



CANADIAN FEDERAL BUDGET  
COMMENTARY 2011

The following commentary on the Canadian Government's 2011 Federal Budget was prepared by members of Stikeman Elliott's Tax Group.

## How Many Leafs Does It Take to Avoid An Election

The Honourable Minister from Whitby knows the answer is "Less than it takes to make the playoffs".<sup>1</sup> The government is either hoping that a few fig leaves will either (a) justify NDP support for the budget, or (b) provide the appearance of movement to the left in advance of the election campaign. Budget 2011 trumpets:

- extending targeted initiatives to help older workers;
- enhancing the Guaranteed Income Supplement ("GIS") for impoverished seniors;
- \$40,000 for young doctors and \$20,000 for young nurses in rural communities;
- a new \$2,000 Family Caregiver Tax Credit;
- a new Children's Arts Tax Credit;
- a \$3,000 Volunteer Firefighters Tax Credit; and
- extension of the ecoENERGY Retrofit program.

The estimated cost of these measures, as reflected in the budget documents, is approximately \$900 million per year. Budget 2011 indicates that the federal government will work with provincial and territorial governments to establish a new, low cost pension option in the form of a Pooled Registered Pension Plan. It has been reported that the measures related to GIS enhancements, encouragement for young doctors and nurses to settle in rural communities, and the extension of the ecoENERGY programs are a direct response to NDP demands. Mr. Layton also requested removal of the federal sales tax from home heating fuel and strengthening of the Canada Pension Plan.<sup>2</sup>

Budget 2011 also touts the following investments in innovation, education and training:

- new funding for collaborative projects between small businesses and colleges;
- new Canada Excellent Research Chairs;
- supporting research links among colleges, universities and businesses;
- enhancing student loan programs; and

<sup>1</sup> This is measured by number of Leafs and not by the cost, as the NHL salary cap would impose an intolerable restraint on GM Flaherty.

<sup>2</sup> Les Whittington, "Budget Goodies Target NDP", Toronto Star, March 22, 2011

- encouraging skills certification.

The estimated cost appears to be less than \$100 million per year. The Forest Innovation and Market Development programs will be extended and a review will be undertaken to evaluate the competitiveness of our aerospace and space industry. Canada's productivity has been growing at just over one-half of the US rate since 1989. Productivity, which measures how much a worker can produce in an hour, is not a gauge of how hard people work; it's more an indication of the quality of the company equipment and management. Canadian firms invest \$900 less per employee than their US counterparts in IT equipment.<sup>3</sup> There is compelling evidence that innovation is an important driver of sustainable growth. A skilled and entrepreneurial workforce with substantial scientific and technological capabilities is critical if we hope to maintain our standard of living.<sup>4</sup> This year Ottawa and the provinces will distribute \$4.7 billion under one of the richest research and development programs in the world. But Canadian companies seem to conduct consistently less R & D than their foreign competitors and produce fewer patents and invest less in technology. It has been estimated that more than one-third of the incentives end up in the hands of consultants and that some of the sponsored programs include baking gluten-free cake and growing potted roses. Numerous studies, including a 2000 Auditor-General's report, have warned of rampant problems with the program, including poor controls, inconsistent decisions and exaggerated benefits.<sup>5</sup>

The budget speech indicates that: "We will not cut transfer payments for crucial services like health care and education, unlike previous Liberal governments". Ottawa will transfer \$25.4 billion to the provinces and territories this year through the Canada Health Transfer. This accounts for 20% of \$128 billion annual expenditures on health care including \$55 billion of private spending.<sup>6</sup> Health care spending eats up 13% of direct federal spending and over 40% of provincial budgets. The 10 year health accord which provides for a 6% per year growth in federal transfers ends in 2014.<sup>7</sup> Health care costs are currently growing at a rate of 6.7% a year. Aging alone is adding 1% per year to health costs.<sup>8</sup> The future cost of providing health and elderly benefits to an aging population, coupled with the accompanying loss of income tax base, presents a dangerous fiscal prognosis.

