

# GGFL FEDERAL BUDGET COMMENTARY

March 4, 2010

## 2010 Federal Budget Brief

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Finance Minister Jim Flaherty tabled the 2010 Federal Budget on Thursday March 4, 2010. The Budget contains a number of income tax changes which appear to be directed at attaining equity for taxpayers.

### **PERSONAL INCOME TAX MEASURES**

#### *Employee Stock Options*

Budget 2010 proposes a number of measures in relation to employee stock options. Prior to the proposals in the Budget it was possible, where an employee elected to “cash out” their option for a cash payment from the employer, for the employer to get a deduction for the cash payment and the employee was taxed on only ½ of the payment. The Budget addresses this possibility by only allowing the employee to get the ½ deduction on the value of the stock option benefit where the employer forgoes its ability to deduct the cash payment.

There are further amendments that clarify that the disposition of a stock option agreement to a non-arm’s length person results in an employment benefit at the time of the disposition.

Prior to Budget 2010 there was an ability to defer tax when stock options were exercised. Unfortunately, if the value of the underlying securities declined the employee may have been left in the unfortunate position of not being able to pay their tax on the disposition of these securities. For that reason the tax deferral election will not be available for employee stock options exercised after March 4, 2010.

As another measure to ensure that taxes owing on stock options are collected there are new provisions requiring an employer to withhold and remit tax based on the net employment income received by the employee. This will no doubt be cumbersome for employers since the value of the stock option benefit may be such that there is not sufficient cash remuneration paid to the employee to withhold and remit in satisfaction of the tax on the stock option benefit. The withholding obligations are not applicable for agreements entered into before the Budget date

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where the employee was required to retain ownership of the securities for a period of time after exercising the option.

There is special relief provided for taxpayers that took advantage of the tax deferral elections and now find that the value of the shares is insufficient to pay the tax on disposition. Effectively, it will limit the amount of tax to the proceeds of disposition on the shares after considering the value of capital losses on the optioned shares offset against capital gains from other sources. This provision may benefit taxpayers that found themselves in this situation before 2010 provided they make an election for this special treatment before April 30, 2011. Individuals that have not disposed of their option shares before 2010 must do so before 2015 and will have to file an election with their tax return to have these benefitting provisions apply.

### ***Medical Expense Tax Credit – Purely Cosmetic Procedures***

Budget 2010 proposes that expenses incurred for purely cosmetic procedures (including related services and other expenses such as travel) be ineligible to be claimed under the Medical Expense Tax Credit. This generally includes surgical and non-surgical procedures purely aimed at enhancing one's appearance such as liposuction, hair replacement procedures, botulinum toxin injections, and teeth whitening.

A cosmetic procedure, including those identified above, will continue to qualify for the Medical Expense Tax Credit 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.

### ***Provincial Payments into Registered Education Savings Plans (“RESPs”) and Registered Disability Savings Plans (“RDSPs”)***

The Government of Canada provides financial assistance to Canadian families saving for their children's education through RESPs and the associated Canada Education Savings Grants and Canada Learning Bond. It also helps families with severely disabled children save for their children's long-term financial security through RDSPs and the associated Canada Disability Savings Grants and Canada Disability Savings Bonds. Provincial and territorial governments may also support the efforts of parents to save by making payments into RESPs and RDSPs. These provincial programs receive the same treatment as federal grants and bonds paid into these plans – they do not use up a beneficiary's RESPs or RDSPs contribution room and they do not attract federal grants. 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.

Budget 2010 proposes to clarify that all payments made to a RESP and 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 not attract or reduce federal grants and bonds.

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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.

### ***Scholarship Exemption and Education Tax Credit***

Budget 2006 introduced a full tax exemption for post-secondary scholarships, fellowships and bursaries to help foster academic excellence by providing tax relief to post-secondary students. 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.

Budget 2010 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.

Budget 2010 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.

### ***Rollover of RRSP Proceeds to a Registered Disability Savings Plan (“RDSP”)***

Budget 2010 proposes to allow a rollover of a deceased individual's RRSP proceeds to the RDSP of a financially dependent infirm child or grandchild. Similar rules also apply in respect of RRIFs and certain lump-sum amounts from RPPs.

