

Highlights of Canada's 2010 Federal Budget

By [Corrado Cardarelli](#) and [Andrew Wong](#)

The federal budget tabled on March 4, 2010 contains a number of unexpected proposed amendments to Canada's *Income Tax Act* (the Tax Act), including welcome amendments to the concept of taxable Canadian property, helpful changes relating to the foreign investment entity and non-resident trust proposals, rules dealing with loss trading in the context of the conversion of SIFTs to corporate form and proposed changes to the stock option rules. Highlights of these proposed amendments are described below.

Proposed Amendments to the Concept of Taxable Canadian Property

The concept of "taxable Canadian property" (TCP) is of importance to non-residents and the 2010 Budget proposes to make significant changes to this concept. Non-residents are subject to Canadian taxation in respect of capital gains on the disposition of property that is TCP. Under the current rules, shares of a private (unlisted) Canadian corporation are TCP regardless of the level of ownership by the non-resident and regardless of the nature of the assets and activities of the corporation. The 2010 Budget proposes to change this by providing an additional requirement – namely, that shares of a private Canadian corporation will be considered to be TCP only if, at any time during a five-year look-back period, more than 50% of the fair market value of the shares was derived directly or indirectly from one or any combination of (i) real or immovable property situated in Canada; (ii) Canadian resource properties; (iii) timber resource properties; and (iv) options or interests in respect of such properties.

A similar change is proposed in respect of interests in partnerships and trusts (other than a unit of a mutual fund trust to which other existing rules are applicable) in that such interests will not be TCP unless this asset test is met by the partnership or trust at any time during a five-year look-back period.

Similar changes are also proposed in respect of shares of public (listed) Canadian corporations. Under the current rules, shares of a listed Canadian corporation are TCP only if the non-resident (together with non-arm's-length persons) owned 25% or more of the shares of any class of the corporation at any time over a five-year look-back period. The 2010 Budget proposes to change this by maintaining the 25% threshold ownership test and adding the additional requirement that the asset test described above must also be met at any time during the five-year look-back period.

Additional changes in the TCP area are proposed in respect of certain "deeming" rules, which in their current form deem "new" property received in substitution for or in exchange for "old" property (as a result of dispositions in the context of certain reorganizations) to be TCP if the "old" property was TCP. These rules are proposed to

To discuss these issues, please contact the authors.

For media calls, please contact [Stuart Wood](#), Chief Marketing Officer, 416.865.8205.

To contact us, please email info@torys.com.

Torys' bulletins can be accessed under Publications on our website at www.torys.com or through the Torys iPhone app.

This bulletin is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this bulletin with you, in the context of your particular circumstances.

© 2010 by Torys LLP.
All rights reserved.

be changed so that the “new” property will be deemed to be TCP for (only) a five-year period after the event giving rise to the disposition.

Non-residents are also subject to certain requirements to notify the tax authorities and to apply for a certificate under section 116 of the Tax Act in respect of dispositions of certain types of TCP and, in certain cases, to file a Canadian income tax return in respect of the disposition. A very important consequence of the remedial proposed changes to the concept of TCP is that the circumstances in which these requirements will apply will be significantly reduced. The proposed changes will therefore be of particular importance to non-resident investors, including private equity investors and sovereign wealth funds in respect of investments in Canadian corporations.

The proposed changes in the TCP area are generally applicable after March 4, 2010.

Proposed Amendments to the Foreign Investment Entity Proposals

The 2010 Budget proposes to make a sweeping change to the complex set of proposals relating to “foreign investment entities,” which have existed in proposed form for over 10 years. The outstanding proposals were intended to replace a fairly simple rule that currently exists in section 94.1 of the Tax Act. The 2010 Budget proposes to overhaul the outstanding proposals and to return to the approach taken in current section 94.1, subject to certain limited enhancements.

