February 11, 2014

CANADIAN 2014 FEDERAL BUDGET

The Government of Canada tabled its federal budget for 2014 on February 11, 2014 ("**Budget 2014**"). Since Budget 2014 is in direct competition with the 2014 Winter Olympics in Sochi, Russia, several commentators had (facetiously) predicted that Budget 2014 might struggle to maintain the top news spot in Canada due to a lack of content and that its release may have been timed with that very result in mind. It is true that there is very little in the way of spending measures. Nevertheless, Budget 2014 does contain some key targeted international and domestic tax measures and updates that will be of interest to certain groups of individual and corporate taxpayers.

Budget 2014 seeks input on what Canada's approach should be to address aggressive international tax planning by multinational enterprises and the perceived abuse associated with so-called "treaty shopping". Particular legislation on treaty shopping is not proposed. Rather, Budget 2014 sets out the key pieces to one proposed approach and solicits comments on how that approach might be applied.

Budget 2014 contains measures aimed at stopping perceived abuses of certain provisions of the *Income Tax Act* (Canada) in the international context (involving both inbound and outbound planning), including: (i) proposals to address certain back-to-back loan arrangements involving a Canadian taxpayer, a non-arm's length non-resident and a third-party designed to circumvent Canada's thin-capitalization rules or avoid withholding tax on non-arm's length interest, (ii) tightening up the foreign affiliate property income ("**FAPI**") rules to ensure that insurance swap arrangements cannot be entered into in order to avoid taxation in Canada of offshore income earned by certain Canadian financial institutions, and (iii) significantly restricting the current exception from the "investment business" definition contained in the FAPI rules in respect of certain foreign regulated business activity.

There are a number of restrictive measures in Budget 2014 of particular interest in the domestic context, including: (i) extending the tax on "split income" to income from a business or rental property that is paid or allocated to minor children from certain partnerships and trusts, (ii) eliminating the tax benefits that arise from taxing certain trusts and estates at graduated rates, and (iii) eliminating an exemption from the non-resident trust rules for individuals during their first five years of Canadian residence.

One somewhat fundamental change to Canada's system of taxation is proposed. Budget 2014 announces a consultation process to eliminate the eligible capital property regime in favour of creating a new capital cost allowance class. One hundred per cent (100%) of eligible expenses would be included in the new class (instead of 75% as is currently the case) and written off at a rate of 5% per annum (instead of 7% as is currently the case).

In one very welcome change, Budget 2014 announces that legislation will be introduced to require the Minister of Finance to table annually in Parliament a list of the Government's outstanding tax measures.

Finally, Budget 2014 does include some welcome (although very modest) personal and other income tax spending measures.

INTERNATIONAL MEASURES AND UPDATES

Consultation on Tax Planning by Multinational Enterprises

Budget 2014 confirms Canada's support for the OECD's BEPS project. The project reflects growing concerns about loss of tax revenue due to international tax planning that exploits the interaction between domestic and international tax rules to shift profits away from countries where the income-producing activities take place.

Budget 2014 seeks input from stakeholders on issues related to tax planning by multinational enterprises while maintaining fairness among different categories of taxpayers and protecting the Canadian tax base. The Government is seeking input on the following general questions: (i) what is the impact of international tax planning by multinational enterprises on other participants in the Canadian economy, (ii) which income tax and sales tax issues identified in the OECD BEPS action plan should be considered as highest priorities for examination and potential action, (iii) are there other corporate income tax or sales tax issues related to improving international tax integrity that should be of concern, (iv) what considerations should guide Canada in determining the appropriate approach to responding to the issues identified, and (v) would concerns about maintaining Canada's competitiveness be alleviated by coordinated multilateral implementation of base protection measures. The Government is also seeking comments on actions that may ensure the effective collection of sales tax on e-commerce sales by foreign vendors to Canadian residents.

The Government invites interested parties to submit comments within 120 days after February 11, 2014.

Consultation on "Treaty Shopping"

Budget 2014 does not propose any rules to deal with "treaty shopping". Instead, the Budget notes that the OECD is expected to issue its recommendations on issues relating to treaty shopping in September 2014, which will be relevant in developing a Canadian approach to address treaty shopping.

Budget 2014 also states that an anti-treaty shopping rule will not be retroactive and requests comments on whether transitional relief would be appropriate, suggesting that some grandfathering may be in order.