The amount of RRSP proceeds rolled over into an RDSP will not be permitted to 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. 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.

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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.

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 apply.

The transitional rules will allow an eligible individual to make an election to contribute up to the amount of a deceased annuitant's RRSP proceeds to the RDSP of a child who is an infirm child or grandchild of the deceased annuitant and who was financially dependent on the deceased annuitant, subject to available RDSP contribution room. An offsetting deduction will be provided either on the deceased annuitant's terminal tax return or on that of the eligible individual making the contribution, it will depend on where the income was taxed, provided the contribution is made before 2012.

### ***Carry Forward of RDSP Grants and Bonds***

Budget 2010 proposes to amend the Canada Disability Savings Act to allow a 10 year carry forward of Canada Disability Savings Grants ("CDSG") and Canada Disability Savings Bonds ("CDSB"). There is currently no carry forward of unused CDSG and CDSB entitlements to future years.

The carry forward will be available starting in 2011.

### ***U.S. Social Security***

Prior to Budget 2010 85% of U.S. Social Security benefits were subject to Canadian tax. The Budget will reduce this inclusion rate to 50% where the Canadian resident was in receipt of U.S. Social Security benefits since before January 1, 1996 and their spouses and common-law partners who are eligible to receive survivor benefits.

### ***Benefits Entitlement – Shared Custody***

Where parents share custody of a child the Budget proposes to allow the parents to split the Canada Child Tax Benefit and the Universal Child Care Benefits as well as share in the benefits associated with the GST/HST credit amounts. This split will be available where the child lives more or less equally with two individuals that live separately. This measure will apply for benefits payable commencing July, 2011.

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## *Mineral Exploration Tax Credit*

The Budget proposes to extend eligibility for the mineral exploration tax credit, a 15% credit of specified mineral exploration expenses incurred in Canada, for individuals investing in mining flow through shares. The program will be extended to flow through share agreements entered into on or before March 31, 2011.

## *Universal Child Care Benefit for Single Parents*

Commencing in 2010 single parents will be entitled to include the \$100 a month Universal Child Care Benefit (for all of his or her children) in their (the parent's) gross income, the income of the dependent for whom an Eligible Dependent Credit is claimed or in the income of one of the children for whom the Universal Child Care Benefit is paid. This may reduce the amount of taxes paid by a single parent on the Universal Child Care Benefit.

## **CORPORATE AND BUSINESS INCOME TAX MEASURES**

### *Income Trust Conversions and Loss Trading*

The Budget contains provisions that will impose restrictions on the use of losses when units of a specified investment flow-through ("SIFT") are exchanged for shares of a company. Other provisions are introduced to ensure that losses will continue to be available and the acquisition of control rules will not apply where a SIFT trust is wound up and distributes the shares of a corporation it holds.

### *Accelerated Capital Cost Allowance for Clean Energy Generation*

The Budget has broadened the description of Heat Recovery Equipment for inclusion in class 43.2 (50% on a declining balance basis) eliminating the requirement that recovered heat be reused in a process of the same type and to include space-heating technologies such as active solar and ground-source heat pumps in the same class

### *Canadian Renewable and Conservation Expenses*

Budget 2010 proposes to amend the definition of "principal-business corporation" for years ending after 2004 to allow flow-through share eligibility with respect to the renunciation of Canadian Renewable and Conservation Expenses incurred by corporations whose principal business is one of producing fuel, generating energy, or distributing energy using Class 43.1 or Class 43.2 property.

### *Television Set-Top Boxes*

Budget 2010 proposes that satellite and cable set-top boxes that are acquired after March 4, 2010 be eligible for a CCA rate of 40%.

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## *Interest on Overpaid Taxes (Refunds)*

The interest rate payable by the Minister to corporations, on any overpayment of taxes and levies, which is determined each quarter, has been reduced by 2%.

## *Specified Leasing Property*

The specified leasing property rules are extended to include properties, otherwise exempt from these rules, but leased to a government or other tax-exempt entity or non-resident unless the total value of the leased property is less than \$1,000,000.

## *Federal Credit Unions*

The Budget proposes to allow for the establishment of federal credit unions. As a result the tax rules will be amended so that federal credit unions are subject to the same tax rules as other credit unions.

