

TAX TALK

2010 FEDERAL BUDGET HIGHLIGHTS

On Thursday, March 4, 2010, the Honourable Jim Flaherty, Minister of Finance, presented his Budget Statement to Parliament. Set out below are highlights of the budget that we believe to be of most interest to you.

ECONOMIC OVERVIEW

	2009/2010	2010/2011 Growth	
	Estimate	Forecast	
	(\$billion)		%
Revenue	213.9	231.3	8.1
Expenditure			
Public debt	29.9	31.3	4.7
Other	237.8	249.2	4.8
Surplus (Deficit)	(53.8)	(49.2)	
Net Public Debt	517.5	566.7	

	2009	2010		2011
	Estimate	Forecast		
	%	%	%	%
Inflation	0.3	1.7		2.2
3 Month Treasury Bill Rate	0.3	0.7		2.4
Unemployment Rate	8.3	8.5		7.9
Real Growth in GDP	(2.5)	2.6		3.2

The Budget projects a budgetary deficit of \$53.8 billion in fiscal 2009-10 and a further \$49.2 billion in 2010-11, but sharp declines thereafter leading to a deficit of only \$1.8 billion in 2014-15. This outlook reflects the government's confidence in longer-term economic recovery as well as the intention to move away from stimulus spending to fiscal restraint.

The deficits will increase federal debt and bring the federal debt to GDP ratio to approximately 34 percent; a multi-year high, but still less than the G7 average debt/GDP ratio of about 60%¹.

¹ Note, however that the average federal and provincial combined debt to GDP ratio approaches the G7 average.

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

While the Budget does not propose major fiscal policy shifts, it contains a number of fairly significant tax-related measures. For example, many welcomed the government's continued commitment to cut the corporate tax rate to 15 percent by 2012, which will be the lowest corporate tax rate in the G7. However, the Canadian Institute of Chartered Accountants ("CICA") urged the government to further reduce the general corporate tax rate to the small-business level, currently 11 percent, as improving finances permit.

There are no new changes in respect of personal or corporate tax rates, or to sales taxes, but corporate tax rates will decrease due to previous initiatives. New measures are proposed to improve the fairness of the tax system and also reduce administrative burden on taxpayers.

PERSONAL TAX MEASURES

Personal Income Tax Rates

The 2010 Budget does not introduce any new personal tax rate changes. The top marginal rate for individuals remains at 46.41%. This rate starts to apply when taxable income exceeds \$127,022².

² In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2010, the brackets have increased by 0.6%. As a result, the top tax rate will apply in 2010 when taxable income exceeds \$127,022 (2009 - \$126,265).

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2010:

Taxable Income	Federal Rate %	Ontario Rate %	Total %
\$ 10,382 to \$ 37,106	15.00	6.05	21.05
\$ 37,107 to \$ 40,970	15.00	9.15	24.15
\$ 40,971 to \$ 62,266	22.00	9.15	31.15
\$ 62,267 to \$ 74,214	22.00	10.98	32.98
\$ 74,215 to \$ 74,467	22.00	13.39	35.39
\$ 74,468 to \$ 81,941	22.00	17.41	39.41
\$ 81,942 to \$127,021	26.00	17.41	43.41
\$127,022 and over	29.00	17.41	46.41

Employee Stock Options

Currently, a stock option deduction of 50% of the gross stock option benefit is available to employees where qualifying criteria are met. The employer is not allowed to claim a tax deduction for the issuance of its shares. However, where the employee “cashes out” their stock option rights without first acquiring the underlying shares, the employee may still qualify for the 50% deduction and the related payment by the employer is fully deductible by the employer.

For transactions occurring after 4:00 pm EST on March 4, 2010, the Budget proposes to limit the 50% stock option deduction to the employee to situations where the employee first acquires the shares. Consequently, this 50% deduction would not generally be available where the employee cashes out their stock option rights without first acquiring the shares. However, the employer can elect to forego the full deduction for the cash payment and thereby allow the employee to claim the 50% stock option deduction.