The speech also stipulates that: "Canada's deficit is much smaller than that of most other advanced countries. We are emerging from the global recession with the lowest net debt-to-GDP ratio of any G7 economy, by far." Canada's overall debt level may not be as attractive as the federal government statements might imply. The current gross government debt to GDP (all governments) is no better than several advanced economies. The following estimates have been made:<sup>9</sup> U.K. (68.17%), Germany (72.5%), France (77.44%), Canada (81.61%), U.S. (83.21%), Italy (115.8%) and Japan (217.56%). However, as the budget speech indicates, the federal government's deficit to GDP number is substantially better than most other advanced economies and all our governments' debt to GDP ratio is expected to fall to 68.9% in 2014.<sup>10</sup> The government is projecting a federal budget surplus of \$4.2 billion, and a federal debt to GDP ratio of 29.7%, in 2015-2016.

The government "will not give in to Opposition demands to impose massive tax increases."<sup>11</sup> On the contrary, Budget 2011 extends the accelerated capital cost allowance rate for investment in manufacturing or processing machinery and equipment for 2 years. Despite urging from the Opposition, the (already-enacted) scheduled reductions in the corporate tax rate will not be rescinded. The general corporate tax rate was reduced from 18% to 16.5% on January 1, 2011 and is scheduled to go down by an additional 1.5% (to 15%) on January 1, 2012. The Opposition has recently referred to the overall 3% reduction as a \$6 billion dollar revenue expenditure that would be better spent on reducing the deficit and funding social programs. However, Jack Mintz<sup>12</sup> has presented a forceful and research-supported view that the \$6 billion amount is a bogus number. Quite the contrary, the Mintz analysis indicates that the federal tax cuts will result in a net

<sup>3</sup> Jay Bryan, "New is Good on the Innovation Front", Montreal Gazette, February 24, 2011

<sup>4</sup> Canadian Chamber of Commerce, Policy Brief, October 2010

<sup>5</sup> Barrie McKenna, "Flawed R&D Scheme Costs Taxpayers Billions", Globe and Mail, March 17, 2011

<sup>6</sup> Andre Picard, "Auditor-General urges Better Long-term Forecasts for Health Care" Globe and Mail, August 25, 2010

<sup>7</sup> Gloria Galloway, "Health Care Stuck on the Waiting List", Globe and Mail, March 15, 2011

<sup>8</sup> Bruce McKenna, "Health Care Costs our Single Most Pressing Budget Item", Globe and Mail, February 27, 2011

<sup>9</sup> "Bragging Rights", Financial Post Magazine, September, 2010

<sup>10</sup> Canadian Chamber of Commerce, Policy Brief, October, 2010

<sup>11</sup> Minister of Finance, Budget Speech, March 22, 2011

<sup>12</sup> Palmer Chair of Public Policy at the School of Public Policy, University of Calgary

increase to the public coffers.<sup>13</sup> The argument is as follows. Even as a static estimate (ignoring behavioural effects), the number is not \$6 billion, but \$4.5 billion. Then subtract another \$300 million for the accompanying increase in the dividend tax rate. Based on empirical studies, the behavioural effect on multi-nationals will result in an expansion of the large corporate tax base by at least 10.6%, producing \$2.4 billion of increased corporate tax (we are now down to a net cost of \$1.8 billion). We can then add an additional revenue pick-up for the provinces, because of the expanded tax base, of \$1.7 billion. Add a smidgen for higher personal incomes and jobs, and for GST, PST and HST resulting from the increased economic activity and we have a net gain. In addition, a three-point reduction in the corporate tax rate is estimated to lead to an increase of \$50 billion in increased capital spending over a 7 year period. In a separate article<sup>14</sup> Jack Mintz notes that, even with the planned reductions, Canada will not be a low taxing jurisdiction by OECD standards. He also refers to studies which show that most, if not all, of the corporate tax is ultimately borne by workers who receive lower compensation or lose their jobs altogether in tandem with higher corporate tax rates. Interestingly, Manitoba now has a zero rate for small businesses and BC is scheduled to follow suit in 2012.<sup>15</sup>

