

Canada  
Tax

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## Canadian Tax Alert

March 4, 2010

### 2010 federal budget highlights

The Minister of Finance, James M. Flaherty, presented the 2010 budget in the House of Commons this afternoon at 4:00 p.m. EST. He announced a slightly lower than forecast, but still recession-fueled, \$53.8 billion current year deficit. This brings the federal debt to GDP ratio to just under 34%, a multi-year high and well above the government's own 25% target. The budget projects continued but declining deficits over the next 5 years, starting with a 2011 deficit of \$49.2 billion. Although it pales in contrast to those of the United States and the United Kingdom, the federal deficit for the current year is the largest ever recorded by a Canadian government. Canada's federal debt load as a per cent of GDP is less than the G7 average of about 60%, although when provincial debts are included, the combined ratio is much closer to the G7 average.

While there is no denying that the global economic outlook has improved from January 2009 when the last budget was introduced, there may be challenging times ahead. The Finance Minister predicts real growth in the economy of 2.6% in calendar year 2010 and 3.2% in 2011. However, global economic concerns still exist with several countries facing an inability to meet debt repayment terms, most notably Greece. The large deficits in the United States and the United Kingdom are also a concern in terms of their impact on the global economic recovery and, by extension, Canada's economy.

Unemployment is expected to remain higher than short-term historical averages, although the budget predicts small reductions in unemployment over the next two years. With 50% of Canada's revenue in the form of personal tax collections, unemployment is the most significant challenge to the revenue targets.

Happily, the Minister resisted the temptation to defer the scheduled corporate tax reductions over the next two years and laid out a generally credible, although short on detail, multi-year path to deficit reductions over the next few years.

He also, has announced much anticipated changes to the rules facing non-resident investors in Canadian private companies, designed to reduce delays and filing requirements which have been a serious impediment to foreign venture capital investors.

Similarly, the Minister expressed a commitment to study the prospect of consolidated corporate filings and the existing draft non-resident trust and related rules. However, he did move to shut down income fund conversions involving loss companies and proposed to study new disclosure rules for aggressive tax planning.

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We were hoping to see an expansion of the research and development (R&D) tax credit regime and wider access to refundable credits. While Canada has long prided itself on its R&D regime, many other countries have introduced increasingly generous programs in this fiercely competitive and very significant area. Minister Flaherty proposed further study and more support for academic research, but nothing specific for private sector activity.

One nice surprise is the elimination of most disbursement quotas for charitable organizations, thereby relieving the administrative burden on many charities.

Not surprisingly, the Minister once again missed the opportunity to offset personal and corporate tax reductions with goods and services tax (GST) increases.

While the basics of the budget are positive, we will continue to look for a more detailed path ahead.

The following is a summary of the highlights contained in the budget.

### **Measures concerning businesses**

- The budget proposes to expand Class 43.2 (specified clean energy generation and conservation equipment – declining balance capital cost allowance (CCA) rate of 50%) to include: (a) heat recovery equipment used in a broader range of applications; and (b) distribution equipment used in district energy systems that rely primarily on ground source heat pumps, active solar systems or heat recovery equipment. 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.
- In order to transfer or “renounce” Canadian Renewable and Conservation Expenses to an investor using flow-through shares, a corporation must be a “principal-business corporation”. The budget proposes to amend the definition of “principal-business corporation” to clarify that flow-through share eligibility extends to corporations the principal business of which is producing fuel or generating or distributing energy, using Class 43.1 or Class 43.2 property. This measure will apply in respect of taxation years ending after 2004.
- The budget proposes that satellite and cable set-top boxes that are acquired after March 4, 2010 and that have neither been used nor acquired for use before March 5, 2010 be eligible for a declining balance CCA rate of 40%.
- The budget proposes that effective July 1, 2010, the interest rate payable by the Minister of 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 up to the nearest percentage point. The interest rate calculations in respect of non-corporate taxpayers will not change.
- Generally, the ability of a corporation to utilize its tax losses is restricted where control of the corporation has been acquired. In the case of a “reverse takeover” of a corporation (the acquiring corporation), there is generally deemed to be an acquisition of control of the acquiring corporation in situations where shares of a particular corporation are exchanged for shares of the acquiring corporation and the former shareholders of the particular corporation as a hypothetical group would control the acquiring corporation. The budget proposes to extend this rule to ensure that it also applies to impose restrictions on the use of losses in situations where units of a specified investment flow-through (SIFT) trust, SIFT partnership, or real estate investment trust are exchanged for shares of a corporation that is the subject of a reverse takeover. There was considerable speculation about whether the government would act to prevent these types of

transactions. It remains to be seen whether the Canada Revenue Agency (CRA) will challenge completed transactions of this nature under the general anti-avoidance rule.

