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Canadian Federal Budget Commentary

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Budget 2009 – The Perfect Storm

The following commentary on the Canadian Government's 2009 Federal Budget was prepared by members of Stikeman Elliott's Tax Group.

It's an ill wind that doesn't benefit someone. Not a bad situation for Mr. Harper and his government. Sure they have to appease the electorate, but virtually everyone has given them a free ticket to sprinkle \$33.5 billion of stimulus around over the next two years as they see fit. Not surprisingly, they have chosen to give at least a little bit to almost everyone. Everyone loves to get a break, and most seem to think they would be better off even if the government simply printed off an extra 33.5 million or so thousand dollar bills and distributed one to every Canadian resident individual. One can only hope that somewhere, sometime, someplace a more principled approach to fiscal affairs will take hold. This is not meant as a criticism directed solely at Mr. Harper's government or at Canada's politicians; it is a serious worldwide problem. A comparison could perhaps be made between the attitude of governments worldwide to fiscal management and the approach to fiscal management employed by the subprime mortgagors. Maybe all that matters is that Canada is better than most? Maybe Canada with its vast natural resources and spirit of compromise, cooperation and hard work could become a world leader?

Budget 2009 projects a deficit of \$63.5 billion over the next two years. \$30 billion of that amount is attributable to the results that would be obtained without taking into account the initiatives in Budget 2009. This leaves the cost of new 2009 budgetary initiatives for 2009-2010 and 2010-2011 at \$33.5 billion. Over the next five years the government projects that these new initiatives will cost \$48 billion, resulting in overall deficits of \$33.7, \$29.8, \$13.0, \$7.3 and (\$0.7) billion, respectively, over the next five years. The Bank of Canada has predicted a steep but short recession. Thus, the current crisis may call for immediate stimulus of short duration. The stimulus needs to enter the economy as soon as possible and to be pulled back to a long-term sustainable level as soon as the recovery begins. This is why the budgetary initiatives are primarily directed towards direct short-term injections of cash, rather than fundamental long-term shifts in tax policy.

Even with a projected deficit of \$33.7 billion for 2009-2010, the deficit is still less than the 1994-1995 deficit of \$36.6 billion. Canada's current federal debt is around \$457 billion and the debt to GDP ratio of all Canadian governments in 2007 was 23.4%, lowest among the members of the G7. The projected deficits for the next two years would push the federal ratio to 32.1%, compared to the projected U.S. ratio of 54.6%. While these numbers are interesting, many would suggest that they are just play numbers. If the amount of federal debt was measured as including the current cost of future commitments, such as maintaining the current levels of health care and social

security, the “real federal debt” (at least in the United States) could be as much as 5 times the currently published amount. Any CFO in private enterprise would not have a lengthy career without a long term plan to deal with such a looming problem. We are not aware of any government that has tackled this issue.

Canadian retail sales declined by 11% in November and the Bank of Canada is predicting that GDP will shrink at an annualized rate of 4.8% in the current quarter and by an overall amount of 1.2% for calendar 2009. The U.S. consumer accounts for 70% of U.S. GDP and 20% of worldwide GDP. Consumer spending in the United States has more than doubled over the last 5 years. Over the last 10 years, U.S. household debt has grown from 90% to more than 130% of GDP, while the U.S. personal savings rate has fallen from 80% to a little over 60% of GDP during the same period. U.S. housing starts in December were 550,000, down from 2 million the previous year. 22% of Canadian economic activity is based on exports to the United States. In Canada total household debt grew from 105% of disposable after-tax income in 1997 to 125% in 2005. The stimulus in Canada and elsewhere is not meant to be inflationary; at best, it will simply fill part of the hole created by reduced consumer spending.

Canada has an obligation to do its share to reverse the worldwide recession. The International Monetary Fund has suggested that countries should inject fiscal stimulus equal to 2% of GDP. The government estimates that its new initiatives will introduce stimulus equal to 1.5% of GDP in 2009-2010 and 1.1% of GDP in 2010-2011. Provincial, territorial and municipal budgets over the next two years will increase the amount of Canadian stimulus.