Most OECD countries rely less on income taxes and more on less economically-damaging taxes like the GST. Some would suggest that similarly switching the mix in Canada would encourage work and capital formulation and stimulate productivity and economic growth.<sup>16</sup> It might also reduce the estimated \$12.6 billion per year that it costs businesses to comply with the income tax rules. Although this government has done an admirable job on tax cuts and harmonization of sales tax, perhaps it could improve our collective lot even more with further reductions in income tax rates and increases in the rate of GST. Studies indicate that while \$1 in federal corporate income tax can take \$1.71 out of the economy, \$1 in sales tax only removes \$1.11. By way of provincial example, the numbers for BC are that \$1 in corporate income tax costs BC residents \$11.64, compared with a cost of \$1.83 for \$1 of personal income tax, and a cost of \$1.13 for \$1 of sales tax.<sup>17</sup> The recent BC and Ontario political experiences would suggest caution in tinkering with the GST. However a New Zealand approach, involving an increase in the GST rate coupled with an equal and equitable simultaneous reduction in personal tax rates might merit consideration.

Budget 2011 attempts to close certain “tax loopholes”. Included in this list are measures to avoid the deferral of partnership income by corporations, prevent corporations from realizing losses on the redemption of shares held by them, extending the tax on split income to certain capital gains realized by minors, tightening the rules for withdrawals from Registered Retirement Savings Plans, tightening certain rules relating to charities, limiting the deductions available when flow-through shares are donated to a charity, and limiting the deferrals available through the use of individual pension plans. Not included in Budget 2011, but released by the Department of Finance on March 16, 2011 (and discussed below), are new proposed rules aimed at limiting deductions in respect of certain “contingent amounts” and amending the rules relating to the payment of withholding tax on interest paid to a non-resident holder of a stripped bond.

## Corporate Partners and Limiting Tax Deferral

As part of its initiative to close perceived tax loopholes, the Federal Government included in Budget 2011 measures designed to limit the tax deferral Canadian corporations are able to realize in cases where they hold significant interests in single-tier and multi-tiered partnership structures. In general terms, this deferral is possible since a partnership consisting of only corporate partners is able to have an off-calendar fiscal period and, under the general partnership rules in the *Income Tax Act* (Canada) (“**Tax Act**”), the income or loss of a partnership for a particular fiscal year is included in the income of its partners for the taxation year of the partners in which the partnership’s fiscal year ends. As a result, in cases where a corporate member of a partnership has a taxation year that ends prior to the fiscal year-end of the partnership, a deferral opportunity exists. This deferral opportunity can be multiplied in cases where a corporation holds an interest in a multi-tiered partnership structure.

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<sup>13</sup> Jack M. Mintz, The Phantom \$6 Billion, Financial Post comment, February 28, 2011

<sup>14</sup> Jack M. Mintz, You Pay Corporate Tax, Financial Post comment, January 17, 2011

<sup>15</sup> Neil Reynolds, ‘There’s Only One Tax Rate That Really Works: Zero Per Cent’, Globe and Mail, March 16, 2011

<sup>16</sup> The Canadian Chamber of Commerce, Policy Brief, October, 2010

<sup>17</sup> Paul Viera, National Post, March 17, 2011

Conceptually, Budget 2011 proposes to limit this deferral opportunity by requiring a corporation that has a significant interest in a partnership that has a different fiscal period relative to the corporation's taxation year, to accrue partnership income for the portion of the partnership's fiscal period that occurs during the corporation's taxation year ("**Stub Period**"). Additional rules are also included in these measures to deal with multi-tiered partnership structures. These new measures will apply to taxation years of a corporation that end after March 22, 2011 – although there are transitional rules that will generally allow a corporation to which the rules apply to recognize the additional income over a five year period.