The existing rules in section 94.1 deal with an interest in property described as “offshore investment fund property” (OIFP). The types of property covered by these rules include a share or an interest in or a debt of certain non-resident entities, including a non-resident corporation, partnership, fund or entity and certain types of trusts. To be OIFP, it must be reasonable to consider that the property derives its value, directly or indirectly, primarily from assets that are “portfolio investments” of certain described kinds. In addition, it must be reasonable to conclude, having regard to all the circumstances, that one of the main reasons for a person acquiring the property was to derive a benefit from the assets constituting the “portfolio investments” in such a manner that the taxes on income, profit and gains from such assets are significantly less than the taxes that would have been applicable under the Tax Act if such income, profit and gains had been earned directly by the person. The consequence of a property being OIFP is that the holder must include an amount in respect of the “designated cost” of the OIFP in computing the holder’s income for the year. The amount is computed by reference to a prescribed rate of interest under the Tax Act.

One of the limited enhancements proposed to the existing rules in section 94.1 is to increase the prescribed rate to the three-month-average treasury bill rate plus two percentage points. A further enhancement is proposed in respect of the rules as they apply to beneficiaries of certain non-resident trusts (that are not deemed to be resident in Canada under the revised non-resident trust rules). It is further proposed to extend the relevant reassessment period for interests in OIFP or in such non-resident trusts by an additional three years. As a supporting change, it is proposed that the existing reporting requirements in respect of “specified foreign property” be expanded so that more detailed information is available for audit use.

Proposed Amendments to the Non-Resident Trust Rules

The non-resident trust (NRT) rules are a complex set of rules dealing with non-resident trusts, which have also existed in proposed form for over 10 years. In general terms, if a non-resident trust has a resident “specified contributor” or a “resident beneficiary,” it becomes subject to the NRT rules with the result that, generally, the trust is deemed to be a resident of Canada and becomes subject to Canadian tax. In

addition, each entity that is a “resident contributor” or a “resident beneficiary” is made jointly and severally, or solidarily, liable for the tax payable by the trust. The 2010 Budget proposes to make certain changes of a remedial nature to the NRT rules.

The 2010 Budget essentially confirms a change that was previously announced in the form of “comfort letters” issued by the Department of Finance with respect to the outstanding NRT proposals and Canadian tax-exempt entities. Under the outstanding proposals, a Canadian tax-exempt entity (such as a pension fund) that invests in a non-resident trust may cause the trust to be subject to the NRT rules and would make the tax-exempt entity jointly and severally, or solidarily, liable for the trust’s income tax liability. The 2010 Budget proposes that an exemption from the resident contributor and resident beneficiary status be provided generally for all tax-exempt entities under the Tax Act (such as pension funds, Crown corporations and registered charities). This is subject to an anti-avoidance rule that applies where it may be considered that the tax-exempt entity is being used as a “conduit” to allow a resident of Canada to make indirect contributions to a non-resident trust.

The outstanding NRT proposals may cause “genuine” non-resident commercial trusts to be caught if they make investments in certain types of defined “restricted property” (such as shares of Canadian corporations). The 2010 Budget proposes to eliminate the provision in the outstanding proposals that would have imposed deemed Canadian residence on a trust only because it acquired or held such “restricted property.”

The outstanding NRT proposals are problematic with respect to investments by Canadian residents in “genuine” non-resident commercial trusts. While the outstanding proposals attempt to provide exemptions for such commercial trusts, the exemptions are narrow and restrictive. The 2010 Budget proposes to expand the scope of the exemption for genuine commercial trusts. The newly proposed exemptions will generally apply to trust interests in respect of which

- i. each beneficiary is entitled to both the income and the capital of the trust;
- ii. the entitlements to income and capital are not based on the exercise of discretion;
- iii. the terms of the trust cannot be varied without the consent of all or a majority of the beneficiaries;
- iv. the trust is not a “personal trust”;
- v. a transfer of the interest in the trust would be a disposition and interests in the trust cannot cease to exist otherwise than by way of a redemption of the interest for fair market value; and
- vi. certain dispersal and ownership tests are met.

