

Tax Memo

2010 Federal Budget: Focus on Fairness

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Introduction

On March 4, 2010, the Honourable Jim Flaherty, Minister of Finance, presented a federal budget intended to create and protect jobs and stimulate economic growth for Canada. The budget delivers on Year 2 of Canada's Economic Action Plan, confirming \$19 billion in federal stimulus spending over the next year, invests in a limited number of new initiatives targeting jobs, innovation and new business investment, and introduces a three-point action plan for returning a balanced budget after 2015.

The budget does not change corporate or personal tax rates or offer any new personal tax credits. However, it proposes new measures to reduce the administrative burden on taxpayers as well as to improve the fairness of the tax system. These measures include elimination of tax on the disposition of certain types of taxable Canadian property and the related section 116 reporting, elimination of the charitable expenditure rule for registered charities, specified investment flow-through trust loss trading restrictions, revised non-resident trust and foreign investment entity proposals, the repeal of the employee stock option deduction for cash outs and a new reporting regime for aggressive tax avoidance transactions. Also, the budget announces that the government intends to explore the introduction of a system of loss transfers or consolidated reporting for corporate groups.

International Tax Measures

Section 116 and taxable Canadian property

Non-residents are taxable on their gains from dispositions of “taxable Canadian property.” As well, the purchaser is generally required to withhold tax from the amount paid unless the non-resident vendor has obtained a clearance certificate under section 116 of the *Income Tax Act* (ITA).

Taxable Canadian property includes shares of corporations resident in Canada, as well as real or immovable property (including Canadian resource property and timber resource property) that is situated in Canada, and certain shares and other partnership and trust interests the value of which is, or was within the previous 60 months, derived principally from such real or immovable property. It also includes shares of Canadian-resident corporations and certain other partnership and trust interests that do not derive their value principally from real or immovable property. Even though gains from the disposition of the latter are generally exempt under Canada’s income tax treaties, the section 116 compliance procedures must still be followed.

The budget narrows the taxable Canadian property definition by excluding shares of corporations, and other entity 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). As a result, dispositions by non-residents of such property after March 4, 2010, will no longer be taxable nor subject to the section 116 clearance certificate requirements. This is intended to enhance the ability of Canadian businesses to attract foreign venture capital.

Refunds under regulation 105 and section 116

Regulation 105 and section 116 require a payer to withhold and remit to the Canada Revenue Agency (CRA) a portion of the amount paid to non-resident service providers and vendors of taxable Canadian property in certain circumstances. The amounts withheld are remitted on account of the non-resident’s potential Canadian tax liability. The non-resident can obtain a refund of any overpaid taxes by filing a Canadian income tax return within the time limits imposed by the ITA. However, in some cases, the non-resident can lose the right to a

refund due to the lack of a deadline for the CRA to assess a payer that has failed to withhold taxes.

The budget permits the CRA to issue a refund if the non-resident files a return within two years of the assessment of the payer and the overpayment of tax relates to amounts withheld pursuant to regulation 105 or section 116. This measure will be effective for applications for refunds claimed in returns filed after March 4, 2010.

Non-resident trusts and foreign investment entities

The budget addresses the “outstanding proposals” for non-resident trusts (NRTs) and foreign investment entities (FIEs). As a result of the review that was announced in the 2009 budget, the government has released for public consultation revised proposals to replace the outstanding proposals. A panel of tax practitioners will work with the Department of Finance to review any issues identified from the public consultation and make recommendations on draft legislation.

The proposed measures for FIEs will apply to taxation years ending after March 4, 2010. A taxpayer that filed under the outstanding proposals has the option to have those years reassessed. If a taxpayer had more income than would have been the case under the existing rules, the taxpayer can choose to not have those years reassessed and instead claim a deduction in the current year for the excess income.

The proposed measures for NRTs will apply for 2007 and subsequent years (apart from the attribution rule, described below, which is effective for taxation years ending after March 4, 2010). A trust will also be allowed to elect to be deemed resident for the 2001 and subsequent years.