We loudly applaud the government’s decision to repeal section 18.2 of the *Income Tax Act* (the “Act”). This provision, dealing with “double-dip financing arrangements”, produced arbitrary results that careful planning could generally avoid. It was a startling example of unnecessary complexity entangled with dubious international tax policy. Its repeal reflects a measure of being prepared to do the right thing.

Proposed amendments dealing with non-resident trusts, foreign investment entities and foreign affiliates are all put on hold pending further consultation and review. This reflects the view of many seasoned commentators that the Canadian system could benefit greatly from a more consultative approach to the introduction of amendments to the Act. Any move in this direction, perhaps coupled with a more transparent and cooperative approach to tax administration, as reflected in the Cape Town Declaration by the tax administrations of the leading industrial nations, can only be beneficial in enhancing Canada’s international competitiveness and ultimately our GDP.

The oft-unheard-from constituency of low and middle income Canadian taxpayers are generally regarded by many economists as carrying much more than a fair share of the Canadian income tax burden. Even if it is because we all have one vote, it is still a welcome gesture to see the basic personal amount and the first two tax brackets increased and indexed.

If this budget does not generate confidence and Mr. Ignatieff gets a chance, it will be interesting to see whether a coalition budget suggests much more significant personal income tax cuts offset by the return to a 7% GST. This may depend on the sophistication of the Canadian electorate.

International Tax Measures

Advisory Panel on Canada’s System of International Taxation – December 2008 Report

In December 2008, Canada’s *Advisory Panel on Canada’s System of International Taxation* released its much anticipated report wherein it recommended, among other things, changes to the foreign affiliate regime including the broadening of the existing exemption system to cover all foreign active business income earned by foreign affiliates and capital gains realized on the disposition of foreign affiliate shares, a review of the base erosion and investment business rules to ensure they are properly targeted, a reduction in the complexity of the foreign investment entity and non-resident trust rules, and a prohibition against additional rules restricting the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates. Budget 2009 only addresses the Panel’s recommendation to repeal the anti-double-dip financing rules contained in section 18.2 of the Act and states that the Government is reviewing the recommendations relating to the foreign affiliate, foreign investment entity and non-resident trust regimes.

Repeal of Anti-Double-Dip Financing Rules

Budget 2007, released in March 2007, proposed that, notwithstanding the general rules contained in the Act with respect to interest deductibility, no deduction would be allowed for a taxpayer “in respect of interest relating to an investment in a foreign affiliate” unless the deduction was specifically allowed under the proposed rules. This proposal was received poorly by both the tax and business communities. Accordingly, in May 2007 the Minister of Finance announced a revised proposal which sought, instead, to limit corporate deductions in respect of interest and other borrowing costs incurred to fund certain investments in the equity or debt of foreign affiliates. In general, the revised rules, which are contained in section 18.2 of the Act and were to become effective in 2012, operate to deny a Canadian corporation a deduction for interest expense or other borrowing costs where: (i) it is reasonable to consider that the borrowing that generated such expense or cost was used, directly or indirectly, to fund a loan made by a foreign affiliate of the taxpayer, and (ii) the interest receivable by the foreign affiliate is re-characterized under the foreign affiliate rules as active business income and added to either exempt earnings or taxable earnings.

The *Advisory Panel on Canada’s System of International Taxation’s* December 2008 report noted that a restriction on the ability of a Canadian corporation to deduct interest on money borrowed to invest in foreign affiliates, even though dividends from the foreign affiliate could be repatriated to Canada on a tax-free basis, would create fundamental disadvantages for Canadian businesses when they compete abroad. Members of the business and tax communities also expressed considerable concerns over the legislation. Accordingly, Budget 2009 proposes that section 18.2 of the Act be repealed.