The budget also proposes to amend the acquisition of control rules to ensure that they do not inappropriately restrict the use of losses where a SIFT trust is wound up and distributes the shares of another corporation it holds. The rules will be amended to provide that where a SIFT trust, the sole beneficiary of which is a corporation, owns shares of another corporation, the wind-up of the trust will not cause an acquisition of control of the other corporation or restrict the subsequent use of that corporation's losses. This relieving provision was required to facilitate the tax deferred unwinding of tiered income trust structures in a manner that did not inappropriately restrict the use of corporate losses incurred while under the control of the income trust.

These amendments will apply to transactions undertaken after 4:00 p.m. EST on March 4, 2010, other than transactions that the parties are obligated to complete pursuant to the terms of an agreement in writing entered into before that time. A party will be considered not to be obligated to complete a transaction if the party may be excused from completing the transaction as a result of changes to the Income Tax Act. These amendments will also apply to completed SIFT conversion transactions if the parties to the transaction make the appropriate election. Therefore, if the parties elect to avail themselves of the benefits of the relieving amendment, that election will also make the so-called loss trading amendment retroactive.

- The budget proposes that the definition of taxable Canadian property be amended to exclude shares of corporations, and certain other interests, that do not derive their value principally from real or immovable property situated in Canada, Canadian resource property or timber resource property (subject to the 60 month rule). This measure will eliminate section 116 compliance obligations for these types of properties and will bring Canada's domestic tax rules more in line with our tax treaties and the tax laws of major trading parties. This measure will apply in determining after March 4, 2010 whether a property is taxable Canadian property of a taxpayer.
- The budget proposes to permit the issuance of a refund of an overpayment of tax under Part I of the Income Tax Act if the overpayment is related to an assessment of the payor or purchaser in respect of a required withholding under section 105 of the Income Tax Regulations or section 116 of the Income Tax Act, and the taxpayer files a return no more than two years after the date of that assessment. This measure will be effective for applications for refunds claimed in returns filed after March 4, 2010.
- The budget proposes an anti-avoidance measure that will deny claims for foreign tax credits, and foreign accrual tax and underlying foreign tax deductions, where the income tax law of the jurisdiction levying the foreign income tax, or another relevant jurisdiction, considers the Canadian corporation to have a lesser direct or indirect interest in a foreign special purpose entity than the Canadian corporation is considered to have for the purposes of the Income Tax Act. This measure is proposed to be effective for foreign taxes incurred in respect of taxation years that end after March 4, 2010. The government encourages stakeholders to submit comments before May 4, 2010.
- Following a review of the outstanding proposals related to foreign investment entities and non-resident trusts, the government has released revised proposals for public consultation with a view to developing revised legislation, which will then also be released for comment.

The previous proposals with respect to foreign investment entities, which have been in draft form for the past decade, have been abandoned. It is proposed that certain measures be taken to tighten up the existing offshore investment fund property rules, applicable to taxation years that end after March 4, 2010. A taxpayer who voluntarily complied with the outstanding proposals in previous years will have the option of having those years reassessed. If the taxpayer does not wish to be reassessed for those years, and had more income than would have been the case under the existing rules, the taxpayer will be entitled to a deduction in the current year for the excess income.

The proposals with respect to non-resident trusts are substantially revised with the aim of simplifying the rules and not hindering *bona fide* commercial transactions. New proposals will attribute to Canadian resident beneficiaries their proportionate share of a trust's income in certain circumstances. The measures regarding non-resident trusts apply for the 2007 and subsequent taxation years. An election allowing a trust to be deemed resident for the 2001 and subsequent taxation years will be available. The attribution of trust income to resident contributors will apply only to taxation years that end after March 4, 2010. The public is invited to submit comments on the proposals before May 4, 2010.