NRT revised proposals

The government received representations on the outstanding proposals citing complexity and uncertainties in their application to legitimate, non-tax motivated transactions. The budget proposes to simplify and better target these proposals in several ways:

- An exemption from potential joint and several liability for tax of a deemed resident trust will be provided for any person exempt from tax under section 149 of the ITA (e.g., pension funds, Crown corporations and registered charities). However, the exemption will not apply to the use of a tax-exempt entity as a conduit

- for a taxable person to avoid the application of the NRT proposals on an indirect transfer to the trust.
- The provision in the outstanding proposals that would have caused a commercial trust to be deemed resident by reason only of acquiring or holding “restricted property” will be eliminated. The role of “restricted property” will be limited generally to transactions of a closely-held corporation when a share with fixed entitlement rights is issued at a tax cost that is less than its fair market value.
 - A commercial trust will not be deemed to be resident in Canada if it meets all of the following criteria:
 - each beneficiary is entitled to both income and capital and the amount of income or capital does not depend upon the exercise or the failure to exercise discretion by any person;
 - any transfer of an interest by a beneficiary results in a disposition under the ITA and interests cannot cease to exist otherwise than as a consequence of a redemption or cancellation under which the beneficiary is entitled to receive the fair market value of the interest;
 - interests in the trust that are listed and regularly traded on a designated stock exchange, are issued for fair market value or, if there are at least 150 investors, are available to the public in an open market;
 - the terms of the trust cannot be varied without the consent of all beneficiaries or, if the trust is widely held, a majority of beneficiaries; and
 - the trust is not a personal trust.
 - A commercial trust that is varied in a non-permitted way will be taxable on all of its income that has been accumulated (together with an interest factor). This anti-avoidance measure is intended to reduce the incentive for Canadians to seek to avoid tax on their personal investments by structuring an arrangement to mimic a commercial trust.
- A trust’s property will be divided into a resident portion and a non-resident portion. The resident portion will consist of property acquired by way of contributions from Canadian residents and certain former residents (and property substituted therefor). Any remaining property will be included in the non-resident portion.
 - Income arising from the non-resident portion (other than from sources in Canada subject to Canadian tax) will be excluded from the trust’s income.
 - Income arising from the resident portion (net of amounts made payable to a beneficiary) will be attributed to resident contributors in proportion to their relative contributions. Special rules will reduce the amount of attributed income for losses incurred in other years and will allocate foreign taxes paid on income attributed. The attribution of income to a resident contributor will apply to taxation years that end after March 4, 2010.
 - The trust will be entitled to a deduction for income that was payable to a beneficiary as well as income attributed to a resident contributor. Income not distributed to a beneficiary will be deemed to be a contribution by the trust’s connected contributors and will form part of the resident portion. However, accumulated income that is part of the non-resident portion will not be subject to this deeming rule if it is kept separate and apart from the resident portion.
 - There will be ordering rules for distributions. Distributions to resident beneficiaries will be considered to first be from the resident portion and similarly distributions to non-residents will be considered to first be from the non-resident portion. Part XIII tax will not apply to distributions to non-residents from the non-resident portion but will apply to distributions to non-residents from the resident portion.
 - The ability to claim foreign tax credit relief will be expanded to address double taxation concerns.
 - The normal reassessment period for these trusts will be extended by three years.
 - The *Income Tax Conventions Interpretations Act* will be amended to clarify that a trust that is deemed resident in Canada is a resident of Canada and subject to tax under the ITA for tax treaty purposes.

The outstanding proposals that can otherwise cause a non-resident trust to be subject to the NRT rules because of a resident contributor or resident beneficiary will essentially remain (except that a tax-exempt entity will be excluded from resident contributor or beneficiary status). It appears that the comprehensive deemed transfer and contribution rules in the outstanding proposals will remain. There continues to be no exemption from the rules for trusts resident in high tax jurisdictions.

Refinements are proposed, however, to the taxation of a deemed resident trust, as follows:

FIE proposals

The outstanding proposals for FIEs have been substantially eliminated. Essentially, the currently enacted version of section 94.1 of the ITA will remain except that the prescribed rate to be applied to offshore investment

fund property will increase to the three-month-average Treasury Bill rate plus 2%, and the normal reassessment period in respect of interests in offshore investment fund property will be extended by three years.

Currently enacted paragraph 94(1)(d), which applies to deem a trust to be a foreign affiliate and thereby subject to the foreign accrual property income regime, will be broadened to apply when a resident beneficiary together with non-arm's length persons, holds 10% or more of any class of interests in that trust. These rules will also apply to any beneficiary that has contributed restricted property to the trust.

The foreign reporting requirements for specified foreign property will also be expanded.