Corporate Tax Measures

Increase of Small Business Limit

In addition to a series of fiscal measures supporting growth and job creation by small businesses, Budget 2009 proposes to increase the business limit of Canadian-controlled private corporations (CCPCs) to \$500,000 from the current limit of \$400,000, effective January 1, 2009. This measure will allow CCPCs to increase the amount of small business income eligible for the reduced federal tax rate of 11 per cent. The increase of the business limit will be pro-rated for corporations with taxation years that do not coincide with the calendar year. Budget 2009 also announces correlative changes to provisions dealing with the allocation of business limits between associated corporations, the flow-through of partnership income, the expenditure limit for computing the additional 15-per-cent investment tax credit for scientific research and experimental development (SR&ED), the proposed qualifying income limit for the refundability of investment tax credits and the payment of instalments by certain CCPCs. The requirement to allocate the business limit among associated corporations remains. More specifically, the small business deduction will continue to be reduced on a straight-line basis for CCPCs having between \$10 million and \$15 million of taxable capital employed in Canada. The maximum qualified expenditures for the additional 15-per-cent SR&ED investment tax credit will remain at \$3 million and the credit is phased out as taxable income of a CCPC increases from \$500,000 to \$800,000. CCPCs with taxable income greater than \$400,000 but not exceeding \$500,000 will have an additional month in which to pay any balance of tax owing. Finally, CCPCs with taxable income not exceeding \$500,000 may be eligible for quarterly instalments.

Timing of Acquisition of Control Rules

“At the end of the day, the only reason why the Minister refuses to give effect to the fiction in the present case is that he does not like the result to which it leads.” With these words Mr. Justice Noel of the Federal Court of Appeal allowed the taxpayer’s appeal in the case of *La Survivance v. The Queen*. In that case, the appellant, a public insurance company, sold shares of a subsidiary to a private company and realized a loss. The appellant claimed that because subsection 256(9) of the Act deemed control of the subsidiary to have been acquired at the beginning of the day on which the sale of the shares took place, the subsidiary was a Canadian-controlled private corporation (CCPC) at the actual time of the sale, such that the loss realized by the appellant was an allowable business investment loss that was deductible in computing the appellant’s income. The Tax Court of Canada had dismissed the appeal.

In allowing the appeal, the Federal Court of Appeal noted that Parliament is well aware of the effect of the presumptions it enacts and so it is up to Parliament and not the Courts to set limits on their scope. Parliament has

taken heed and Budget 2009 proposes to amend subsection 256(9) so that it will not apply for the purpose of determining whether a corporation is a small business corporation or a CCPC.

The amendment will apply to acquisitions of control that occur after 2005 unless the taxpayer elects not to have it apply to an acquisition of control that occurs after 2005 but before January 28, 2009. In addition, a taxpayer will be deemed to have elected not to have the amendment apply to an acquisition of control if it can be reasonably considered that the position taken in respect of the acquisition of control in a return of income or objection or appeal filed or served before January 28, 2009 relies on an interpretation of the subsection to the effect that the subsection does apply for the purpose of determining whether a corporation is a small business corporation or a CCPC. In other words, it seems once a taxpayer has taken the position that the subsection applies for this purpose it cannot take advantage of the amendment to take a contrary position.

Accelerated Capital Cost Allowance (CCA) – Computers

Budget 2009 proposes that eligible computers and software acquired after January 27, 2009 and before February 2011 will be subject to a temporary CCA rate of 100 per cent. This accelerated rate will not be subject to the half-year rule, which normally limits the CCA deduction to 50 per cent of the tax write-off available under the Act and the *Income Tax Regulations* (the “Regulations”). For these purposes, eligible computers and software will generally include general-purpose electronic data processing equipment and related systems software, as described in Class 50 of Schedule II to the Regulations, provided that following additional conditions are satisfied:

- > The property is situated in Canada;
- > The property is acquired by the taxpayer:
 - for use in a business carried on by the taxpayer in Canada or for the purpose of earning income from property situated in Canada; or
 - for lease by the taxpayer to a lessee for use in a business carried on by the lessee in Canada or for the purpose of earning income from property in Canada; and
- > The property has not been used, or acquired for use, for any purpose before it is acquired by the taxpayer for use in Canada.

Accelerated CCA for Manufacturing and Processing Equipment

Budget 2008 proposed to extend accelerated CCA treatment for three additional years in respect of Class 29 manufacturing and processing machinery and equipment acquired after March 19, 2007 and before 2009. This included a one-year extension of the 50-per-cent straight-line accelerated CCA rate for eligible assets acquired before 2010 followed by accelerated CCA treatment on a declining balance basis for eligible assets acquired in 2010 and 2011. Budget 2009 proposes 50-per-cent straight line accelerated CCA treatment for Class 29 eligible assets acquired in 2010 and 2011 in lieu of the accelerated CCA on a declining balance basis proposed in Budget 2008. The half-year rule will apply to the properties subject to this measure.

