rules to require employers to make withholdings from employees' remuneration on the hypothetical basis that the corresponding employment benefit (reduced where capital gains rates apply) has been paid as a cash bonus to the employee. The proposals provide no guidance as to where employers could source any such hypothetical cash to the extent that an employee's regular salary is insufficient to fund such withholding obligations, but provide that the Minister of National Revenue will not be entitled to consider the fact that the benefit arose from the acquisition of securities as a basis to discretionarily reduce withholdings. This could lead to particularly harsh results in circumstances where there is no public market for the securities (unless they are shares of a Canadian-controlled private corporation) that are subject

to the employee options. Stock option agreements may need to be amended to provide funding arrangements for such withholding.

These newly "clarified" withholding proposals are to take effect beginning in 2011.

NON-RESIDENT TAXATION

Taxable Canadian Property

One of the major impediments to attracting cross-border venture capital and private equity investment in Canada has been the taxation of gains on such investments and the invasive compliance burden imposed by the section 116 filing and withholding regime under the Tax Act. The section 116 process has become increasingly time-consuming, with the result that sellers frequently have 25% of their proceeds tied up in escrow for months, even when no tax is owing. While some changes to section 116 were announced in 2008, it is widely believed that those changes were defective, as they did not absolve a non-withholding purchaser of liability if the non-resident seller was ultimately found to be taxable on any gain from the sale.

The source of the problem is the very broad definition of "taxable Canadian property" (TCP) in the Tax Act. Unlike most OECD countries, Canada's domestic rules generally taxed non-residents on gains from sales of any non-listed shares. However, most Canadian tax treaties then exempted such gains from tax provided the shares were not a real property interest. It was frequently the case that selling shareholders would be entitled to treaty relief, but the process of proving that entitlement required disclosure of significant information regarding the identity and treaty status of the seller. This would lead to time-consuming and burdensome withholding and compliance obligations in situations where there was almost always no tax actually payable. Typically, private equity funds investing in Canada, particularly those having non-treaty country participants, would establish "blocker" entities in third countries to address the Canadian taxation of gains and to simplify the compliance burden.

The Budget introduces a welcome and long advocated change to this regime by dramatically narrowing the TCP definition. As a result, the time-consuming and invasive section 116 procedure will now apply only in a very narrow range of cases. Essentially, TCP will now consist only of:

CONT'D ON PAGE 3

CONT'D FROM PAGE 2

- Canadian real property (including resource property);
- property used in a Canadian business;
- designated insurance property of insurers; and
- shares (or interests in trusts or partnerships) that are real property interests.

Options to acquire such types of property will also be TCP.

A share or other investment will generally be a real property interest at a point in time only where, at that point in time, or at any time in the preceding 60 months, more than 50% of its fair market value was derived from Canadian real property. The five-year lookback is significant, and will require some diligence to verify in many M&A contexts.

This change should dramatically simplify many venture capital and private equity investments into Canada, by eliminating the need for "blocker" entities in many situations. There will, of course, be a need for buyers to satisfy themselves that the shares they are buying did not derive more than 50% of their value from real property in the preceding 60 months. Unfortunately, the Budget does not suggest that there will be a due diligence defence for a buyer who wrongly concludes that shares are not a real property interest. It is hoped that the legislation will provide some protection for buyers who reasonably rely on representations made to them by sellers regarding the status of shares as non-real property interests.

The Budget also proposes to amend a number of provisions in the Tax Act that deem shares received as consideration for the disposition of TCP to themselves be TCP from applying indefinitely to applying for a 60-month period following which the amended rules previously described would apply.

These rules apply to the determination of whether a property is TCP after March 4, 2010.

Refunds of Withheld Amounts

The Budget proposes a measure to counteract an anomaly affecting non-residents in respect of whom withholdings under Regulation 105 or under section 116 have been enforced as against the payor. Such assessments can occur outside the time within which the non-resident is entitled to file a tax return to claim

a refund of such amounts. The Budget proposes to permit the Minister of National Revenue to refund an overpayment of tax withheld under Regulation 105 or section 116 if the application for such refund is made after March 4, 2010 and within two years after the date of the assessment.