Foreign tax credit generators

The budget includes measures that target certain transactions, referred to as "foreign tax credit generators." These transactions are designed to shelter tax otherwise payable in respect of interest income on loans made, directly or indirectly, to foreign corporations. Typically, they do so by exploiting an asymmetry, between Canadian and foreign tax laws, concerning the characterization of a taxpayer's direct or indirect investment in a foreign entity earning the income that is subject to the foreign tax.

The draft legislation released with the budget denies claims for foreign tax credits, and deductions for foreign accrual tax and underlying foreign tax, when 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 the foreign entity than the Canadian corporation is considered to have for Canadian income tax purposes. This proposal generally should put the Canadian corporation in the same tax position as if it had made a simple loan to the foreign corporation. It is likely targeted at financial institutions that engage in structured financing transactions and will be effective for foreign taxes incurred in respect of taxation years that end after March 4, 2010. The government will accept comments from the public on the proposed legislation until May 4, 2010.

The budget indicates that transactions entered into before the effective date of these proposals could be subject to reassessment under other provisions of the ITA such as the general anti-avoidance rule (GAAR).

Business Tax Measures

Corporate tax rates

The budget does not change federal corporate income tax rates. The following rates apply to December 31 year ends:

	General and M&P income ¹	Canadian-controlled private corporation (CCPCs)	
		Active business income up to \$500,000	Investment income
2009	19%	11%	34.67%
2010	18%		
2011	16.5%		
2012	15%		

1. The rates do not apply to the income of credit unions, most deposit insurance corporations, mutual fund corporations, mortgage investment corporations and investment corporations.

Information reporting of tax avoidance transactions

The budget announces a public consultation on proposals to require the reporting of certain tax avoidance transactions to the CRA, with the goal of improving the fairness of the tax system. The consultation process will be announced in the future.

Under the proposed regime certain tax "avoidance transactions" would be "reportable transactions." Specifically, a tax "avoidance transaction" will be a "reportable transaction" if it features at least two of the three following hallmarks:

- a promoter or tax adviser is entitled to fees that are to any extent:
 - attributable to the amount of the tax benefit from the transaction;
 - contingent upon obtaining the tax benefit from the transaction; or
 - attributable to the number of taxpayers that participate in the transaction or that have been provided access to advice given by a promoter or adviser regarding the tax consequences from the transaction;
- a promoter or tax adviser requires "confidential protection" about the transaction; and
- the taxpayer or the person that entered into the transaction obtains "contractual protection" in respect of the transaction.

Tax shelters and flow-through share arrangements will not be subject to these new reporting requirements but will continue to be subject to their respective current regimes.

If the CRA discovers a reportable transaction that has not been reported to the CRA when required, the CRA can deny the tax benefit resulting from the transactions. The taxpayer may nonetheless be entitled to claim the tax benefit upon filing any required information and paying a penalty.

The disclosure of a reportable transaction would have no bearing on whether the tax benefit is allowed under the law and would not be considered in any way to be an admission that GAAR applies to the transaction.

These proposals, as modified to take into account any consultations, would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions that are completed after 2010.

Group taxation

The government proposes to explore whether to introduce new rules for the taxation of corporate groups, such as a formal loss transfer or consolidated reporting system. PricewaterhouseCoopers, on behalf of a number of Canadian companies, has been urging the federal government to undertake such consultations with the provinces and the tax community to improve the efficiency of the tax system and support the competitiveness of Canadian businesses. The budget promises that stakeholder views will be sought before introducing any changes.

Clean energy generation: accelerated CCA

The capital cost allowance (CCA) system currently provides accelerated CCA deductions under Class 43.2 at 50% per year on a declining balance basis for certain clean energy generation and conservation equipment. For new equipment acquired after March 3, 2010, the budget expands Class 43.2 to include:

- heat recovery equipment 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.

Canadian renewable and conservation expenses

When the majority of tangible property in a project is included in Class 43.2, certain project start-up costs qualify as Canadian renewable and conservation

expenses (CRCE). CRCE can be deducted immediately. However, if a corporation is a “principal-business corporation,” they can be transferred to investors using flow-through shares.

For taxation years ending after 2004, the budget clarifies that the “principal-business corporation” definition includes corporations the principal business of which is one, or any combination, of:

- producing fuel;
- generating energy; or
- distributing energy

using Class 43.1 or Class 43.2 property.

Television set-top boxes: CCA

The budget increases the CCA rate for satellite and cable set-top boxes from 20% and 30% declining balance, respectively, to 40% to better reflect the useful lives of these assets. This change will apply to new satellite and cable set-top boxes acquired after March 4, 2010.