In general terms, these proposed rules will apply to a corporate member of a partnership for a taxation year if: (i) it is a member of a partnership at the end of the taxation year; (ii) the partnership's last fiscal period that began in the taxation year ends in a subsequent taxation year of the corporate partner; and (iii) it, together with affiliates and related persons, is entitled to more than 10% of the partnership's income for the fiscal period of the partnership that ends in the taxation year.

If these proposed rules apply to a corporation that is a member of a partnership at the end of its taxation year, the member will be required to include in its income for the year: (i) its share of the income or loss of the partnership from the fiscal period that ends in the year; *plus* (ii) accrued income, if any, for the Stub Period subject to certain adjustments ("**Stub Period Accrual**"), *less* (iii) the Adjusted Stub Period Accrual, if any, for the corporate partner's previous taxation year. The amount of the Stub Period Accrual cannot be less than zero.

Conceptually, the Stub Period Accrual is an estimate of the partnership's income for the portion of an uncompleted fiscal period of the partnership that falls during the corporate partner's taxation year. This estimate is based on the income or loss of the partnership for its fiscal period that actually ended during the corporate partner's taxation year, less certain notional deductions for specified resource expenses. The corporate partner is also permitted to elect to include a lesser amount for its Stub Period Accrual. However, if it does so, it will be subject to a penalty tax if the amount that it included in its income as the Stub Period Accrual is less than the lesser of: (i) the amount determined by the rules, and (ii) the corporation's share of the income or loss of the partnership for the Stub Period. Special rules will be included that will mitigate the effect of these rules on a corporation that becomes a member of partnership during the Stub Period.

The proposed rules also will permit partnerships to make a one-time election to change their fiscal period so that it aligns with the taxation year of one or more of its corporate partners provided certain requirements are satisfied. In cases where this election results in two fiscal periods of the partnership ending in the taxation year of a corporate partner, the corporate partner's share of partnership income or loss for the second fiscal period ("**Alignment Income**") may be eligible for the transitional relief measures even though it reflects a corporate partner's actual share of income of the partnership for that second fiscal period.

As noted above, these proposed rules include measures to provide corporate partners with transitional relief with respect to the increased amount of income that the corporate partner is expected to realize as a result of these rules for its first taxation year that ends after March 22, 2011. Specifically, the corporate partner will be able to claim a reserve based on its "Qualifying Transitional Income" ("**QTI**") which is, in general terms, the sum of its Stub Period Accrual and Alignment Income. The amount of the reserve will typically be equal to 100% of QTI for a corporate partner's taxation year that ends in 2011 and will decline incrementally until it reaches 0% for a corporate partner's taxation year that ends in 2016 – although adjustments are contemplated to address particular fact scenarios. The amount of the QTI reserve will also be limited to the extent that a corporate partner has income for the year (computed from all sources) before claiming the reserve. While the ability to claim a QTI reserve is broad, not all corporate partners will be eligible to claim it.

The proposed rules also contain additional measures for addressing additional considerations inherent in multi-tiered partnership structures. Conceptually, the idea behind these rules is to require all partnerships in a multi-tiered structure to adopt a common fiscal period. Under the proposed rules, this will be achieved either by having the partnerships in the structure elect to have one common fiscal period (which may or may not be a calendar year) or, if no such election is made, by requiring such partnerships to adopt a calendar year as their fiscal period. Because this requirement will typically result in, through the operation of the existing partnership rules, a corporate member of the top-tier partnership recognizing partnership income in a

taxation year from more than one fiscal period of the top-tier partnership, the proposed measures also include rules which will allow this additional income to benefit, in certain circumstances, from the transitional years described above. While there are many complexities associated with the multi-tiered partnership rules, they conceptually operate in a similar fashion as noted above.