Budget 2014 sets out the following main elements of a proposed rule to address treaty shopping and invites comments from interested stakeholders:

- *Main purpose provision* – subject to relief, a treaty benefit will be denied if it is reasonable to conclude that one of the main purposes for undertaking a transaction or series of transactions was to obtain a benefit.

- *Conduit presumption* – it will be presumed (subject to proof to the contrary) that one of the main purposes for undertaking a transaction or series of transactions that results in a treaty benefit was to obtain the benefit if the relevant item of income is primarily used to pay, distribute or otherwise transfer, directly or indirectly, at any time or in any form, an amount to another person that would not have been entitled to an equivalent or more favorable benefit had such person received the relevant item of income directly.

- *Safe harbour presumption* – subject to the conduit presumption, it will be presumed, in the absence of proof to the contrary, that none of the main purposes for undertaking a transaction was to obtain a treaty benefit in respect of treaty income if: (i) the relevant person carries on an active business in the state whose treaty with Canada is at issue and, where the relevant treaty income is derived from a related person in Canada, the active business is substantial compared to the activity carried on in Canada giving rise to the relevant treaty income, (ii) the person is not controlled, directly or indirectly in any manner whatever, by another person or persons that would not have been entitled to an equivalent or more favourable treaty benefit had such persons received the treaty income directly, or (iii) the person is a publicly traded corporation or trust.

- *Relieving provision* – if the main purpose provision applies, the treaty benefit is to be provided (in whole or in part) but subject to a reasonability standard.

Budget 2014 invites comments on certain examples in relation to the application of the proposed anti-treaty shopping rule to certain specific arrangements.

Automatic Exchange of Information and U.S. FATCA

Budget 2014 highlights the Government's recent successful negotiation of an intergovernmental agreement with the United States, signed on February 5, 2014, which deals with the transmission to the U.S. Internal Revenue Service of certain information collected by the Canada Revenue Agency (and vice versa) under a new domestic reporting regime that will come into effect in July 2014. A number of registered accounts (including RRSPs, RRIFs, RESPs, RDSPs and TFSAs) and smaller deposit-taking institutions (such as credit unions with assets of less than $175 million) will be exempt from reporting. In the absence of such agreement, Canadian financial institutions and U.S. persons holding financial accounts in Canada would have been required to comply with the *Foreign Account Tax Compliance Act*.

Changes to the FAPI Regime – Captive Insurance/Insurance Swaps

Budget 2014 proposes a targeted measure intended to stop Canadian financial institutions from shifting income from the insurance of Canadian risks to no- or low-tax jurisdictions without that income being recharacterized as FAPI through the use of sophisticated insurance swap transactions.

Under the existing FAPI rules, income from the insurance of Canadian risks earned by a foreign affiliate of a Canadian taxpayer will be recharacterized as FAPI where 10% or more of the gross premium income of the foreign affiliate in respect of all risks insured by the affiliate (net of reinsurance ceded) is premium income from Canadian risks.

Budget 2014 suggests that some foreign affiliates have circumvented this rule by exchanging the insurance of Canadian risks for the insurance of foreign risks while entering into "insurance swap" agreements that ensure the foreign affiliate's overall risk and economic returns are essentially the same as they would be if the foreign affiliate had not entered into the exchange.

Budget 2014 proposes to amend the existing anti-avoidance rule in the FAPI regime relating to the insurance of Canadian risks to *clarify* that it applies where: (i) having regard to arrangements entered into by the foreign affiliate, or a non-arm's length person or partnership, the foreign affiliate's risk of loss or opportunity for gain or profit in respect of one or more foreign risks can, or could if the affiliate had entered into the arrangement

directly, reasonably be considered to be determined by reference to the returns from one or more other risks (the tracked risks) that are insured by other parties, and (ii) at least 10% of the tracked risks are Canadian risks.

Where the rule applies, both the foreign affiliate's income from the insurance of foreign risks and any income from the insurance swap will be FAPI.

Changes to the FAPI Regime – Regulated Foreign Financial Institution Exception

The FAPI regime generally requires that income from property earned by, and income from certain businesses (including "investment businesses") carried on by, a controlled foreign affiliate of a Canadian taxpayer be included in the Canadian taxpayer's foreign accrual property income, which is taxed on an accrual basis. An "investment business" is generally a business the principal purpose of which is to derive income from property and it would include most financial services businesses but for an exception. The exception is for a business carried on by a foreign affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated under the laws of the country in which the business is principally carried on or the laws of one or more other relevant foreign jurisdictions.