Specified leasing property rules

For leases entered into after 4:00 p.m. EST on March 4, 2010, the budget extends 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
- a non-resident.

The exemption from the specified leasing property rules will continue to apply if the total value of the property that is the subject of the lease is less than \$1 million. An anti-avoidance rule will apply if one of the purposes of dividing property or a class of property among separate leases is to meet the \$1 million exception.

This change is of general application, but is likely of interest primarily to “principal business corporation” lessors described in regulation 1100(16), i.e., companies that earn at least 90% of their gross revenue from leasing, which are the only ones that can claim leasing losses.

Interest on overpaid taxes

Effective July 1, 2010, the interest payable to corporations for overpayments of most taxes and other levies (i.e., income tax, Goods and Services Tax (GST)/Harmonized Sales Tax (HST), Employment Insurance premiums, Canada Pension Plan contributions, excise tax and duty on most items, the Air Travellers

Security Charge and the softwood lumber products export charge) 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). This reduction of two percentage points from the current rules was prompted by the spring 2009 Auditor General's Report.

SIFT conversions and loss trading

Specified investment flow-through (SIFT) trusts and partnerships can convert their structures into corporate form on a tax-deferred basis, typically by having all unitholders exchange their units for corporate shares followed by a wind-up of the SIFT into the new public parent corporation. Some SIFTs have completed their conversions using existing corporations that have available tax losses or other tax attributes. These schemes have avoided the application of the corporate acquisition of control (AOC) rules and resulted in inappropriate tax-loss trading that would not be allowed between two corporations. The budget expands the current AOC rules for reverse takeovers to ensure that they also apply on the reverse takeover of a corporation by the unitholders of a SIFT trust or partnership.

The budget also amends the AOC rules to ensure that they do not inappropriately result in an AOC of subsidiary corporations and restrictions on the ability to use their losses or other tax attributes when a SIFT trust is wound-up and distributes the shares of its subsidiary corporations to the new public parent corporation.

These amendments apply to transactions undertaken after 4:00 pm EST on March 4, 2010, other than transactions that the parties are obliged to complete pursuant to the terms of an agreement in writing between parties entered into before that time. However, if the obligation to complete the transaction is conditional on tax changes, the grandfathering provision will not apply.

Employment Insurance

The budget confirms that the Employment Insurance premium rate will be frozen at \$1.73 per \$100 of insurable earnings to the end of 2010. Furthermore, until March 31, 2011, existing or recently terminated work-sharing agreements will be extended by an additional 26 weeks, to a maximum of 78 weeks.

Federal credit unions

The establishment of federal credit unions will be permitted. Federal credit unions that satisfy the definition "credit union" in the ITA will be subject to the same income tax rules as other credit unions.

Personal Tax Measures

Personal tax rates

The budget does not change personal tax rates. Top combined 2010 personal tax rates are outlined in the following table.

Top 2010 Personal Tax Rates

(Taxable income above \$127,021)	Ordinary income & interest	Capital gains	Canadian dividends	
			Eligible	Non-eligible
Federal only	29.00%	14.50%	15.88%	19.58%
Alberta	39.00%	19.50%	15.88%	27.71%
British Columbia	43.70%	21.85%	21.45%	33.71%
Manitoba	46.40%	23.20%	25.09%	38.21%
New Brunswick	43.30%	21.65%	19.46%	30.83%
Newfoundland and Labrador	44.50%	22.25%	24.37%	32.71%
Non-resident ¹	42.92%	21.46%	23.50%	28.98%
Northwest Territories	43.05%	21.53%	19.81%	29.65%
Nova Scotia	48.25%	24.13%	29.80%	33.06%
Nunavut	40.50%	20.25%	23.64%	28.96%
Ontario	46.41%	23.20%	26.57%	32.57%
Prince Edward Island	47.37%	23.69%	25.95%	39.66%
Quebec	48.22%	24.11%	30.68%	36.35%
Saskatchewan	44.00%	22.00%	21.64%	30.83%
Yukon	42.40%	21.20%	18.80%	30.49%

1. Non-resident rates for interest and dividends apply only in limited circumstances.

The table below shows the federal tax payable at various income levels.