## Stop-Loss Rules on the Redemption of Shares

The Tax Act contains a number of rules designed to reduce the amount of a loss otherwise realized by a corporation on the disposition of a share. In general, a corporation's loss on the disposition of a share must be reduced by the aggregate amount of tax-free dividends received, or deemed to have been received, on such share by the corporation on or before the disposition ("**stop-loss rules**"). These stop-loss rules are subject to certain exceptions and limitations and certain dividends are excluded from the computation. For example, a tax-free dividend is generally excluded from the computation in circumstances where the following two conditions are met: (i) the dividend was received when the corporation and persons with whom the corporation was not dealing at arm's length did not own in total more than 5% of the issued shares of any class of the capital stock of the corporation from which the dividend was received, and (ii) the dividend was received on a share that the corporation owned throughout the 365-day period that ended immediately before the disposition.

According to Budget 2011, some corporations have been entering into tax avoidance arrangements that rely on the existing exceptions to the stop-loss rules. In its barest form, a corporation would acquire a share having a high value (eg. \$100), but low paid-up capital (eg. \$10). After meeting the requisite holding period test, the share would be redeemed for an amount equal to its fair market value (eg. \$100). Such redemption will give rise to a deemed dividend to the extent that the redemption price exceeds the paid-up capital in respect of the share (\$90) (which dividend the participating corporation would generally receive tax-free). Having met the two conditions described above, the corporation will also realize a loss of \$90 which, depending on whether the share was held on capital or income account or was a mark-to-market property, could be used by the corporation to shelter capital gains or other income. Accordingly, in this example, on a \$100 investment the corporation will have received \$100 (economically neutral), recognized no net taxable income and realized a \$90 loss. If, on the other hand, the stop-loss rules had applied, the \$90 tax-free dividend would reduce the \$90 loss to nil.

Budget 2011 proposes to extend the application of these stop-loss rules to any dividend deemed to be received on the redemption of shares held by a corporation (whether the shares are held directly or indirectly through a partnership or trust). These rules will not apply, however, to any dividends deemed to be received on the redemption of shares of the capital stock of a "private corporation" that are held by a private corporation (other than a financial institution) whether directly or indirectly through a partnership or trust (other than a partnership or trust that is a financial institution).

These rules will apply to redemptions that occur on or after March 22, 2011.

## Enhanced Anti-Avoidance Rules for RRSPs

Budget 2011 proposes several changes to the existing RRSP anti-avoidance rules to address concerns regarding the use of Registered Retirement Savings Plans ("**RRSPs**") in tax planning arrangements which purport to enable taxpayers to withdraw amounts from their RRSPs without paying tax. The proposed changes are largely based on the anti-avoidance rules that currently apply to Tax-Free Savings Accounts ("**TFSA**") and that include (i) the advantage rules, (ii) the prohibited investment rules and (iii) the non-qualified investment rules.

First, Budget 2011 proposes to expand the existing RRSP rules by adopting the "advantage" concept from the TFSA rules, with certain modifications. Under the TFSA rules, an "advantage" may generally be described as a benefit obtained from a transaction that is intended to exploit the tax attributes of a TFSA (for example, by shifting returns from a taxable investment to a TFSA investment). TFSA advantages are subject to a tax that is generally equal to their fair market value. As a result of the Budget proposals, most benefits that are taxable as "advantages" under the TFSA rules will be treated as RRSP advantages. The RRSP advantage concept will also

specifically include benefits from “RRSP strip transactions” (i.e. transactions that enable RRSP annuitants to access their RRSP funds without including the appropriate amount in income). As is the case for TFSA advantages, the amount of tax payable in respect of any RRSP advantage will generally be the fair market value of the benefit. The tax will be payable by the RRSP annuitant, unless the advantage was extended by the issuer (or a person who does not deal at arm’s length with the issuer) in which case the tax will be payable by the issuer.