## **GST / HST Measures**

### *Simplification of GST/HST for direct sellers*

Budget 2010 proposes to clarify the previously announced network seller's method of accounting for GST/HST by direct sellers.

Budget 2010 proposes the following enhancements and clarifications: new entrants in the direct selling industry may be able to use the method, hosts gifts by a network seller to host would not be subject to GST/HST, and a "safety mechanism" for a network seller that does not meet the qualification criterion concerning the commissions paid by the network seller to its sales representatives for a particular fiscal year.

Budget 2010 proposes that these enhancements apply in respect of fiscal years of a network seller that begin after 2009.

### *Cosmetic medical procedures*

Basic health care services are exempt from GST/HST. Purely cosmetic procedures, as well as goods and services related to these procedures, are not considered to be basic health care and are subject to GST/HST.

Budget 2010 proposes to clarify that GST/HST applies to all purely cosmetic procedures, to devices or other goods used or provided with cosmetic procedures, and to services related to cosmetic procedures. Taxable procedures would generally include surgical and non-surgical procedures aimed at enhancing one's appearance such as liposuction, hair replacement procedures, botulinum toxin injections, and teeth whitening.

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A cosmetic procedure will continue to be exempt 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. As well, cosmetic procedures paid for by a provincial health insurance plan will continue to be exempt.

The proposed clarifying measures related to cosmetic medical procedures will apply to supplies made after March 4, 2010 and to supplies made on or before March 4, 2010 if the supplier charged, collected or remitted GST/HST in respect of the supply.

### **INTERNATIONAL TAXATION**

#### ***Sale of Taxable Canadian Property by Non-Residents***

Canada taxes non-residents of Canada on their income and gains from the disposition of “taxable Canadian property”. Where such property is disposed of by a non-resident, generally the purchaser must withhold a portion of the amount paid, and remit it to the Government on account of the non-resident vendor’s potential Canadian tax liability. The purchaser’s obligation to withhold does not apply if the non-resident vendor obtains a “clearance certificate” from the Canada Revenue Agency. To obtain a clearance certificate, the non-resident vendor needs to remit an amount, post security, or satisfy the Canada Revenue Agency that no tax will be owing.

The Budget proposes that the definition of “taxable Canadian property” be narrowed to exclude shares of corporations and certain other interests that do not derive their value and have not, at any time within the 60 month period prior to sale, derived their value principally (more than 50%) from real or immovable property situated in Canada (includes real estate), Canadian resource or timber resource property. This will eliminate the need for a clearance certificate if such shares and other interests are sold by a non-resident of Canada.

These amendments will apply in determining, after March 4, 2010, whether a property is taxable Canadian property of a taxpayer.

#### ***Refunds Under Regulation 105 and Section 116***

Provisions under the Income Tax Act impose requirements on payors of funds to non-resident service providers and purchasers of taxable Canadian property from non-residents, respectively, to withhold and remit to the Canada Revenue Agency a portion of the amount paid to the non-resident in certain circumstances. The amounts are to be withheld and remitted on account of the non-resident’s potential Canadian tax liability. The obligation to withhold and remit can arise even where the non-resident is not liable for Canadian tax, for example, because of protection under an applicable tax treaty.

A taxpayer is permitted to receive a refund of tax overpaid for a taxation year provided that the taxpayer has filed its income tax return for the year in question within the period prescribed in the Income Tax Act. A timing issue can arise if the payor of the funds fails to withhold taxes

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and is reassessed by Canada Revenue Agency subsequent to the prescribed period for filing of a tax return by the taxpayer to recoup such taxes.

A taxpayer will be permitted the issuance of a refund of 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 Act 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 amendment is effective for applications for refunds claimed in returns filed after March 4, 2010.

### ***Foreign Tax Credit Generators***

Measures have been introduced to eliminate claims for artificially created foreign taxes paid to shelter income tax otherwise payable in respect of interest income earned on loans made directly or indirectly by Canadian corporations to foreign corporations.

These measures are proposed to be effective for foreign taxes incurred in respect of taxation years that end after March 4, 2010 with final legislation to be introduced following public consultations.

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

The Income Tax Act includes rules designed to prevent Canadians from using foreign intermediaries to avoid paying their fair share of tax. However, the rules are not fully effective in certain circumstances where aggressive offshore tax-planning schemes are used to circumvent their application.

