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Federal Budget 2016 – Did it Live Up to the Hype?

Budget 2016 was arguably one of the most anticipated budgets in recent history. Between the wide ranging promises made by the Liberals during the election to swirling rumours (are capital gains rates going up?!), many in the tax world thought the sky might be falling. In the end, Budget 2016 wasn't earth shattering. Most of the announcements could be categorized as tweaks to fix perceived problems rather than fundamental changes in taxation. Many of the measures are consistent with the Federal Government's focus on climate change and higher taxation for "wealthy" Canadians.

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What wasn't in the Budget:

1. Major changes to small business taxation: Professional corporations and other businesses with few employees were left untouched and the kiddie tax wasn't expanded to include spouses.
2. Changes to stock option taxation.
3. An increase in the capital gains inclusion rate.

What was in the Budget:

1. Measures aimed at unfair advantages of "wealthy" Canadians.
2. New anti-avoidance provisions for the small business deduction.
3. New anti-avoidance measures for certain insurance transactions.
4. Incentives to support green energy.
5. Enactment of changes to "eligible capital property".
6. Narrowing eligibility for GST/HST closely related election.

Personal Tax Measures

Consistent with their election platform, the Federal Government announced it was repealing several measures which they perceive as primarily benefitting Canada's top earners. These actions include:

(a) repealing the income splitting credit for couples with at least one child under the age of 18 for 2016 taxation year onwards.

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(b) terminating the Budget 2015 proposal to exempt capital gains on dispositions of real property and private shares where the proceeds were donated to charity.

(c) repealing the Universal Child Care Benefit and Canada Child Tax Benefit and replacing them with a means based Canada Child Benefit effective July 1, 2016.

(d) eliminating the education and textbook tax credits effective January 1, 2017. The tuition tax credit will still be available and unused education and textbook credit amounts can be carried forward to 2017 and subsequent tax years.

(e) reducing the Children's Fitness and Arts tax credits in 2016 and eliminating the credits completely for the 2017 and subsequent taxation years.

Small Business Tax Measures

Small Business Tax Rate Stays Put

The small business tax rate for Canadian-controlled private corporations ("CCPCs")was scheduled to be phased down to 9% by 2019. In a change from their election platform, the Federal Government announced in Budget 2016 that it will keep the small business tax rate at 10.5% for future tax years.

Restrictions on Multiplying the Small Business Deduction

The Federal Government has expressed concern that taxpayers are using structures to inappropriately multiply the small business deduction within a group. A common structure is to have a corporation owned by a spouse provide services to a corporation or partnership of which the other spouse is a shareholder or partner. As there is no cross-ownership, the two corporations (or the corporation and the partnership) are not required to share the small business deduction.

In general terms, a CCPC that is a member of a partnership is entitled only to a pro-rata allocation of a notional $500,000 business limit determined at the partnership level (its "SPI limit"), which must be shared among all the partners. Budget 2016 proposes to expand the anti-avoidance rules to capture structures in which a CCPC provides services or property to a partnership in an attempt to multiply access to the small business deduction within a group.

Under the Budget proposals, if a CCPC provides property or services to a partnership and the CCPC or a shareholder of the CCPC is a member of the partnership, or does not deal at arm's length with a member of the partnership, any active income earned by the CCPC from providing such services or property will be deemed to be partnership income. This effectively limits the CCPC's access to the small business deduction to its SPI limit for this income.

The Federal Government notes that similar planning can also be achieved within a corporate structure where a CCPC provides services to or property to another related corporation (but with which it is not associated). Accordingly, Budget 2016 proposes that a CCPC's active business income from providing services or property to a private corporation will be ineligible for the small business deduction where the CCPC, one of its shareholders or person who does not deal at arm's length with such a shareholder has a direct or indirect interest in the private corporation.

These proposals could have a significant impact on corporate groups with related members. All arrangements where a corporation is providing services or property to another member of a group should be reviewed.

Preventing Recharacterization of Investment Income as Active Business Income

Under the current rules, a CCPC's investment income (e.g., rent or interest) may be re-characterized as active income eligible for the small business deduction if that income is derived from the active business of an associated corporation. This is generally accomplished by one corporation in an associated group filing an election which (i) deems the corporation not to be an associated corporation for purposes of the small business deduction and (ii) makes the corporation ineligible to claim the small business deduction. However, the corporations in the group continue to be associated for purposes of the income re-

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characterization rules despite the election. This can result in a situation where the other corporations each claim the small business deduction on investment income earned from the electing corporation even though the electing corporation itself is not entitled to claim the small business deduction.

Budget 2016 proposes to amend the current rules to ensure that investment income derived from an associated corporation's active business will be ineligible for the small business deduction and will be taxed at the general corporate rate in cases where an election not to be associated has been made. In addition, where this exception applies, the electing corporation will continue to be associated with the other corporations in the group for the purpose of applying the $15 million taxable capital limit.

Greater Taxation of Insurance Policy Proceeds

Significant changes to the taxation of insurance have been announced in previous budgets and become effective on January 1, 2017. The measures announced in Budget 2016 in respect of insurance respond to specific perceived abuses involving corporations and partnerships.