The last test relating to dispersal and ownership is proposed to be expanded to cover situations in which (i) the interests in the trust are listed and regularly traded on a designated stock exchange; (ii) the interests in the trust were issued by the trust for fair market value; or (iii) where the trust has at least 150 investors, the interests in the trust are available to the public in an open market.

Proposed Amendments to the SIFT Conversion Rules Relating to Loss Trading

In 2008, rules were introduced to facilitate the “conversion” of “specified investment flow through” (SIFT) entities, such as income trusts, to corporations on a tax-deferred manner to the entity and its unitholders. In general terms, the conversion rules provide for the ultimate “exchange” or “redemption” of a unitholder’s units of the SIFT in return for shares of a corporation that acquires the property owned by the SIFT and that continues on following the termination of the SIFT. The result is that the corporation effectively becomes owned by the former unitholders of the SIFT and the corporation owns the property

previously owned by the SIFT. The corporation that is used for this purpose can be a new corporation or an existing corporation. In a number of SIFT conversions, an existing corporation was used for the purpose of the conversion – a corporation that had losses from prior activities. The conversion was structured to occur so that, as a technical matter, there was arguably no “acquisition of control” by a person or group of persons of the loss corporation used for the purposes of the conversion so that the prior losses of the corporation may continue to be used, unaffected by the rules in the Tax Act that restrict the use of prior losses of a corporation following an acquisition of control of the corporation.

In general, such “loss trading” transactions in the context of SIFT conversions were technically not caught by the rule in existing paragraph 256(7)(c) of the Tax Act, which applies to a “reverse takeover” of one corporation by another corporation. That rule provides that where corporation A is acquired by corporation B in a transaction whereby the shareholders of corporation A exchange their shares of corporation A in return for shares of corporation B, control of corporation B is deemed to be acquired by a person or group of persons for purposes of the Tax Act unless, viewing the shareholders of corporation A that acquired shares of corporation B as one person, that fictional person would not control corporation B. In other words, there would be an acquisition of control of corporation B for purposes of the Tax Act if the shareholders of corporation A end up owning more shares of corporation B than the former shareholders of corporation B. This existing rule would arguably not, as a technical matter, apply to the SIFT loss trading transactions to result in an acquisition of control of the loss corporation (the acquiring corporation) since the rule deals with the acquisition of shares of corporation B by the shareholders of another corporation, not by unitholders of an income trust.

The 2010 Budget proposes to amend the Tax Act to add a rule similar to that in existing paragraph 256(7)(c) that would apply in “reverse takeover” situations in which unitholders of a SIFT trust (or partners of a publicly traded SIFT partnership) dispose of their units of the SIFT trust (or interests in a SIFT partnership) to a corporation in a SIFT conversion transaction and such former SIFT unitholders essentially control the corporation from then on. The new rule would result in an acquisition of control of the corporation used to facilitate the SIFT conversion transaction. This new rule is proposed to be applicable to SIFT conversion transactions that occur after 4:00 p.m. Eastern Standard Time on March 4, 2010, subject to grandfathering rules for transactions that are the subject of an agreement in writing entered into before that time (other than an agreement that provides for an exception from completion as a result of amendments to the Tax Act).

The 2010 Budget conversely proposes to add a helpful rule in the context of SIFT conversions that relates to control of corporations owned in the SIFT structure. Under the SIFT conversion rules, the most common method used to facilitate a conversion is to use a corporation that acquires all of the units of the SIFT trust in exchange for its shares. This “exchange-co” then becomes the sole holder of the SIFT’s units (the only beneficiary of the SIFT trust). This is followed by a windup of the SIFT trust (in certain cases this is preceded by the windup of an intermediary trust owned by the SIFT trust), which results in the property of the SIFT, including the shares of corporations owned by the SIFT, being subsequently owned by the exchange-co. Under the relevant jurisprudence, if a corporation is owned by a trust, the trustees of the trust control the corporation. Under the existing rules, on the basis of this jurisprudence, it is possible that the termination of the SIFT trust and the resulting transfer of the shares of corporations owned by the SIFT trust to exchange-co may result in an acquisition of control of such corporations owned by the SIFT trust. Such an acquisition of control would restrict the use of prior losses in the corporations, including the termination of losses derived from property and capital losses. The 2010 Budget proposes to add a helpful rule to the effect that where a corporation (exchange-co) that is used to facilitate a SIFT conversion is the only beneficiary of the SIFT trust and the SIFT trust controls other corporations, on a distribution of the shares of such other corporations on the termination of the SIFT trust, the exchange-co will be deemed not to have acquired control of such other corporations because of that distribution. This