Second, Budget 2011 proposes to introduce a “prohibited investment” concept for RRSPs. This concept will be based on the TFSA definition of “prohibited investment” which generally includes debt of the TFSA holder and investments in entities in which the TFSA holder or a non-arm’s length person has a “significant interest” (generally 10% or more) or with which the TFSA holder does not deal at arm’s length. A special tax equal to 50% of the fair market value of the investment will apply to an RRSP annuitant on the acquisition of a prohibited investment by his or her RRSP, which will generally be refunded if the investment is disposed of from within the RRSP within one year after the year in which the tax is applied. It is noteworthy that income (including capital gains) derived from prohibited investments will be treated as an “advantage” under RRSPs, thereby eliminating any benefit of holding a prohibited investment in an RRSP.

Finally, Budget 2011 proposes to modify certain tax rules that apply when an RRSP acquires a “non-qualified investment” (e.g. shares in private investment holding companies or foreign private companies, and real estate). The current rules, which include the fair market value of the non-qualified investment acquired by an RRSP into the annuitant’s income, will be replaced with a special 50% tax, similar to the one applicable to prohibited investments. Like in the case of prohibited investments, such tax will be refundable. Investment income earned on a non-qualified investment in an RRSP will remain taxable to the RRSP.

## Tightening Certain Rules Relating to Charities

Budget 2011 introduces a package of “integrity measures” for charities to combat fraud and abuse of the charitable donations incentives in an attempt to protect the tax base and support “legitimate charities”. Budget 2011 also contains measures to limit the tax benefits available to the donation of flow-through shares.

### Donations of Publicly Listed Flow-Through Shares

Previous budgets introduced tax assistance for donations of publicly listed securities to all registered charities by eliminating any capital gains tax on such donations in the hands of the donor. According to Budget 2011, these measures were designed to provide an incentive to donate listed securities which have appreciated in value (and, as a result, carry unrealized capital gains). However, the regime in respect of flow-through shares makes the donation of a flow-through share attractive whether or not the flow-through share has appreciated in value.

A flow-through share is a share that allows a corporation to renounce resource deductions, often on an accelerated basis, to shareholders who may be able to immediately utilize the deduction to offset income. The amount the corporation is able to renounce on a particular share is generally limited to the consideration paid to the corporation for the share. Recognition of the benefit realized by the shareholder in connection with the renunciation of such expenses is generally deferred until the shareholder disposes of the share – this is accomplished by treating flow-through shares as having a cost of zero for purposes of calculating any gain or loss on their subsequent disposition. The portion of any capital gain subsequently realized by the taxpayer that is attributable to the proceeds of disposition up to the taxpayer’s original cost amount represents a partial recovery by the government of the tax benefit realized by the taxpayer in connection with the renunciation and deduction of the resource expenses. However, this portion of the capital gain is not related to any appreciation in the value of the flow-through share itself, which appreciation was what the above-noted amendments to the donations regime was designed to shelter. The exemption from capital gains tax on the donation of publicly listed flow-through shares allows taxpayers to avoid taxation on any gain related to the share, including gain resulting from the reduction in basis occasioned by renounced expenses.

Accordingly, Budget 2011 proposes that if a share, or a right to acquire a share, of a particular class of the capital stock of a corporation is issued to a taxpayer under a flow-through share agreement entered into on or

after March 22, 2011, the exemption from capital gains tax on donations of publicly listed securities will be available in respect of a subsequent donation by the taxpayer of a share of that class only to the extent that the capital gain on the donation exceeds a threshold amount (the “**exemption threshold**”). The exemption threshold of a taxpayer in respect of a particular class of shares at any particular time will generally be equal to the amount by which (i) the sum of the original cost of all flow-through shares of the particular class issued to the taxpayer on or after March 22, 2011, exceeds (ii) the amount of each capital gain realized by the taxpayer on a disposition, before the particular time and after the first time on or after March 22, 2011 on which flow-through shares of the particular class were issued to the taxpayer (not exceeding the amount of the exemption threshold immediately before the time of disposition). In other words, it appears that the donation of a flow-through share issued pursuant to an agreement entered into on or after March 22, 2011 will trigger a capital gain in the hands of the donor to the extent of the lesser of the original cost amount of the share and the fair market value of the share on the donation date. This limitation could also apply to mutual fund corporation shares acquired in exchange for flow-through shares.