FOREIGN INVESTMENT ENTITY AND NON-RESIDENT TRUST RULES

There are three regimes in Canada which are designed to prevent the use of investments in foreign corporations or funds to avoid or defer Canadian tax. In general terms:

- The "foreign accrual property income" (FAPI) regime applies to require current taxation in Canada of passive income earned in a controlled foreign affiliate.
- The non-resident trust (NRT) rules apply to interests in non-resident trusts that have a direct or indirect Canadian beneficiary where the trust has directly or indirectly acquired property from a Canadian person that was related or was the uncle, aunt, nephew or niece of the Canadian beneficiary; where the non-resident trust is non-discretionary, the NRT rules apply a modified FAPI regime to certain beneficiaries of the trust and where the non-resident trust is discretionary, the trust itself is deemed resident in Canada and subject to Canadian tax on FAPI-type income.
- The offshore investment fund (OIF) rules apply a deemed income accrual regime to investments in non-controlled entities (corporations, partnerships, funds or trusts other than non-resident trusts) that derive their value primarily from portfolio investments where it may reasonably be considered that one of the main reasons for making the investment is to defer or avoid current tax in Canada.

In 1999, the Minister of Finance announced proposed changes to tighten up the NRT provisions and replace the OIF regime with the foreign investment entity (FIE) rules. These proposed changes have been postponed and revised several times in response to criticisms that they were too complex, too broad, and impossible to administer. In the 2009 federal budget, the Minister of Finance announced that the Department of Finance would be reconsidering the proposed changes in response to the continuing criticisms.

CONT'D ON PAGE 4

CONT'D FROM PAGE 3

Foreign Investment Entities

The Budget proposes to abandon the proposed changes to the FIE rules and to revert to the existing rules. This is a welcome announcement. The only change is to increase the prescribed rate of interest at which income on the FIE investment is deemed to accrue to the Canadian investor for Canadian tax purposes.

This measure is proposed to be effective for taxation years that end after March 4, 2010. Special measures apply to taxpayers who voluntarily filed their returns under the old proposed FIE rules.

Non-Resident Trusts

In the Budget, the Minister of Finance proposed to proceed with the basic format of the existing proposed NRT rules, but with some significant changes.

A major criticism of the proposed NRT rules is that they applied to legitimate investments in foreign commercial trusts. In order to address this concern, it is proposed that the exemption for commercial trusts would be simplified and expanded. The Budget also proposes a specific exemption for all tax exempt entities – including pension funds, Crown corporations and registered charities.

There are also proposed changes to the method of taxation of non-resident trusts and their beneficiaries that are caught by the rules. Under the previously proposed NRT rules, the non-resident trust is subject to Canadian tax on all of its income, regardless of who contributed the property from which the income was derived or the source of the income, with each Canadian resident contributor and Canadian resident beneficiary of the trust jointly and severally liable (with the non-resident trust) for the Canadian tax liability of the trust. Under the revised proposals, income from property acquired by the trust from Canadian resident contributors (and substituted property) (the Resident Portion) will be attributed back to the Canadian contributors. Income not arising from the Resident Portion, other than Canadian-source income in respect of which non-residents are normally subject to Canadian tax, will be excluded from the trust's income. It is expected that the non-resident trust will ordinarily pay Canadian tax only on income derived from contributions from certain former Canadian resident contributors. In addition, as under the current proposals, there could be Canadian non-resident withholding tax on distributions from the non-resident trust to its non-resident

beneficiaries, but this is intended to be only where the distributions are out of the Resident Portion.

It appears that, if a non-resident trust is not caught by the revised NRT rules – i.e., in the case of exempt commercial trusts – the interest may be caught by the existing rules which apply a modified FAPI regime where the fair market value of the Canadian beneficiary's interest is equal to or exceeds 10% of the value of all interests in a non-resident trust. It is proposed that the modified FAPI rule will be broadened to apply to any resident beneficiary who, together with any non-arm's-length person, holds 10% or more of any class of interests in a non-resident trust.

The measures regarding non-resident trusts are generally proposed to apply for the 2007 and subsequent taxation years, except that attribution to Canadian resident contributors will apply only to taxation years ending after March 4, 2010. An election will be available to allow a trust to be deemed resident in Canada for the 2001 and following taxation years.