According to Budget 2014, certain Canadian taxpayers that are not financial institutions establish foreign affiliates, the businesses of which they attempt to fit within the regulated foreign financial institution exception by electing to subject those affiliates to regulation under foreign banking and financial laws, although the main purpose of those foreign affiliates is to invest or trade in securities on their own account and not to provide financial services. Budget 2014 notes that only *bona fide* financial services businesses are intended to qualify for the exception.

Budget 2014 proposes to address this concern by adding new conditions for qualifying under the regulated foreign financial institutions exception that effectively provide that only a foreign affiliate of a Canadian taxpayer that carries on a regulated financial services business in Canada can qualify for the exception.

The exception will only be available where the following conditions are satisfied:

a) the relevant Canadian taxpayer is a regulated Canadian financial institution (which is a defined term), a subsidiary wholly-owned corporation of such an institution or a corporation that wholly-owns such an institution (and is also subject to regulation), and

b) either

   (i) the financial institution described in (a) has, in general, $2 billion or more in equity, or

   (ii) more than 50% of the taxable capital employed in Canada (as defined in Part I.3 of the *Income Tax Act* (Canada)) of the taxpayer – or a corporation resident in Canada that is related to the taxpayer – is attributable to a regulated financial services business carried on in Canada.

This measure will apply to taxation years that begin after 2014. Stakeholders are invited to submit comments concerning its scope within 60 days after February 11, 2014.

Back-to-Back Loans, Thin-Capitalization and Withholding Tax

Budget 2014 expresses the concern that some taxpayers have sought to avoid the application of Canada's thin-capitalization rules and Part XIII withholding tax to a loan by interposing a third party (such as a foreign bank) between two related taxpayers. These rules would ordinarily apply if the loan were made (and interest paid on the loan) directly between the two taxpayers but would not apply if the loan was "back-to-back" through a third party lender.

Budget 2014 proposes to address these arrangements by adding a specific anti-avoidance rule in respect of withholding tax under Part XIII of the *Income Tax Act* (Canada) on interest payments, and by amending the existing anti-avoidance provision in the thin-capitalization rules.

Pursuant to these rules, a back-to-back loan arrangement will exist where a Canadian taxpayer has an outstanding interest-bearing obligation owing to an intermediary lender and the intermediary (or a non-arm's length person) is pledged property by a non-resident as security for the obligation (guarantees are excluded), is indebted to a non-resident under a limited recourse debt, or receives a loan from a non-resident on condition that a loan be made to the taxpayer.

Where a back-to-back loan arrangement exists, appropriate amounts in respect of the obligation (and interest paid or payable thereon) will be deemed to be owing by the taxpayer to the non-resident person for purposes of the thin-capitalization rules and Part XIII withholding tax will generally apply to the extent that it would otherwise be avoided by virtue of the arrangement.

The taxpayer will be deemed to owe an amount to the non-resident equal to the lesser of the outstanding amount owed to the intermediary and the fair market value of the pledged property, the outstanding amount of the limited recourse debt, or the conditional loan. The taxpayer will also be deemed to have an amount of interest paid or payable to the non-resident person equal to the proportion of the interest paid or payable on the obligation owing to the intermediary that the deemed amount owing is of that obligation.

This measure will apply: (i) in respect of the thin-capitalization rules, to taxation years that begin after 2014, and (ii) in respect of Part XIII withholding tax, to amounts paid or credited after 2014.

PERSONAL MEASURES AND UPDATES

Tax on Split Income

Budget 2014 proposes a targeted measure to maintain the integrity of the taxation on split income. These rules aim to reduce the ability of higher-income taxpayers to split taxable income in an inappropriate manner with lower-income individuals by taxing certain income paid or payable to a minor at the highest marginal tax rate.

The tax on split income does not currently apply to situations where a minor is allocated income from a partnership or trust that is derived from business or rental activities conducted with third parties. Budget 2014 proposes that the definition of "split income" in the *Income Tax Act* (Canada) be modified to include income that is, directly or indirectly, paid or allocated to a minor from a trust or partnership if: (i) the income is derived from a source that is a business or a rental property, and (ii) the person related to the minor is either actively engaged on a regular basis in the activities of the trust or partnership to earn

income from any business or rental property, or has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership). This measure will apply to the 2014 and subsequent taxation years.