helpful rule is proposed to be applicable to transactions undertaken after 4:00 p.m. Eastern Standard Time on March 4, 2010, subject to grandfathering rules for transactions that are the subject of an agreement in writing entered into before that time (other than an agreement that provides for an exception from completion as a result of amendments to the Tax Act). However, parties that have implemented or agreed to implement a SIFT conversion prior to March 4, 2010 may elect in writing to have this helpful rule apply in their circumstances.

Proposed Amendments to the Stock Option Rules

The 2010 Budget proposes certain amendments to the stock option rules, many of which were unexpected and "adverse" in nature.

1. Under the current rules and administrative practice, certain beneficial results arise where an optionholder has the right to elect to receive a cash amount equal to the "in the money" amount on the exercise of stock options in respect of which the employee would otherwise be entitled to the "1/2" treatment on the ordinary exercise of the stock options. In particular, the employee would be entitled to receive the 1/2 treatment on the stock option benefit represented by the cash payment (only one half would be included in income). In addition, the corporate employer would be entitled to a deduction for the cash payment (as an employment expense in effect). The 2010 Budget proposes to change the treatment of the cash payment received on such a cash payment alternative, which is designed to prevent the employer from claiming the deduction. The 2010 Budget proposes to do this by providing that the employee will not be entitled to the 1/2 treatment unless the employer files an election in prescribed form and within the prescribed time that it will not deduct any amount in respect of the cash payment alternative (in respect of all of its stock options issued or to be issued after 4:00 p.m. Eastern Standard Time on March 4, 2010) and the employer provides the employee with evidence in writing of such election. This change is proposed to be applicable to stock option dispositions that occur after 4:00 p.m. Eastern Standard Time on March 4, 2010.
2. Under the current rules, a limited deferral is provided in respect of publicly listed securities acquired on the exercise of stock options where the employee would be entitled to the 1/2 treatment. A deferral by means of an election is provided for the "first" \$100,000 of value of securities acquired under the options (that vest in a particular year) so that the benefit is not included in the income of the employee at the time the option is exercised to acquire the securities; the inclusion of the benefit is deferred until the employee disposes of such securities. The 2010 Budget proposes to eliminate this deferral rule for rights under an agreement to sell or issue securities exercised after 4:00 p.m. Eastern Standard Time on March 4, 2010.
3. The 2010 Budget proposes to introduce rules to "clarify" that a disposition of rights under a stock option agreement to a non-arm's-length party will be considered to give rise to a stock option benefit at the time of the disposition. This is proposed to apply to dispositions of rights occurring after 4:00 p.m. Eastern Standard Time on March 4, 2010.
4. The 2010 Budget proposes to introduce rules that will strengthen the withholding and remittance obligations of employers in respect of securities acquired on the exercise of stock options by employees after 2010. In particular, employers will be required to remit amounts in respect of stock option benefits of employees (other than amounts relating to stock options in respect of "Canadian-controlled private corporations") in the same way as they are currently required to remit for amounts paid as cash bonuses subject to a one-half reduction if the requirements for the 1/2 treatment are met.

5. The 2010 Budget proposes to add special rules to assist employees who took advantage of the deferral rule described above in the past and are experiencing financial difficulties as a result of the decline in the value of the optioned securities to the point that the value of the securities is less than the deferred tax liability on the underlying stock option benefit. **11**