Non-Resident Reporting

In order to ensure that the CRA has the information to identify Canadian taxpayers that have invested in NRTs and FIEs, the Budget proposes to expand the foreign property reporting requirements in the Tax Act. It is also proposed to extend the reassessment period for interests in NRTs and FIEs by a further three years.

These proposed changes to the NRT and FIE proposals are a vast improvement over the old proposals. Our experience with the old proposals has told us, however, that the devil is in the details. The Budget proposals are given for public consultation with a view to developing revised legislation which will also be released for comment. Public comments are requested before May 4, 2010. The Budget announced that a panel consisting of respected tax practitioners will be formed to work with the Department of Finance in reviewing any issues identified in the comments received and in making recommendations on the design of the draft legislation.

"AGGRESSIVE" TAX PLANNING

The Budget contains four initiatives purporting to target "aggressive" tax arrangements.

SIFT Conversions and Loss Trading

The Budget delivered the anticipated reaction to January media reports concerning the number of income trusts

CONT'D ON PAGE 5

CONT'D FROM PAGE 4

that were considering utilizing corporations with large tax losses in their conversion plans: the proposal of a rule similar to an existing rule – which deems an acquisition of control to occur on certain reverse take-overs of a corporation by another corporation – to deem control of a corporation to be acquired where its shares are exchanged for units of a SIFT trust or SIFT partnership. A companion rule is also proposed to prevent the acquisition of control of a corporation that is a subsidiary controlled by a SIFT trust solely because of the distribution of its shares to a SIFT wind-up corporation on a SIFT trust wind-up event.

The new rules apply to transactions undertaken after 4 p.m. EST March 4, 2010, other than transactions that the parties are obliged to complete pursuant to the terms of a written agreement entered into before that time. Where such agreements permit a party to abort the transaction due to a change in the Tax Act, the new rules will also apply to the transaction.

Foreign Tax Credit Generators

The government has, for some time, indicated its concerns with Canadian corporations that have entered into transactions that have come to be known as “foreign tax credit generators”. These transactions make use of the rules that allow a Canadian taxpayer to obtain a credit against Canadian tax for foreign taxes paid by the taxpayer. Although there are a number of variations, the structures have generally involved the Canadian taxpayer becoming a partner in a foreign partnership with a non-resident and claiming credits against Canadian tax for foreign taxes paid in respect of the partnership’s activities. Another alternative involves a jointly owned foreign affiliate of the taxpayer that earns “foreign accrual property income” and obtains relief against the Canadian taxation thereof through the “foreign accrual tax” and “underlying foreign tax” mechanisms. The government believes that these transactions are structured to provide a Canadian taxpayer with credit for foreign taxes paid far in excess of the Canadian taxpayer’s entitlement to profits or gains from the relevant structure. The CRA is in the process of challenging certain corporations which have entered into these types of transactions including through the application of the general anti-avoidance rule (GAAR).

The Budget proposes new rules affecting the foreign tax credit provisions applicable to Canadian taxpayers and the foreign accrual tax and underlying foreign tax

mechanisms relevant to foreign affiliates of Canadian taxpayers. The purpose of these proposed changes is to limit the availability of relief for foreign taxes to the taxpayer’s direct or indirect economic interest in the foreign vehicle, the activities of which have given rise to the foreign taxes paid. The proposal is to be effective for foreign taxes incurred in respect of taxation years ending after March 4, 2010, although the Budget papers indicate that the government will be accepting comments on the finalization of the legislation and encourages stakeholders to submit any such comments before May 4, 2010.

Tax Avoidance Transaction Reporting

The Budget announced a “public consultation” process on its proposal to implement a reporting regime to identify “avoidance transactions” which bear a high risk of constituting tax abuse, similar to the recently proposed “aggressive tax planning regime” in Quebec.

The proposals would require a taxpayer to report any tax avoidance transaction where two of the following three characteristics are present: (1) the promoter/tax advisor is entitled to fees that are attributable to the amount of the tax benefit, contingent upon obtaining the tax benefit or attributable to the number of taxpayers who participate in the transaction; (2) the promoter/tax advisor requires “confidential protection” about the transaction; and (3) the taxpayer (or a person who entered into the transaction for the benefit of the taxpayer) obtains “contractual protection” in respect of the transaction (other than a fee arrangement described in (1)).