### Granting of Options to Qualified Donees

Budget 2011 proposes to clarify that the charitable donations tax credit or deduction is not available to a taxpayer in respect of the granting of an option to a qualified donee to acquire a property of the taxpayer until such time that the donee acquires property of the taxpayer that is the subject of the option. Recognition of the credit or deduction will be deferred until such time that the donee acquires the property and will be based on the amount by which the fair market value of the property at the time of acquisition exceeds the total amounts, if any, paid by the donee for the option and the property.

## Other Measures

### Extending the Tax on Split Income to Capital Gains

Budget 2011 proposes to extend the tax on split income to capital gains realized by, or included in the income of, a minor from a disposition of shares of a corporation to a person who does not deal at arm’s length with the minor, if taxable dividends on the shares would have been subject to the tax on split income. Capital gains that are subject to this measure will be treated as dividends and, therefore, will not benefit from capital gains inclusion rates nor qualify for the lifetime capital gains exemption. This measure will apply to capital gains realized on or after March 22, 2011.

### Accelerated CCA for Manufacturing & Processing Equipment

Under the current rules, machinery and equipment acquired by a taxpayer, after March 18, 2007 and before 2012, primarily for use in Canada for the manufacturing or processing of goods for sale or lease is eligible for a temporary accelerated capital cost allowance (CCA) rate of 50% on a straight line basis (subject to the application of the “half-year rule”) under Class 29 of Schedule II to the *Income Tax Regulations*. Budget 2011 proposes to extend this temporary incentive, for two years, in respect of eligible machinery and equipment acquired before 2014. Machinery and equipment acquired by a taxpayer, after 2013, primarily for use in Canada for the manufacturing or processing of goods for sale or lease will be required to be included in Class 43 of Schedule II to the *Income Tax Regulations*, for which a 30% declining balance CCA rate applies.

### Accelerated CCA for Clean Energy

In view of further encouraging clean energy generation, Budget 2011 proposes to allow the accelerated CCA for certain types of thermal equipment that recovers waste heat in order to generate electricity. In particular, Budget 2011 proposes to amend Class 43.2 of Schedule II to the *Income Tax Regulations* which currently provides the accelerated CCA (50% per year on a declining balance basis) for specified clean energy generation equipment to include equipment that is used by the taxpayer, or by the lessee of the taxpayer, to generate electrical energy in a process in which all or substantially all of the energy input is from waste heat. The new provision will not cover energy-generating equipment that currently qualifies for inclusion in Class 43.2 (or Class 43.1), subject to energy efficiency thresholds.

## Employee Profit Sharing Plans

Budget 2011 notes that employee profit sharing plans have increasingly been used as a means for some business owners to direct profit participation to members of their families with the intent of reducing or deferring taxes on these profits. There is also a concern that some employers are using employee profit sharing plans to avoid making Canadian Pension Plan contributions and avoid paying Employment Insurance premiums on employee compensation. Budget 2011 announces that the Government will review the existing rules for employee profit sharing plans through a public consultation process to determine whether technical improvements are required.

## Limiting Deferrals Through the Use of Individual Pension Plans

Budget 2011 proposes that annual minimum amounts will be required to be withdrawn from an “Individual Pension Plan”, similar to current minimum withdrawal requirements from Registered Retirement Income Funds, once a plan member attains the age of 72. In addition, contributions made to an Individual Pension Plan that relate to past years of employment will be required to be funded first out of a plan member’s existing RRSP assets or by reducing the individual’s accumulated RRSP contribution room before new deductible contributions in relation to the past service may be made. For these purposes, an Individual Pension Plan will be a defined benefit Registered Pension Plan: (i) with three or fewer members, if at least one member is “related” to an employer that participates in the plan, or (ii) that is a “designated plan” (generally, a plan where at least 50 per cent of the total pension adjustments for plan members in a year belong to individuals who are connected to the employer or who are highly compensated employees), if it is reasonable to conclude that the rights of one or more members under the plan exist primarily to avoid this new definition.