	Amount of tax ¹		Tax saving
	2009	2010	
\$500,000	\$133,555	\$133,487	\$68
\$250,000	\$61,055	\$60,987	
\$150,000	\$32,055	\$31,987	\$46
\$100,000	\$18,343	\$18,297	
\$50,000	\$6,601	\$6,575	\$26
\$30,000	\$2,952	\$2,943	\$9

1. The amounts assume that only the basic tax credit is claimed.

Employee stock options

Stock option cash outs

The budget proposes that the employee stock option deduction will be available only if the employee exercises the options by acquiring the employer's securities. Employees who cash out their stock option rights will remain eligible for the stock option deduction only if the

employer makes an election to forgo a deduction for the cash payment.

A clarification will provide that the disposition of rights under a stock option agreement to a non-arm's length person results in an employment benefit at the time of the disposition. Although these benefits are considered taxable under existing law, the government believes that clarification of these rules is warranted.

These measures will apply to dispositions of employee stock options after 4:00 p.m. EST on March 4, 2010.

Tax deferral election and remittance requirement

Under certain conditions, an employee of a publicly traded company can elect to defer the recognition of the stock option employment benefit until the optioned securities are disposed. The budget repeals the tax deferral election for employee stock options exercised after 4:00 p.m. EST on March 4, 2010.

The budget also clarifies existing withholding requirements to ensure that the tax on the employment benefit associated with the issuance of a security must be remitted to the government by the employer. This amount will be added to the employer's remittances of tax withheld at source in respect of all employee salary and benefits for the period that includes the date on which the security was issued or sold. These measures will prevent situations in which an employee is unable to meet his or her tax obligation as a result of a subsequent decrease in the value of the securities. They apply to benefits arising on the issuance of securities after 2010, but not in respect of options granted before 2011 pursuant to an agreement in writing entered into before 4:00 p.m. EST on March 4, 2010, if at that time the agreement included restrictions on the disposition of the optioned securities.

Special relief for tax deferral elections

Taxpayers who elected under the current rules to defer taxation of their stock option benefits until the disposition of the optioned securities may find that the value of the optioned securities may be less than the deferred tax liability on the underlying stock option benefit. To provide relief, a special election will ensure that the tax liability on a deferred stock option benefit does not exceed the proceeds of disposition of the optioned securities, taking into account tax relief resulting from the use of capital

losses on the optioned securities against capital gains from other sources.

In any year in which a taxpayer is required to include in income a qualifying deferred stock option benefit, the taxpayer can elect to pay a special tax equal to the taxpayer's proceeds of disposition, if any, from the sale or other disposition of the optioned securities. When this election is made:

- the taxpayer can claim an offsetting deduction equal to the amount of the stock option benefit; and
- an amount equal to half of the lesser of the stock option benefit and the capital loss on the optioned securities will be included in the taxpayer's income as a taxable capital gain, which can be offset by any unused allowable capital loss on the optioned securities.

Individuals who disposed of their optioned securities before 2010 will have to make the special election on or before their filing due-date for the 2010 taxation year (generally, April 30, 2011). Others must do so before 2015.

U.S. social security benefits

Canadian-resident recipients of certain types of U.S. social security benefits are, pursuant to Article XVIII of the Canada-U.S. Tax Convention, required to include in income only 85% of the amount of the benefit. For U.S. social security benefits received after 2009, the budget reduces the inclusion rate to 50%, to restore the rate that applied before 1996.

To qualify for this reduced inclusion rate, a taxpayer is required to have been resident in Canada continuously since 1996 and to have received the qualifying social security benefit throughout that period. If such a taxpayer has died, the spouse or common-law partner may qualify for the reduction if the spouse or partner was resident in Canada continuously since 1996 and received the social security benefit continuously since the taxpayer's death.

Scholarship exemption and education tax credit

The budget clarifies 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). As a result, post-doctoral fellowships will be taxable.

The budget also proposes that an amount is eligible for the scholarship exemption only if it is received in connection with enrolment in an eligible educational program for the duration of the study period related to the scholarship.

It further clarifies that the scholarship exemption for a scholarship, fellowship or bursary amount provided in connection with a part-time program will be limited to:

- the amount of tuition paid for the program; plus
- the costs of program-related materials.

This limitation will not apply if the student is entitled to the disability tax credit or cannot be enrolled full-time because of a mental or physical impairment.

These measures will apply commencing 2010.

Registered Disability Savings Plans

The budget proposes to allow:

- the rollover of Registered Retirement Savings Plan (RRSP) proceeds to a Registered Disability Savings Plan (RDSP); and
- a 10-year carryforward of the RDSP grant and bond entitlements.