Mandatory Electronic Filing

In an effort to create a more efficient administrative tax regime, Budget 2009 proposes that certain businesses will be subject to a mandatory electronic tax filing requirement under the Act, effective for corporate taxation years ending after 2009. Generally, this new requirement applies to corporations with annual gross revenues exceeding \$1 million, with some exceptions. In this regard, non-resident corporations and insurance corporations are provided as examples that could fall within this exception.

In addition, after 2009, where a taxpayer is required to file 50 of any particular type of income tax information return, such returns must be filed electronically. Previously, this requirement applied only where the number of returns to be filed was 500. In particular, this requirement is relevant to corporations required to file T4 information returns in respect of employees.

Penalties for Incorrect Filing

Beginning in 2011, the following penalties for a failure to file a corporate income tax return in the correct format will apply:

TAXATION YEAR END	PENALTY
2011	\$250
2012	\$500
2013 and beyond	\$1000

Budget 2009 proposes further changes to the existing general penalty for a failure to comply with an obligation under the Act, which is currently imposed at an amount of \$100 per failure plus \$25 times the number of days, up to 100, during which the failure continues. The proposed changes will apply fixed penalties based on the number of information returns which are filed incorrectly. The purpose of this measure is to reduce the penalties that may result in the event of a failure to file a large number of similar returns by a taxpayer, such as T4 information returns.

Mineral Exploration Tax Credit

Budget 2009 proposes to extend for another year the eligibility for the mineral exploration tax credit in respect of flow-through share agreements entered into before April 2010. This investment tax credit is equal to 15-per-cent of certain eligible exploration expenses incurred in conducting “grass-roots” mining activities. Using the “look-back” provision in the Act, funds raised during the first three months of 2010 with the benefit of the credit can be spent on eligible exploration expenses up to the end of 2011.

Personal Tax Measures

Personal Rates

Budget 2009 proposes several measures of relief on the personal income tax front, with the stated purpose of providing “immediate benefits” for low and middle income Canadians. In the Act, the basic personal amount (including the spouse and common law partner amount and the eligible dependant amount) will be increased from \$9,600 to \$10,320 beginning in 2009. In effect, the basic personal amount represents the amount of income that an individual taxpayer can earn free of federal income tax. With a view to providing continued future relief, the basic personal amount will be indexed to inflation for subsequent taxation years.

In addition, Budget 2009 proposes changes to the lower income tax brackets as set out in the Act, intended to reduce the effective rate of personal income tax, although the actual rates themselves remain unchanged. The upper threshold of the first bracket (taxed at 15 per cent) will be increased from \$37,885 to \$40,726 in 2009. With respect to the second bracket (taxed at 22 per cent), the upper threshold will be increased from \$75,769 to \$81,452 in 2009. Like the basic personal amount, the tax bracket thresholds will be indexed to inflation for future taxation years.

The above changes to personal income tax are proposed to take effect in the spring of 2009, when the Canada Revenue Agency revises its tax withholding tables.

Seniors may also benefit from the proposed \$1,000 increase in the Age Credit amount to \$6,408, which will be indexed in subsequent years. Budget 2009 expects that this measure will result in additional annual tax savings of up to \$150 for low and middle income seniors. The upper income threshold at which the Age Credit is phased out will be increased from \$68,365 to \$75,032.

RRSP/RRIF Loss Relief

Last year’s fourth quarter stock market crash was the worst in 70 years. Changes in the direction of equity markets that occur so quickly and unexpectedly may create severe and unintended income tax consequences. Budget 2009 proposes to address one such unintended consequence.