### Measures concerning individuals

- The existing rules restrict the receipt of the Canada Child Tax Benefit and the Universal Child Care Benefit (UCCB) to only one eligible individual in respect of a qualified dependant each month. This restriction also applies to the child component of the GST/HST credit payable each quarter. Effective for benefits payable starting in July 2011, it is proposed that two eligible individuals can share these benefits in respect of a child, if the recipients would be eligible to receive amounts under the existing shared eligibility policy of the CRA. This policy applies when a child lives more or less equally with two individuals who live separately.
- In two-parent families, the UCCB must be included in the income of the lower income spouse or common-law partner, while in a single parent family the UCCB is generally included in the single parent's income. To alleviate the inequity of a single parent potentially paying more tax on UCCB amounts than a couple with one income earner, it is proposed that effective in 2010, a single parent will have the option of including the UCCB amounts in the parent's income or the income of the dependant.
- It is proposed that medical expenses incurred after March 4, 2010 for purely cosmetic procedures be ineligible for the Medical Expense Tax Credit.
- A Registered Disability Savings Plan (RDSP) is a tax-assisted savings vehicle that is available to help parents and others save for the long-term financial security of a child with a severe disability. The existing Registered Retirement Savings Plan rollover rules on death will be extended to the RDSP of a financially dependent child or grandchild, effective for deaths occurring after March 3, 2010.
- RDSPs are supported by the Government of Canada in the form of Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs). The CDSG and CDSB are limited annually based on the beneficiary's family income and legislated lifetime limits, and unused CDSG and CDSB entitlements cannot be carried forward to future years. In recognition of the fact that families of children with disabilities may not be able to contribute regularly to their plans, it is proposed to allow a 10-year carryforward of CDSG and CDSB entitlements, starting in 2011.
- It is clarified that all payments made to a Registered Education Savings Plan or a RDSP through a program funded directly or indirectly or administered by a

province will be treated the same way as federal grants and bonds and will therefore not attract or reduce federal grants and bonds. This measure will apply to payments made after 2006 in the case of programs administered by a province and to payments made after 2008 in the case of programs that are not administered by a province.

- It is also clarified that for 2010 and subsequent years, the scholarship exemption and education tax credit will apply to a post-secondary program that consists principally of research only if it leads to a college or CEGEP diploma or a bachelor, masters or doctoral degree.
- A disbursement quota is intended to ensure that a significant portion of a registered charity's resources are devoted to charitable purposes. The disbursement quota can be very constraining on many small and rural charities that rely mainly on tax-receipted donations. Recent legislative and administrative initiatives have strengthened the CRA's ability to ensure a charity's fundraising practices are appropriate. As a result of these initiatives, it is proposed that for fiscal years that end on or after March 4, 2010, the disbursement quota rules be reformed to reduce complexity and the administrative burden on charities.
- If an employee acquires a security of his or her employer under a stock option agreement, the difference between the fair market value of the security at the time the option is exercised and the amount paid by the employee to acquire the security is treated as a taxable employment benefit. Furthermore, if certain conditions are met, the employee is entitled to a deduction equal to one-half of the employment benefit (the stock option deduction) for federal tax purposes. In this situation, the employer cannot claim a tax deduction for the issuance of the security. However, if an employee disposes, or "cashes out", of their stock option rights for a cash payment from their employer, the employment benefit is still eligible for the stock option deduction and the cash payment is fully deductible by the employer. It is proposed that the stock option deduction will still generally be available to employees where they exercise their options by acquiring securities of their employers. It will also be available under the cash out scenario, provided that the corporation elects to forgo the deduction for the cash payment. This proposal will apply to dispositions of employee stock options that occur after 4:00 p.m. EST on March 4, 2010.
- Under certain conditions, an employee of a publicly-traded company who acquires shares under a stock option agreement may elect to defer the recognition of the employment benefit until the disposition of the optioned securities. It is proposed that this deferral election be repealed for stock options exercised after 4:00 p.m. EST on March 4, 2010. It is also proposed that taxpayers who have previously elected to defer the taxation of their optioned securities and who have experienced financial difficulties as a result of the decline in the value of optioned securities, will be eligible for special elective tax relief for dispositions occurring before 2015. This special election will generally ensure that the tax liability on a deferred stock option will not exceed the proceeds of disposition of the optioned securities, taking into account the tax relief resulting from the use of capital losses on optioned securities being applied against capital gains from other sources. The special election is also available for securities disposed of before 2010.
- It is proposed that the inclusion rate for US Social Security benefits received after 2009 be reduced from 85% to 50% for Canadian residents who have been receiving US Social Security benefits since before January 1, 1996.
- Eligibility for the mineral exploration tax credit is extended for one year to flow-through share agreements entered into before April 1, 2011.