According to the Budget papers, those characteristics (referred to as “hallmarks”) are not themselves considered to be evidence of abuse, but their presence indicates a higher risk of abuse. For those taxpayers who fail to report such transactions, the Budget proposes to deny the tax benefit resulting from the transaction, which benefit could still be claimed if the taxpayer was prepared to pay penalties and supply any information required by the CRA. Such a taxpayer is still subject to regular audit and challenge by the CRA.

The proposals, although presented as “for consultation” are, as modified to take account of the consultations, proposed to apply to transactions entered into after 2010 **as well as transactions that are part of a series of transactions completed after 2010.**

CONT'D ON PAGE 6

CONT'D FROM PAGE 5

While consultations are planned, it is suggested that the introduction of such a regime raises difficult questions regarding matters such as solicitor-client privilege.

Specified Leasing Property Rules

In recent years, some leasing companies and other financial institutions have carried out complex leveraged leasing transactions using certain types of property that are exempt from the "specified leasing property" rules. This has enabled the lessors to claim tax depreciation on the leased assets to shelter other income, including non-leasing income. An example of this is the transaction which was unsuccessfully attacked by CRA in the *Canada Trustco* case, which is one of the leading cases on the GAAR. One of the features of these structures is that they involve a lease of the exempt property to a non-resident or tax exempt lessee.

In order to curtail these types of arrangements, the Budget proposes to extend the application of the specified leasing property rules to otherwise exempt property that is subject to a lease to a government or other tax-exempt entity, or to a non-resident, unless the total value of the property that is subject to the lease is less than C\$1-million. The Budget proposes to institute an anti-avoidance provision to prevent the artificial division of property into leases to defeat the C\$1-million threshold. These proposals apply to leases entered into after 4 p.m. EST March 4, 2010.

While this measure will curtail the use of the sophisticated tax planning structures that were successful in *Canada Trustco*, they could conceivably affect the taxation of regular leasing transactions involving exempt property. The *Canada Trustco* case involved the lease of trailers with a total value of C\$120-million, but it is unclear whether any individual trailer was valued at more than C\$1-million. If the effect of the proposed change is to catch a single "lease" of multiple items of equipment which have a total value of over C\$1-million but an individual value of under C\$1-million, it would appear that regular lease financing of exempt property to government institutions could be caught in some cases.

MINERAL EXPLORATION

The temporary mineral exploration tax credit, the availability of which was extended in the 2009 budget, will be extended again. Thus, a 15% tax credit will be available for qualifying expenditures renounced under flow-through share agreements entered into on or before March 31, 2011.

CONSOLIDATED TAX RETURNS

The Budget also indicated that the government will explore whether new rules for 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. While this would be a welcome and overdue change, as Canada is one of very few developed countries with no tax consolidation or group relief regime, such proposals have been considered in the past and have not been pursued in some measure due to provincial income tax issues.

PREVIOUSLY ANNOUNCED MEASURES

The Budget confirms the government's intention to proceed with a number of previously announced tax measures, as modified to take into account consultations and deliberations since their announcement, including:

- technical amendments to the foreign affiliate rules released in draft form on December 14, 2009 and the remaining measures released in draft in 2004 relating to foreign affiliates;
- improvements to the application of the GST/HST to the financial services sector released on September 23, 2009; and
- technical legislative proposals addressing recent court decisions on the GST/HST and financial services, announced on December 14, 2009.

The proposed GST/HST amendments exclude certain "credit management" services (e.g., evaluating or authorizing credit) and "preparatory" services (e.g., market research, document preparation, promotional services) from the definition of a financial service. The scope of these exclusions is unclear, but could fundamentally impact the financial services sector. All suppliers of financial services will need to review the GST/HST treatment of their services in light of these draft amendments.

Notably absent from the list are previously-announced changes to the rules regarding deductibility of interest and the promised introduction of a tax-deferred rollover for share exchanges involving a foreign corporation and Canadian corporation.

For further information, please contact any member of our [Tax Group](#) listed on the following page.

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