Graduated Rate Taxation of Trusts and Estates

Budget 2014 proposes to apply flat top-rate taxation to certain grandfathered *inter vivos* trusts, trusts created by will and certain estates. Two exceptions would be proposed: (i) graduated rates will apply for the first 36 months of an estate that arises on and as a consequence of an individual's death and that is a testamentary trust, and (ii) graduated rates would continue to apply in respect of trusts having as their beneficiaries individuals who are eligible for the federal Disability Tax Credit. Trusts subject to the new rules will also not benefit from special treatment under a number of related tax rules, such as: (i) an exemption from the income tax instalment rules, (ii) an exemption from the requirement that trusts have a calendar year taxation year, (iii) the basic exemption in computing the alternative minimum tax, (iv) preferential treatment under Part XII.2 of the *Income Tax Act* (Canada), (v) classification as a personal trust without regard to the circumstances in which beneficial interests in the trust have been acquired, (vi) the ability to make investment tax credits available to beneficiaries, and (vii) a number of tax administration rules that otherwise apply only to ordinary individuals.

Non-Resident Trusts (Elimination of 60-Month Exemption – Immigration Trusts)

The non-resident trust rules do not apply to deem a trust to be resident and taxable in Canada in circumstances where the contributors to the trust are individuals each of whom is resident in Canada for a total period of not more than 60 months. Budget 2014 proposes to eliminate this 60-month exemption from the deemed residence rules (including related rules that apply to non-resident trusts).

This measure will apply in respect of trusts for taxation years that end after 2014 if: (i) at any time that is after 2013 and before February 11, 2014, the 60-month exemption applies in respect of the trust, and (ii) no contributions are made to the trust on or after February 11, 2014 and before 2015. The measure will apply in respect of trusts for taxation years that end on or after February 11, 2014 in all other cases.

VARIOUS PERSONAL & OTHER SPENDING MEASURES

Budget 2014 contains various personal and other income tax spending measures that can best be described as having a very modest revenue impact on the government:

Adoption Expense Tax Credit – Budget 2014 increases the amount of eligible adoption expenses that adoptive parents may use to claim a tax credit. Currently, adoptive parents may claim a tax credit equal to 15% of eligible adoption expenses up to a maximum of $11,774 per child for 2014. Budget 2014 proposes to increase the maximum amount of eligible expenses from $11,774 to $15,000 per child for 2014.

Medical Expense Tax Credit – this credit is designed to provide relief in respect of above-average medical and disability-related expenses by providing a 15% tax credit for eligible expenses in excess of a particular threshold. Budget 2014 proposes to expand the list of eligible medical expenses to include amounts paid for the design of certain individualized therapy plans, and expenses for service animals specifically trained to assist an individual in managing severe diabetes.

Search and Rescue Volunteers Tax Credit – Budget 2014 proposes a new 15% non-refundable search and rescue volunteers tax credit based on an amount of $3,000 for eligible ground, air and marine search and rescue volunteers.

Extension of the Mineral Exploration Tax Credit for Flow-Through Share Investors – Budget 2014 proposes to extend eligibility for the Mineral Exploration Tax Credit for an additional year to flow-through share agreements entered into on or before March 31, 2015.

Farmers, Fishermen, Intergenerational Rollovers and the Lifetime Capital Gains Exemption – Budget 2014 proposes to adjust the intergenerational rollover rules and the lifetime capital gains exemption to accommodate taxpayers involved in a combination of farming and fishing by ensuring that property used in a combination of such businesses will count towards the requisite "all or substantially all" test contained in those provisions.

Donations of Ecologically Sensitive Land – Budget 2014 proposes to extend to 10 years (from the current 5 years) the carry-forward period for which charitable tax credits, from donations of ecologically sensitive land, or easements, covenants and servitudes on such land, may be used.

Estate Donations – Budget 2014 proposes that donations made by will no longer be deemed to have been made by the deceased immediately before death, but rather by the estate at the time of transfer to a qualified donee. However, the trustee of an individual's estate will have the flexibility to allocate donations to the taxation year of the estate in which the donation is made, an earlier taxation year of the estate, or the last two taxation years of the individual.