The Federal Government indicated it was concerned that insurance was being used to allow shareholders of corporations or partners of partnerships to extract funds tax free which should be taxable. To eliminate this benefit, Budget 2016 proposes specific technical amendments to restrict the ability to artificially increase a corporation's capital dividend account or the adjusted cost base of a partnership interest. The proposed amendments could impact structures implemented before and after the Budget Date.

Similarly, the Federal Government expressed concern that policyholders were inappropriately receiving amounts tax free on the transfer of an insurance policy to a corporation or a partnership. Budget 2016 proposes amendments to the policy transfer rule to include the fair market value of any consideration received by the policyholder as proceeds of disposition. These proposals would impact transfers of policies from Budget Day onwards. In addition, if a policy is transferred to a corporation or partnership as a contribution of capital, the increase in the paid-up capital of the shares or the adjusted cost base of the partnership interest will be limited to the proceeds of disposition. These proposed amendments will impact transfers completed before and after the Budget Date.

Incentives to Support Climate Change

In support of the Federal Government's focus on climate change, Budget 2016 introduced accelerated capital cost allowance (Classes 43.1 and 43.2) for certain clean energy generation and conservation equipment, electric vehicle charging stations and electrical energy storage. If the majority of the project's tangible property is eligible for Classes 43.1 and 43.2, certain intangible project start-up expenses can be treated as Canadian renewable and conservation expenses ("CRCE"). CRCE can be fully deducted in the year incurred, carried forward indefinitely or transferred to investors through flow-through shares.

Overhaul of Eligible Capital Property Regime

In Budget 2014, the Federal Government announced a consultation on the conversion of eligible capital property ("ECP") into a new class of depreciable property. The Federal Government stated that it wished to simplify the tax compliance burden on taxpayers relating to the accounting for goodwill. In Budget 2016, the Federal Government followed through with its initiative by proposing to repeal the ECP regime and replace it with a new capital cost allowance ("CCA") class.

Under the current rules, 75% of eligible capital expenditures (such as customer lists, licences, franchise rights and the acquisition of goodwill) are included in a cumulative eligible capital ("CEC") pool. A deduction can be claimed at the rate of 7% per year on a declining balance basis. Up to 75% of the proceeds received on the disposition of ECP will reduce the CEC pool. If the receipts exceed the CEC pool, the excess first recaptures any previously claimed deductions. The remainder is included in business income at a 50% inclusion rate.

Budget 2016 introduces a new class

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of depreciable property for CCA purposes, namely Class 14.1. Starting January 1, 2017, 100% of expenditures that would previously have been included in the CEC pool will be included in Class 14.1. As a result of the increased inclusion rate, the new Class 14.1 will have a 5% (declining balance) annual depreciation rate (instead of a 7% of 75% of eligible capital expenditures). To retain the simplification objective, the rules that currently apply to depreciable property such as the "half-year rule", recapture and capital gains will apply to the properties included in this class.

In order to facilitate the addition of all types of ECP into Class 14.1, special rules will apply to goodwill and expenditures and receipts that do not relate to a specific property of the business that would be eligible capital expenditures or eligible capital receipts under the current ECP regime.

Expenditures that do not relate to a particular property will increase the capital cost of the goodwill of the business and, consequently, the balance of the Class 14.1 pool. A receipt that does not relate to specific property will reduce the capital cost of the goodwill of the business and therefore the balance of the Class 14.1 pool, by the lesser of the capital cost of the goodwill (which may be nil) and the amount of the receipt. Any excess will be treated as a capital gain. Any previously deducted CCA will be recaptured to the extent that the receipt exceeds the balance of the Class 14.1 pool.

Under the proposed rules, CEC balances will be transferred to the new Class 14.1 pool as of January 1, 2017, including for taxpayers whose taxation year straddles January 1, 2017. The opening balance of the Class 14.1 pool will be equal to the CEC balance as at December 31, 2016. The CCA depreciation rate for property included in the Class 14.1 pool related to expenditures incurred before January 1, 2017 will be 7% until 2027.

Qualifying amounts received on a disposition after December 31, 2016 that relate to property acquired or expenditures made before January 1, 2017, will reduce the Class 14.1 pool at a 75% rate. Receipts that do not represent the proceeds on the disposition of property will also be included in the 75% rate.

While conversion of the ECP into a new class of depreciable property may simplify the tax compliance burden on taxpayers relating to the accounting for goodwill, a gain on the sale of goodwill will now give rise to a capital gain (i.e., investment income). The current tax planning deferral opportunity for Canadian private companies on active business income on a sale transaction will be eliminated. According to the Federal Government, this outcome is consistent with the overall intent of the proposal to treat ECP as a type of depreciable property.

Stricter Conditions for GST/HST Closely Related Persons Election

Currently under the *Excise Tax Act* (Canada), groups of corporations and/or partnerships that are "closely related" can elect that supplies made within the group are effectively made without GST/HST. For a subsidiary corporation to qualify as "closely related" to its parent corporation or partnership, the parent must own 90 percent or more of the value and number of shares with full voting rights in all circumstances. Budget 2016 proposes to change this test such that a parent must also hold and control 90 percent or more of the votes in respect of every corporate matter. This measure appears to address circumstances where a shareholders agreement or other arrangement allocates significant control over various corporate decisions to an unrelated shareholder while the parent maintains all or substantially all voting rights. The measure applies immediately to newly filed section 150 and 156 elections. The measure will apply to existing elections on March 22, 2017.

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