The Act provides that on the death of the annuitant under an RRSP or RRIF, the annuitant is generally considered to have received, immediately before death, a benefit under the plan equal to the fair market value of the assets in the plan at that time (other than assets that are paid out of the plan to the annuitant’s spouse or

common-law partner or another annuitant under the plan in the case of a RRIF). The full amount of this benefit is included in computing the annuitant's income. When the assets are then distributed to the beneficiary under the plan, the beneficiary is required to include in income the difference between the value of the assets distributed and the amount included in the income of the annuitant as described above. Accordingly, any increase in value of the assets while they continue to be held in the RRSP or RRIF is taxable in the hands of the beneficiary. However, if the assets in the plan decrease in value between the date of the death of the annuitant and the date the assets are distributed to the beneficiary, the Act currently provides no relief for this loss.

A simple example easily demonstrates the potential financial hardship of these rules. Suppose the annuitant of an RRSP died on September 13, 2008 at a time when the value of the assets in the plan was \$1 million. The assets are distributed to the beneficiary under the plan at the end of 2008 when they have a value of \$700,000. The tax payable by the annuitant will be approximately \$450,000 leaving the beneficiary with effectively a net amount of \$250,000 out of the original \$1 million.

Budget 2009 proposes to allow the annuitant of an RRSP or RRIF to deduct, in the year of death, the decrease in value of the assets in the plan between the time of the death of the annuitant and the distribution of the assets to the beneficiary. Specifically, the annuitant of an RRSP or RRIF will be entitled to deduct in computing income in the year of death the amount by which the aggregate of the amount included in the income of the annuitant in respect of the value of the assets in the plan at the time of death and any amount included in the beneficiary's income as a result of the distribution of the assets of the plan to the beneficiary exceeds the value of the assets distributed to the beneficiary. The Minister will have discretion to deny this deduction if the RRSP or RRIF owned a non-qualified investment at the time of the annuitant's death or the last payment out of the RRSP or RRIF occurs after the year following the year in which the annuitant died.

While this is obviously a welcome proposal to help relieve the financial hardship illustrated above, there are other similar situations that have not been addressed. For example, an employee that exercised a stock option in September 2008 to acquire shares that had a value of \$100,000 for an exercise price of \$20,000 would have a minimum income inclusion of \$40,000. Tax on this income would be approximately \$20,000. If the employee sold the shares at the end of the year for \$60,000, the employee would have a capital loss of \$40,000 which would not be available to offset the prior income inclusion with the result that the employee would have no cash remaining after paying the exercise price and the taxes payable in respect of the exercise of the option. Consideration could also have been given to providing relief in these situations.

Action to Stimulate Housing Construction

Budget 2009 proposes measures to help stimulate housing construction, including: (i) increasing the Home Buyers' Plan RRSP withdrawal limit to \$25,000 from \$20,000, (ii) introducing a Home Renovation Tax Credit in respect of qualifying renovations, and (iii) introducing a First-Time Home Buyers' Tax Credit.

Home Renovation Tax Credit

The proposed Home Renovation Tax Credit will provide a *temporary* 15-per-cent income tax credit on eligible home renovation expenditures for work performed (not including routine repairs or maintenance), or goods acquired (not including appliances, tools or audio-visual equipment) after January 27, 2009 and before February 1, 2010 in respect of a taxpayer's principal residence, pursuant to agreements entered into after January 27, 2009. The credit may be claimed for the 2009 taxation year on the portion of eligible expenditures exceeding \$1,000, but not more than \$10,000, and will provide up to \$1,350 in tax relief (\$9,000 x 15%).

It is noteworthy that the proposal requires that there be an agreement between the parties and that taxpayers will need to keep receipts for expenditures in order to support a claim for the credit. In addition, eligibility for the credit may be limited in circumstances where the taxpayer and contractor do not deal at arm's length. Given these criteria, query how many taxpayers will be in a position to actually benefit from the proposed credit and whether, if taxpayers demand full receipting by contractors, the proposals could result in a net benefit to the federal treasury.

First-Time Home Buyers' Tax Credit

Budget 2009 proposes to introduce a First-Time Home Buyers' Tax Credit, which is a \$5,000 non-refundable income tax credit amount on a qualifying home acquired after January 27, 2009, that will provide eligible individuals with up to \$750 in federal tax relief starting in 2009. Further details have not been provided.

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