Currently, an employee of a non-CCPC (Canadian-controlled private corporation) can potentially elect to defer the applicable tax liability on the taxable stock option benefit where a stock option is exercised and the related shares are not sold. This deferral can apply to the benefit on up to \$100,000 worth of stock options per year.

The Budget proposes to repeal this tax deferral election for stock options exercised after 4:00 pm EST on March 4, 2010. In addition, the existing withholding tax requirements will be clarified to ensure that the applicable tax on the stock option benefit is required to be withheld and remitted by the employer at the time the stock option is exercised.

The amendments to the withholding and remittance requirements will apply to stock option benefits arising on the issuance of securities after 2010 to provide time for businesses to adjust their compensation arrangements and payroll systems.

RRSP Tax Deferred Transfers on Death

Under current legislation, where the balance in a deceased annuitant’s Registered Retirement Savings Plan (RRSP) is payable to a surviving spouse or partner or an infirm financially dependent child or grandchild, the amount may be transferred to the beneficiary’s RRSP and tax thereby deferred. The Budget proposes to extend this “rollover” treatment where the RRSP proceeds are transferred to a Registered Disability Savings Plan (RDSP)³ for the benefit of an infirm dependent child or grandchild, effective for deaths after March 4, 2010.

Carry Forward of RDSP Entitlements

RDSPs are entitled to Canada Disability Savings Grants (CDSG) of up to \$3,500 per year and Canada Disability Savings Bonds of up to \$1,000 per year. Currently, in order to access these government contributions to the RDSP, private contributions must be made in the year. As there is no carry forward of these entitlements, they are lost if private contributions are not made. The Budget introduces a 10-year carry forward of the CDSG and CDSB room, retroactive to the introduction of RDSPs in 2008. The carry forward room amounts will first be able to be accessed in 2011.

Shared Custody Child Benefits

Currently, only one individual, usually the mother, may receive the Canada Child Tax Benefit, Universal Child Care Benefit and the child component of the refundable Goods and Services Tax/Harmonized Sales Tax Credit, even where there is shared custody of the eligible child. Effective for benefits payable commencing July, 2011, these payments may be shared equally between two individuals who live separately where the child lives approximately equally with each of them. Each will receive one-half of the amount to which they would be entitled if they were the sole recipient. These benefits will still be able to be received by one individual if the two parties so agree.

³ The amount transferred cannot exceed the RDSP contribution room (lifetime limit of \$200,000). The amount transferred will not generate CDS grants, and will be part of the taxable portion of disability assistance payments to be included in income of the beneficiary on withdrawal from the RDSP.

US Social Security Benefits

Prior to 1996, Canadian residents receiving US social security benefits were only required to include 50% of these benefits in income, pursuant to the Canada-United States Income Tax Convention. Tax changes in 1996 increased the income inclusion rate for these benefits to 85%. The Budget proposes to reinstate the 50% inclusion rate for Canadian residents who have been in receipt of US 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 US social security benefits received on or after January 1, 2010.

EI Premiums

EI premiums will be frozen to the end of 2010 at \$1.73 per \$100 of insurable earnings.

Mineral Exploration Tax Credit (METC)

The METC provides an additional tax benefit of 15% of specified mineral exploration expenses renounced by corporations to individual investors on the issue of flow-through shares. The METC, which was to expire at the end of March 2009, has been extended until the end of 2012, for flow-through agreements entered into before April 1, 2011.

BUSINESS TAX MEASURES

Corporate Income Tax Rate

The 2010 Budget does not introduce any new corporate tax rate changes. However, corporate rates are scheduled to decrease pursuant to previously enacted or announced measures.