## GST/HST

- The budget clarifies that the GST/HST applies to all purely cosmetic procedures and related services, other than for medical or reconstructive purposes, for supplies after March 4, 2010, and in some cases before this date.
- The budget proposes enhancements to the previously announced proposals to allow direct sellers using a commission-based model to elect to use a special GST/HST accounting method, provided certain conditions are met. This approach is to be available for fiscal years beginning after 2009.
- The budget also confirms the government's intention to proceed with certain other previously-announced measures, as modified to take into account consultations and deliberations since their release, including:
  - 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.

## Other measures

- The budget proposes to extend the application of the Specified Leasing Property rules to otherwise exempt property that is the subject of a lease to a government or other tax-exempt entity, or to a non-resident. An exception would apply to leases for property valued at less than \$1 million, subject to an anti-avoidance provision. This measure will apply to leases entered into after 4:00 p.m. EST March 4, 2010.
- The budget announces public consultation on proposals to require the reporting of certain tax avoidance transactions. The proposed regime is similar to, but less inclusive than, the reporting regimes of the United States, the United Kingdom and, most recently, Quebec. A tax "avoidance transaction" entered into by or for the benefit of a taxpayer would be a "reportable transaction" that must be reported to the CRA if it features at least two of the following three "hallmarks":
  - a promoter or tax advisor is entitled to fees that are attributable to the amount of, or contingent upon the obtaining of, a tax benefit;
  - a promoter or tax advisor requires "confidential protection";
  - the taxpayer or the person who entered into the transaction for the benefit of the taxpayer obtains "contractual protection".

Upon discovery of a reportable transaction that has not been reported when required, the CRA could deny the resulting tax benefit. If the taxpayer still wanted to claim the tax benefit, it would be required to file with the CRA any necessary information and pay a penalty. The disclosure of a reportable transaction would have no bearing on whether the benefit is allowed under law; it is only intended to assist the CRA in identifying the transaction. How these mechanisms will ultimately work is unclear at this stage. These proposals, as modified to take into account consultations, would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

- Various statutes will be amended to allow for the electronic issuance of notices that can currently be sent by ordinary mail, other than notices required to be served personally or by registered or certified mail. The application of these measures will commence at such time as will be announced by the Minister of Revenue.

- The budget proposes to rationalize the rules concerning the application of the proceeds of crime and money laundering regime by repealing the exclusion for indictable tax offences under tax statutes from the definition of a designated offence under the Criminal Code. The Crown will then be able to prosecute these tax offences using that regime.
- The government will explore whether new rules for the taxation of corporate groups – such as the introduction of a formal system of loss transfers or consolidated reporting – could improve the functioning of the tax system.
- The budget confirms the government’s intention to proceed with several previously-announced tax measures.

### Customs Tariff measures

- The budget proposes to eliminate the remaining tariffs on manufacturing inputs and machinery and equipment. Tariffs on the affected goods currently vary from 2% to 15.5%. The reductions apply to 1,541 tariff items as currently listed in the Schedule to the Customs Tariff. As of March 5, 2010, 1,160 tariff items will be duty free. The duty rates on 381 tariff items will gradually be reduced beginning March 5, 2010 and “free” by no later than January 1, 2015. As well, the government will continue working with Canadians to identify areas where further trade liberalization could take place.

For further details, we refer you to the [Department of Finance](#) website, where you can access the official budget documents without charge.

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