Federal Budget Tax Proposals and the Capital Markets

The March 19th federal budget included two welcome proposals intended to make Canada's capital markets more attractive to foreign investors and to allow Canadian investors greater access to foreign capital markets. These policy objectives are to be achieved by updating the concept of "prescribed stock exchange" that is currently used in the *Income Tax Act* (Canada) (the "*Tax Act*") and by broadening the types of securities that are qualified investments for deferred income plans, such as RRSPs.

Prescribed Stock Exchanges

Current Use of the "Prescribed Stock Exchange" Concept

The *Tax Act* currently treats securities listed on a "prescribed stock exchange" differently from those that are not. A stock exchange is prescribed if it is identified in one of two lists contained in the *Income Tax Regulations* (one for Canadian stock exchanges and one for foreign stock exchanges). If a stock exchange is prescribed, a share listed on the exchange is subject to a number of tax consequences, including:

- the share is a qualified investment for RRSP purposes;
- even if it is a share of a Canadian company, the share will typically not be "taxable Canadian property" - meaning that a non-resident who disposes of the share will not be subject to Canadian tax on any resulting capital gain and the withholding procedure under section 116 of the *Tax Act* will not apply;
- if the share is taxable Canadian property, a person who acquires it from a non-resident is exempted from the usual requirement to withhold 25% of the proceeds on account of the non-resident's potential Canadian tax liability (the withholding procedure under section 116 of the *Tax Act*);
- the share may be lent under a securities lending arrangement;
- there is a capital gains exemption for certain charitable donations of the share;
- where the prescribed stock exchange in question is located in Canada, the corporation that issued the share is a public corporation for tax purposes; and
- where the share is acquired under an employee stock option, the employee may be able to defer taxation of the associated employment benefit.

The list of prescribed stock exchanges has taken on added significance in recent years with the popularity of the Alternative Investment Market of the London Stock Exchange (typically called the AIM market). As the AIM is not a prescribed stock exchange, Canadian companies looking to list there have been forced to jointly list on a prescribed stock exchange (usually the TSX or the TSX-V) or use a more cumbersome mutual fund corporation structure in order to prevent the Canadian company's shares from being "taxable Canadian property" and subjecting foreign investors to Canadian tax and section 116 reporting and withholding obligations. The budget proposal specifically refers to the AIM and the proposed changes will apparently eliminate this concern, at least with respect to section 116 withholding tax requirements.

Proposed Changes

The budget proposes to replace the two existing lists of prescribed stock exchanges with a new 3-tier system:

1. Designated Stock Exchange

The "designated stock exchange" category will consist of stock exchanges that have been designated by the Minister of Finance, and will include all existing stock exchanges that are currently prescribed in the *Income Tax Regulations*. The Minister's designation, which will be carried out by way of public notice, will be both necessary and sufficient for a stock exchange to be a designated stock exchange.

This category will initially apply for the purposes of all current references to "prescribed stock exchange" in the *Tax Act*, other than the section 116 withholding procedure and the securities lending rules. Accordingly, the determination of whether a share of a Canadian company is "taxable Canadian property" will be based on the "designated stock exchange" category.

The budget papers do not indicate whether any specific stock exchanges which are currently not “prescribed stock exchanges”, such as the AIM, the Canadian Venture Exchange (CDNX) and CNQ, will become designated stock exchanges.

2. Recognized Stock Exchange

The “recognized stock exchange” category will consist of stock exchanges that are located in Canada or in another country that is a member of the Organisation for Economic Co-operation and Development (OECD) and that has a tax treaty with Canada.[1] This category will also include all designated stock exchanges. There will be no formal identification of recognized stock exchanges. Rather, a stock exchange is a recognized stock exchange based strictly on its location, and not (except in the case of a designated stock exchange) by any action on the part of the Minister.

This category will apply for the purpose of the section 116 withholding procedure, meaning that non-resident vendors of shares listed on one of these exchanges will be exempt from the capital gains tax withholding and reporting requirement. However, whether or not the shares are taxable Canadian property will be unaffected. Non-residents who dispose of taxable Canadian property will still be required to file a Canadian income tax return.

The AIM will fall within the recognized stock exchange category.

3. Stock Exchange

The “stock exchange” category will include any stock exchange, regardless of where located, and will include all designated and recognized stock exchanges. As in the case of a recognized stock exchange, there will be no process by which an entity is formally identified as a "stock exchange". Instead, it is intended that the general legal and commercial meaning of the term will govern. This category will be used for the purposes of the securities lending rules.

According to the budget proposals, most tax provisions that now refer to "prescribed stock exchange" will initially refer to "designated stock exchange". Over time, the Government will review the appropriateness of using the second and third categories for certain of those provisions.

These changes are proposed to be effective upon Royal Assent to the necessary amending legislation.

<u>Qualified Investments for RRSPs</u>

In an attempt to provide Canadian registered plan investors with greater investment choice and opportunities for portfolio diversification, the March 19th budget proposes to extend eligibility status to:

- any debt obligation that has an investment grade rating and that is part of a minimum $25 million issuance; and

- any security that is listed on a designated stock exchange (other than a futures contract or other derivative instrument in respect of which the holder’s risk of loss may exceed the holder’s cost).

This proposal goes beyond company shares listed on designated stock exchanges and will include investments in foreign-listed trust and partnership units and Canadian dollar bonds issued by foreign entities.

As mentioned above, the budget papers do not provide any guidance on whether any specific stock exchanges which are currently not “prescribed stock exchanges”, such as the AIM, CDNX and CNQ, will become designated stock exchanges and thereby make their listed securities qualified investments for RRSPs.

These changes are effective after March 18, 2007.

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[1] The countries that currently fall into this category are: Australia, Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States.