The following table summarizes federal and Ontario corporate tax rates, with respect to active business income (ABI) earned by a Canadian controlled private corporation in Ontario, and reflects federal and Ontario tax rate reductions to apply in 2010:

Based on a December 31, 2010 year end

Active Business Income	Federal Rate %	Ontario Rate %	Total Rate %
up to \$500,000	11.00	5.00	16.00
from \$500,001 to \$1,500,000*	18.00	15.13	33.13
> \$1,500,000	18.00	13.00	31.00
> \$1,500,000 with M&P**	18.00	11.00	29.00

* includes claw back of Ontario small business deduction

**M & P - manufacturing and processing tax credit

Clean Energy Equipment

Taxpayers who acquire specified clean energy generation and conservation equipment after February 22, 2005 and before 2020 are permitted to treat these assets as Class 43.2 (50% declining balance CCA rate) property. Generally, such assets acquired before February 23, 2005 are classified as Class 43.1 (30% declining balance CCA rate) property.

With a view to further encouraging taxpayers to invest in energy generation equipment with low or zero emission levels, the Budget proposes to broaden the definition of Class 43.2 (50% rate) to include heat recovery equipment used in a broader range of applications and distribution equipment used in district energy systems that rely primarily on ground source heat pumps, active solar systems or heat recovery equipment. Lower-efficiency fossil-fuel-based distribution equipment will now be included in Class 43.1. These measures will apply to eligible assets acquired on or after March 4, 2010 that have not been used or acquired for use before that date.

Canadian Renewable and Conservation Expenses

If the majority of a project's tangible property qualifies for inclusion in Class 43.2, then certain project start-up expenses (for example, feasibility studies and engineering and design work) qualify as Canadian Renewable and Conservation Expenses. Canadian Renewable and Conservation Expenses can be fully deducted in the year incurred or transferred to investors using flow-through shares. A corporation must be a "principal business corporation" in order to transfer or "renounce" Canadian Renewable and Conservation Expenses to an investor using flow-through shares. Accordingly, to enhance investment in this sector, the "principal business corporation" definition has been expanded, effective for taxation years ending after 2004, to include corporations the principal business of which is any of distributing energy, fuel production or generating energy using Class 43.1 or Class 43.2 property.

Interest on Overpaid Corporate Taxes

To curb possible deliberate overpayments of tax by corporations to earn attractive rates of refund from the government, and to reduce its cost of borrowing funds, the prescribed rate of interest (set quarterly) on amounts owing to corporations will no longer include the 2% premium above the prescribed quarterly rate of interest. This new lower interest rate for corporations will apply in respect of amounts including, but not limited to, income tax, Goods and Services Tax/Harmonized Sales Tax (GST/HST), employment insurance premiums and Canada Pension Plan contributions. The refund interest rates for non-corporate taxpayers will remain unchanged.

This measure is effective July 1, 2010.

Taxation of Corporate Groups

The Budget indicates that the government intends to review the framework for the taxation of corporate groups to assess if changes could be made in this area to improve the functioning of the tax system. Potential new rules will be explored, including a formal system of loss transfer or consolidated reporting. The government intends to solicit stakeholders' views before introducing any legislation.

SIFT Conversions and Loss Trading

Currently, tax rules exist to facilitate the conversion of specified investment flow-through (SIFT) trusts and partnerships into corporate form on a tax-deferred basis. Absent the conversion to corporate form, SIFT trusts and partnerships will be taxed on their distributions no later than 2011.

The Budget contains measures intended to curtail what it perceives as inappropriate tax-loss trading using the SIFT conversion rules that would not be permitted between two corporations.

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

CHARITIES

Disbursement Quota Reform

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

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

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

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

The new disbursement quota will be less onerous, and will allow more time for charities to disburse money that they raised.