Draft legislation has been introduced and revised over the years relating to proposals to eliminate the aggressive off-shore tax planning schemes. Budget 2009 stated that the government would review the most recent outstanding proposals at that time before proceeding with measures in this area. As a result of this review, the government has developed another set of amendments to the on-going evolution of the legislation that once again will be subject to consultation.

Changes have been proposed with respect to the inclusion of income subject to taxation in Canada relating to an interest in an “offshore investment fund property” that includes changes to the prescribed rate applicable in the computation of such income.

With respect to a non-resident discretionary trust that is deemed to be resident in Canada if it has a Canadian contributor and a related Canadian beneficiary and therefore subject to tax on its world-wide income, changes are proposed to only subject the income from the “resident portion” of the property contributed by the Canadian contributor to taxation in Canada. Income from the “non-resident portion” of the property owned by the trust will be excluded from taxation in Canada.

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It is proposed that the measures regarding foreign investment entities which includes an “off-shore investment fund property” apply for taxation years that end after March 4, 2010. It is proposed that 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.

### **CHARITIES: DISBURSEMENT QUOTA REFORM**

The ITA specifies requirements for registration as a charity as well as grounds for revocation of that status. The CRA determines the eligibility of an organization to be a registered charity for federal income tax purposes, based on an examination of the organization’s purposes and activities. In addition, charities are subject to corporate and trust law.

The disbursement quota was introduced in 1976 to help curtail fundraising costs and limit capital accumulation. The disbursement quota is intended to ensure that a significant portion of a registered charity’s resources are devoted to charitable purposes. In general terms, the disbursement quota requires that the amount a charity spends each year on charitable activities (including gifts to qualified donees) 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 (a “charitable expenditure rule”); and
- 3.5% of all assets not currently used in charitable programs or administration, if these assets exceed \$25,000 (a “capital accumulation rule”).

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

- Repealing the charitable expenditure rule,
- Modifying the capital accumulation rule, and
- Strengthening related anti-avoidance rules.

#### ***Repeal of Charitable Expenditure Rule***

Budget 2010 proposes to repeal the charitable expenditure rule. Consequently, provisions relating to a number of concepts will no longer be required to calculate the disbursement quota:

- Enduring property,
- The capital gains reduction and the capital gains pool,
- Specified gifts, and
- Exclusions from the calculation of the base to which the 3.5% disbursement rate is applied.

Budget 2010 also proposes to amend the existing rule that provides the CRA with the discretion to allow charities to accumulate property for a particular purpose, such as a building project. The existing provision states that property accumulated after approval from the CRA and any income

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earned in respect of that property is deemed to have been spent on charitable activities. This rule will require amendments in the absence of the charitable expenditure rule. In order to allow a charity to accumulate property for a particular project, the CRA will be given the discretion to exclude the accumulated property from the capital accumulation rule calculation.

### *Modify the capital accumulation component*

There is currently an exemption from the capital accumulation rule for charities having \$25,000 or less in assets not used in charitable programs or administration. Budget 2010 proposes to increase this threshold to \$100,000 for charitable organizations. The threshold for charitable foundations will remain at \$25,000.

The amount of all assets not currently used in charitable programs or administration, for the purpose of the capital accumulation rule in the disbursement quota, is subject to a calculation provided for in the Income Tax Regulations. This calculation requires a technical amendment to clarify that it applies both to charitable foundations and charitable organizations.

### *Strengthen anti-avoidance rules*

Budget 2010 proposes to extend existing anti-avoidance rules to situations where it can reasonably be considered that a purpose of a transaction was to delay unduly or avoid the application of the disbursement quota.

Budget 2010 proposes provisions to ensure that amounts transferred between non-arm's length charities will be used to satisfy the disbursement quota of only one charity. It is proposed that a recipient charity, in such circumstances, be required to spend the full amount transferred on its own charitable activities, or to transfer the amount to a qualified donee with which it deals at arm's length, in the current or subsequent taxation year. Alternatively, the transferring charity will be able to elect that the amount transferred will not count towards satisfying its disbursement quota, in which case the recipient charity would not be subject to the immediate disbursement requirement under the anti-avoidance rules.

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