Rollover of RRSP proceeds to an RDSP

Effective for deaths of RRSP annuitants after March 3, 2010, the RRSP rollover rules will be extended to rollovers of a deceased individual's RRSP proceeds to the RDSP of a financially dependent infirm child or grandchild. Similar rules will apply to Registered Retirement Income Fund (RRIF) proceeds and certain lump-sum payments from Registered Pension Plans (RPPs).

RDSP beneficiaries who meet the age and residency requirements for RDSP contributions can elect to roll over RRSP proceeds (up to their available RDSP contribution rooms) received as a result of their parents' or grandparents' death, to their RDSP if the existing RRSP rollover rules are satisfied (i.e., the RDSP beneficiary was financially dependent on the deceased individual by reason of physical or mental infirmity).

The rolled-over RRSP proceeds will reduce the beneficiary's RDSP contribution room, but will not attract Canada Disability Savings Grants. Because the rolled-over amount will not have been subject to income tax, the amount will be taxable to the beneficiary when withdrawn from the RDSP.

Transitional rules will apply when the death of an RRSP annuitant occurs after 2007 and before 2011, which effectively allows the proposed measures to apply as of January 1, 2008 (the date RDSPs became available). For deaths after March 3, 2010, and before 2011, taxpayers can use either the general rules or the transitional rules.

RDSP contributions benefitting from the rollover provisions cannot be made before July 2011. This will allow financial institutions and Human Resources and Skills Development Canada to update their systems.

Carryforward of RDSP grants and bonds

The *Canada Disability Savings Act* will be amended to allow a 10-year carryforward of Canada Disability Savings Grant (CDSG) and Canada Disability Savings Bond (CDSB) entitlements.

The annual CDSG and CDSB entitlement is shown in the table below.

Net family income ¹	CDSG		CDSB	
	≤ \$81,941	> \$81,941	≤ \$23,855	Between \$23,855 and \$40,970
Matching rates on RDSP contributions	300% on first \$500 200% on next \$1,000	100% on first \$1,000	No RDSP contributions required	
Annual RDSP contribution qualifying for maximum	\$1,500	\$1,000		
Annual maximum	\$3,500			
Lifetime maximum	\$70,000		\$20,000	

1. Net family income thresholds are indexed. Amounts shown are for 2010.

Starting 2011, when an RDSP is opened, the CDSG and CDSB entitlement will be determined for the preceding 10 years (but not before 2008) based on the beneficiary's family income in those years. For:

- CDSGs, the amount paid will be based on the RDSP contributions made in the year and on the unused CDSG entitlement, up to an annual maximum of \$10,500, with the remainder of the unused CDSG entitlement to be carried forward to future years; and
- CDSBs, 100% of the entitlement will be paid into the RDSP.

The matching rate on unused CDSG entitlements will be the same as that which would have applied had the contribution been made in the year in which the entitlement was earned. Matching rates on RDSP

contributions will be paid in descending order, with contributions using up any grant entitlements at the highest available matching rate first, followed by any grant entitlements at lower rates. Plan holders will receive annual statements of CDSG entitlements.

Provincial payments into RESPs and RDSPs

The budget clarifies that all payments made to Registered Education Savings Plans (RESPs) or RDSPs through a program funded, directly or indirectly, by a province or territory, or administered by a province or territory, will receive the same treatment as federal grants and bonds (i.e., the payments will not use up a beneficiary's RESP or RDSP contribution room and will not attract or reduce federal grants). This change will apply retroactively to payments made:

- after 2006, for programs that are administered by a province or territory; and
- after 2008, for programs that are not administered by a province or territory.

Medical expense tax credit – purely cosmetic procedures

Expenses incurred after March 4, 2010, for purely cosmetic procedures will not qualify for the medical expense tax credit. A cosmetic procedure will continue to qualify for the medical expense tax credit if it is required for medical or reconstructive purposes.

Benefits entitlement – shared custody

Under existing rules, only one eligible individual can receive the Canada Child Tax Benefit, the Universal Child Care Benefit or the child component of the GST/HST Tax Credit in respect of a qualified dependant. For parents who live separately, but share custody of a child more or less equally, the budget proposes to allow each eligible individual to receive half of the annual entitlement that they would have received if they were the sole eligible individual. This measure will apply to benefits payable commencing July 2011.

Universal Child Care Benefit for single parents

The Universal Child Care Benefit provides families with \$100 a month for each child under the age of six years. Commencing 2010, the budget allows a single parent the option of including the benefit in his or her income or in

the income of the dependant for whom an eligible dependant credit is claimed. If a single parent is unable to claim an eligible dependant credit, the benefit can be included in the income of one of the children for whom it is paid.