INTERNATIONAL TAXATION

Non Residents and Taxable Canadian Property

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

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

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

Refunds under Regulation 105 and Section 116

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

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

Foreign Investment Entities and Non-resident Trusts

The Budget contains new proposals to replace previous draft proposals pertaining to Foreign Investment Entities and Non-Resident Trusts. Taxpayers who voluntarily complied with the previous draft proposals for Foreign Investment Entities may choose either to have applicable previous years reassessed or may claim a deduction, in respect of any excess income previously reported, in its current year.

GST/HST MEASURES

Cosmetic Procedures and Related Goods and Services

Current GST/HST legislation specifies that dental and surgical services for cosmetic purposes (not reconstructive or medical purposes) are subject to GST. The Budget proposes that all purely cosmetic procedures whether dental, surgical or otherwise will be subject to GST. Typical procedures will include: liposuction, hair replacement procedures, botox injections and teeth whitening.

If a cosmetic procedure is paid for by a provincial health insurance plan it will continue to be GST/HST exempt. This proposal will apply to all supplies made after March 4, 2010 or supplies made on or before March 4, 2010 if the supplier charged, collected or remitted GST/HST in respect of the supply.

OTHER MEASURES

Tax Avoidance Transactions

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

The purpose of the eventual legislation will be to institute a reporting mechanism⁴ in respect of potentially abusive transactions to enable the CRA to identify aggressive tax planning on a timely basis in order that existing anti-avoidance rules, such as the General Anti-Avoidance Rule (GAAR), can be applied, if warranted.

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

1. A promoter or tax advisor is entitled to fees that are to any extent based on the amount of tax benefit from the transaction, contingent on obtaining the

tax benefit or attributable to the number of taxpayers who participate in the transaction.

2. A promoter or advisor in respect of the transaction requires “confidential protection” about the transaction.
3. The taxpayer obtains “contractual protection” in respect of the transaction.

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

Non-reporting will result in the denial of the tax benefit sought to be obtained. Alternatively, the taxpayer may elect to provide the information, pay a penalty and still receive the tax benefit. The proposals are intended to apply to avoidance transactions entered into after 2010 and those that are part of a series of transactions completed after 2010. The Budget papers make it clear that reporting is not considered to be an admission that GAAR is applicable to the transaction or series of transactions.

Online Tax and other Notices

Under current legislation, certain notices, such as notices of assessment under the *Income Tax Act*, can only be received by taxpayers through the mail or personally. The Budget proposes that the *Income Tax Act*, *Excise Tax Act*, *Excise Act, 2001*, *Air Travellers Security Charge Act*, *Canada Pension Plan Act* and *Employment Insurance Act* be amended to allow for electronic issuance of notices that can currently be sent only by ordinary mail. Electronic issuance must be authorized by the taxpayer. If a notice is specifically required to be served personally or by registered or certified mail it will be ineligible for electronic transmission.

PREVIOUSLY ANNOUNCED MEASURES

The Budget confirms the government’s intention to proceed with the following tax measures previously announced:

- Improvements to the application of the GST/HST to the financial services sector released on September 23, 2009;
- Modifications to the rules governing Tax-Free Savings Accounts, announced on October 16, 2009;
- Increased flexibility for employer funding of registered pension plans by increasing the pension surplus threshold for employer contributions to 25 per cent from its previous 10 per cent limit, announced on October 27, 2009;

⁴ *Quebec and the IRS (US) have introduced similar rules re: “aggressive” transactions.*

- Technical legislative proposals addressing recent court decisions on the GST/HST and financial services, announced on December 14, 2009;
- Measures released in draft form on December 18, 2009 relating to the income taxation of shareholders of foreign affiliates, as well as the remaining measure released in a previous draft relation to foreign affiliates;
- Increases to the Air Travellers Security Charge rates announced on February 25, 2010;
- Rules to facilitate the implementation of Employee Life and Health Trusts, released in draft form on February 26, 2010; and
- The income tax technical amendments that were previously released but not yet implemented.

Many of these proposals require reintroduction as a result of the suspension of Parliament on December 30, 2009.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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