Tax Incentives for Clean Energy Creation – Class 43.2, which provides accelerated capital cost allowance in respect of investments in specified clean energy generation and conservation equipment, will be expanded to include investments in water-current energy equipment and equipment used to gasify eligible waste fuel for use in a broader range of applications.

CONSULTATION ON ELIGIBLE CAPITAL PROPERTY REGIME

In an effort to simplify the current eligible capital property regime, Budget 2014 announces a public consultation on a proposal to repeal the eligible capital property regime and replace it with a new capital cost allowance class available to businesses. Existing cumulative eligible capital pools would be transferred to the new class. Moreover, existing capital cost allowance rules would generally apply to the new class. Detailed legislative proposals will be released for comment in the near future. This proposal is not intended to affect the application of Goods and Services Tax / Harmonized Sales Tax in this area.

Budget 2014 outlines some proposed rules for stakeholders to consider. Expenditures that currently qualify to be added to cumulative eligible capital at a 75% inclusion rate would be included in the new capital cost allowance class at a 100% inclusion rate. Because of the increased expenditure recognition, the new class would have a 5% annual depreciation rate instead of the current 7% rate that applies in respect of eligible capital expenditures.

Special rules would apply in respect of goodwill and in respect of expenditures that do not relate to a specific property of the business and that would be eligible capital expenditures or eligible capital receipts under the existing eligible capital property regime. It is proposed that existing cumulative eligible capital pool balances would be calculated and transferred to the new class as of an implementation date on a dollar-for-dollar basis. This would result in an economic disadvantage, given that only 75% of an expenditure would have originally

been added to the pool. However, the depreciation rate for the first 10 years for the new class would be set at 7% for expenditures incurred before the implementation of the new rules – presumably as a way to compensate for the disadvantage discussed above.

CONSULTATION ON NON-PROFIT ORGANIZATIONS

Paragraph 149(1)(l) of the *Income Tax Act* (Canada) exempts from tax an organization that is a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or for any other purpose except profit if it meets certain additional conditions.

In response to concerns that some non-profit organizations may be improperly earning profits that are not incidental to carrying out the entity's non-profit purposes, making income available for the personal benefit of members, or maintaining large reserves, Budget 2014 announces the Government's intention to review whether the income tax exemption for non-profit organizations remains properly targeted and whether sufficient transparency and accountability provisions are in place. This review will also address reporting and disclosure requirements for non-profit organizations.

The Government will release a consultation paper for comment and will further consult stakeholders as appropriate.

GST/HST MEASURES

Budget 2014 announces a few relevant GST/HST measures as well. Prime among these measures are changes to the election for nil consideration among closely related persons, contained in section 156 of the *Excise Tax Act* (Canada) (the "ETA"). Effective January 1, 2015, an election under section 156 must be filed with the CRA in prescribed form and within a specified time (instead of simply being retained on file, as is currently the case). Parties to an election made prior to January 1, 2015 but effective on that date will have until January 1, 2016 to file a new election. A new provision in section 156 will also subject the parties to an election to joint and several liability with respect to a failure to account for or pay any GST/HST as and when required, if the tax is attributable to a supply made between the parties at a time when the election is in effect or when the parties conduct themselves as if the election is in effect. The definition of "qualifying member" is amended to include new members that may not have acquired any property provided such members continue as going concerns engaged exclusively in commercial activities.

In order to strengthen compliance with the ETA, Budget 2014 also gives the Minister of National Revenue the discretionary authority to automatically register a person for GST/HST purposes if such person fails to register of its own accord after having been notified of the requirement to register. Automatic registration in this manner will be effective no earlier than 60 days from the date of a notice requiring such person to register.

Budget 2014 also proposes to introduce legislation (later in the year) to make joint venture elections available for more commercial joint ventures and participants, concurrently with anti-avoidance measures. Currently, the election (allowing an "operator" to account for all GST/HST on behalf of all joint venture participants) is only available for limited activities (even though the *Joint Venture (GST/HST) Regulations* were amended in 2011 to increase the list of activities). Budget 2014 proposes to amend this list to allow joint venture participants to make the election as long as the activities of the joint venture are exclusively commercial and the participants are engaged exclusively in commercial activities. Stakeholders will be allowed to provide their views on the proposed legislation.

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