## Previously Announced Measures

Budget 2011 confirms the Government’s intention to proceed with the certain previously announced tax and related measures (as modified to take into account consultations and deliberations since their release), including: (i) legislation relating to measure announced in Budget 2010, (ii) legislative proposals released on November 5, 2010 relating to various income tax technical amendments, (iii) legislative proposals released on December 16, 2010 relating to the “real estate investment trust” rules, (iv) proposed changes to certain GST/HST rules relating to financial institutions released on January 28, 2011, and (v) outstanding draft legislative proposals relating to foreign affiliates.

## March 16, 2011 Proposed Amendments

On March 16, 2011, less than one week before the release of Budget 2011, the Department of Finance released draft legislative proposals concerning the deductibility by a taxpayer of certain “contingent amounts” and modifying the rules relating to withholding tax that apply to interest paid to a non-resident holder of a stripped bond. The draft legislative proposals are in response to two Federal Court of Appeal decisions (*Collins v. The Queen*, 2010 FCA 12 and *Lehigh Cement Limited v. The Queen*, 2010 FCA 124).

## Collins – Contingent Amounts

In *Collins*, two taxpayers deducted accrued, but unpaid, interest expense in circumstances where they had the right to satisfy all of their interest obligations under an early payout option pursuant to which they could pay a substantially lower amount of interest. In 1983, the taxpayers refinanced an existing mortgage arrangement by entering into an amending agreement, the terms of which provided that the taxpayers were only required to make minimum annual interest payments for each of the first 15 years and the remaining unpaid interest in respect of those 15 years was immediately due at the end of the 16<sup>th</sup> year. In addition, the taxpayers were granted an early payout option where upon the payment of a specified lump sum amount prior to maturity, the taxpayers would not be required to actually pay a large portion of the accrued, but unpaid, interest. The Crown challenged the deduction on the basis that the early payout option made the payment of unpaid interest a contingent liability and, therefore, not deductible. The Federal Court of Appeal found that it was not the original obligation to pay the interest that was contingent, but that it was each taxpayer’s subsequent decision to exercise the early payout option to pay the lower amount that was contingent. Accordingly, the Federal Court of Appeal decided in favour of the taxpayer and upheld the deductions.

In response, the Department of Finance proposes that the amount of a taxpayer's unpaid expenditure otherwise deductible for income tax purposes exclude an amount in respect of which the taxpayer, or a person that does not deal at arm's length with the taxpayer, has a right to reduce or eliminate. This treatment will also apply where the right is contingent upon the happening of another event, or in any other way, if it is reasonable to conclude having regard to all the circumstances that the right will become exercisable. In the *Collins* case, this would mean that the interest payable under the original obligation in excess of the lower amount that the taxpayer could elect to pay would not be deductible for income tax purposes unless and until it was actually paid.

### Lehigh – Stripped Bonds and Withholding Tax

The *Lehigh* decision concerns a Canadian corporation that had borrowed money from a non-resident member of its foreign-based multinational group. Withholding tax under Part XIII of the *Income Tax Act* (Canada) was payable on the interest paid on the loan. In 1997, the interest was stripped from the loan and was sold to an arm's length Belgian bank, but the original residual principal obligation continued to be held by the non-resident member of the multinational group. The issue before the Federal Court of Appeal was whether, in this situation, the general anti-avoidance rule applied to impose Part XIII tax on interest paid to a non-resident person that dealt at arm's length with the Canadian payer, if the principal amount of the debt remained with a non-arm's length non-resident. The Federal Court of Appeal held that it did not.

The Department of Finance proposes that the withholding tax provisions be amended to provide that non-participating interest in respect of a stripped bond can only be paid by a Canadian resident taxpayer to its non-resident holder free of Canadian withholding tax in circumstances where the Canadian resident taxpayer deals at arm's length with *both* the holder of the residual principal obligation and the holder of the stripped bond.



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