Mineral exploration tax credit for flow-through shares

The mineral exploration tax credit equals 15% of specified mineral exploration expenses incurred in Canada. The budget extends the credit by one year to flow-through share agreements entered into before April 1, 2011. Therefore, the credit is available for expenditures that are incurred before 2012, or in 2012 with respect to funds raised with the credits in the first three months of 2011 pursuant to the existing "look-back" rules.

Sales and Excise Tax Measures

Asset and credit management services

Draft legislation is released for previously announced changes making asset management and credit management services subject to GST/HST. In the case of asset management services, this is a new definition and is retroactive in effect, quashing several GST/HST rebate claims that were filed in the wake of the decisions of the Tax Court of Canada and the Federal Court of Appeal relating to the Canadian Medical Protective Association. For credit management services, the effective date is December 14, 2009 – the original announcement date.

Financial intermediation services

Excluded from the GST/HST exemption of the service of "arranging for" the supply of a financial service, effective December 14, 2009, is a service that is "preparatory to the provision or the potential provision of" a financial service. Originally announced on December 14, 2009, this is an unclear exclusion that will be problematic in application, a point that is already the subject of discussions with the Department of Finance. All suppliers of financial intermediation services should review the GST/HST treatment of their supplies to see if this new exclusion applies. The CRA released GST/HST Notice No. 250 on February 11, 2010, which provides some examples, but there are several uncertain areas, such as brokerage/trading of shares, where further guidance is required, given the December 14, 2009 application date.

Direct selling

The 2009 budget allowed direct selling organizations (referred to as “network sellers”) that employ a network of sales representatives who receive commissions for arranging the sale of goods to consumers to use the simplified method of GST/HST compliance if certain conditions were met. The 2010 budget confirms that the government intends to implement the 2009 budget’s direct selling measures and proposes further enhancements and clarifications for network sellers’ fiscal years beginning after 2009.

Purely cosmetic procedures

For supplies made after March 4, 2010, and for supplies made before March 5, 2010, if the supplier charged, collected or remitted GST/HST in respect of the supply, the budget clarifies that GST/HST applies to:

- all purely cosmetic procedures;
- devices or other goods used or provided with cosmetic procedures; and
- services related to cosmetic procedures.

Taxable procedures generally include surgical and non-surgical procedures aimed at enhancing one’s appearance (e.g., liposuction, hair replacement procedures, botulinum toxin injections and teeth whitening). Cosmetic procedures paid for by a provincial health insurance plan or required for medical or reconstructive purposes will continue to be exempt.

Customs tariffs measures

The budget speaks of “making Canada a tariff-free zone for industrial manufacturers by eliminating all remaining tariffs on machinery and equipment and goods imported for further manufacturing.” To this end, duty rates are reduced or eliminated on about 1,500 tariff items effective March 5, 2010. If the duty rate is not eliminated immediately, in most cases, the remaining duty rate will gradually be reduced to “Free” by January 1, 2015.

Other Tax Measures

Online notices

The budget amends the *Income Tax Act*, *Excise Tax Act*, *Excise Act, 2001*, *Air Travellers Security Charge Act*, *Canada Pension Plan* and *Employment Insurance Act* to allow for the electronic issuance of those notices that currently can be sent by ordinary mail (e.g., notices of assessment and reassessment of income tax and notice

of determination and re-determination of GST/HST). However, notices that are specifically required to be served personally or by registered or certified mail will not be eligible for electronic transmission. The effective date of these measures will be announced by the Minister.

Charities: disbursement quota

A main indicator of whether a registered charity has fulfilled its charitable mandate under the ITA is if it has spent a minimum amount of its funds and resources each year on charitable activities including gifts to qualified donees. This is referred to as the charity’s annual disbursement quota. The disbursement quota is a complex computation that in general terms requires that a charity spend on its charitable activities 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 or the “80%” rule); and
- 3.5% of all assets not currently used in charitable programs or administration, if these assets exceed \$25,000 (the capital accumulation rule or the “3.5%” rule).

The budget reforms the disbursement quota for fiscal years that end after March 3, 2010 to:

- eliminate the charitable expenditure rule;
- modify the capital accumulation rule; and
- provide for additional anti-avoidance rules for charities.

Elimination of the 80% rule

Elimination of the charitable expenditure rule means that the following concepts will no longer be required when calculating the disbursement quota:

- enduring property;
- the capital gains reduction and the capital gains pool;
- specified gifts; and
- exclusion of assets from the asset base used to compute the 3.5% rule if the assets are otherwise subject to the 80% rule.

Under current provisions, a registered charity can request permission to accumulate property for a specific purpose and over a specified period without the accumulation affecting the charity’s disbursement quota. The budget proposes that property accumulated after receipt of and in accordance with the CRA’s approval, including income earned in respect of the accumulated property, will be

excluded from the assets that are subject to the 3.5% rule during the specified period of accumulation.

Capital accumulation

For purposes of computing a charity's disbursement quota or obligation, the current rules provide for an exemption from the capital accumulation rule for charities with \$25,000 or less in assets that are not used in their charitable programs or in their administration. The budget increases that asset exemption threshold to \$100,000 for registered charities that are designated as charitable organizations. The asset exemption threshold for public foundations and private foundations remains at \$25,000.

Anti-avoidance rules

Existing anti-avoidance rules will be extended to situations (including gifts between charities) when it can reasonably be considered that a purpose of a transaction was to unduly delay the expending of amounts on charitable activities or avoid the application of the disbursement quota. A penalty equal to 110% of the amount of the expenditure avoided or delayed can be levied against the charity, and in the situation of an intercharity gift, against both charities.

A new provision will ensure the spending of a property gifted (excluding designated gifts) by a charity to a non-arm's length charity will be used to satisfy the disbursement quota of only one charity. The recipient charity will be required to:

- spend the full amount transferred on its own charitable activities; or
- transfer the amount to a qualified donee with which it deals at arm's length,

in the current taxation year or by the end of the next taxation year. The charity can be assessed a penalty equal to 110% of the fair market value of the property in excess of the amounts spent if it fails to spend the required amounts.

Alternatively, the transferring charity will be able to elect that the transferred amount will not count towards the fulfillment of its disbursement quota, in which case the recipient charity will not be subject to the immediate disbursement requirement under the anti-avoidance rules.

The new and amended rules will apply to charities for fiscal years that end after March 3, 2010.

Proceeds of crime and money laundering regime

Under the *Criminal Code*, the proceeds of crime and money laundering regime provides the Crown, in respect of designated offences, with various powers including enhanced powers to search, seize and retain proceeds of crime. In addition, the *Criminal Code* can be applied to prosecute tax evasion offences that constitute fraud, in which case the proceeds of crime and money laundering regime may apply. Notably, however, indictable tax offences prosecuted under the *Income Tax Act*, the *Excise Tax Act*, certain provisions of the *Excise Act* and the *Budget Implementation Act, 2000* are excluded from the ambit of the proceeds of crime and money laundering regime. The budget proposes to repeal these exclusions from the *Criminal Code*. As a result, the proceeds of crime and money laundering regime can be used to prosecute these tax offences, regardless of whether they are prosecuted under the *Criminal Code* fraud provisions or the tax statutes.

Aboriginal tax policy

The budget reaffirms the government's willingness to discuss and implement direct taxation arrangements with Aboriginal governments.

Previously Announced Measures

The budget confirms that the government will proceed with the following previously announced tax measures:

- modification to the Tax-Free Savings Account rules;
- increased flexibility for employer funding of RPPs by increasing the pension surplus threshold for employer contributions to 25% (up from 10%);
- amendments to the foreign affiliate rules, which were released in draft form on December 18, 2009 (see our *Tax Memo*, "Foreign Affiliates: Draft Regulations Released" at www.pwc.com/ca/taxmemo), as well as other foreign affiliate rules released in a previous legislative draft;
- introduction of the Employee Life and Health Trusts rules, which were released in draft form on February 26, 2010;
- improvements to the application of the GST/HST to the financial services sector; and
- increase in the Air Travellers Security Charge rates for tickets purchased after March 31, 2010.

For More Information

For more information on how the budget changes affect you or your business, please contact:

- your PricewaterhouseCoopers tax adviser;
- any of the individuals listed at www.pwc.com/ca/taxcontacts; or
- a member of PricewaterhouseCoopers' Canadian National Tax Services (CNTS).¹ For more on CNTS and its members, go to: www.pwc.com/ca/cnts.

1. Canadian National Tax Services (CNTS) is a group of tax specialists from a variety of professional backgrounds, including government, with the mandate to enhance the overall value and scope of tax services PricewaterhouseCoopers provides to its clients.

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