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2016 Federal Budget

2016 Federal Budget – March 22, 2016

A summary of the key tax measures that may have a direct impact on you

Federal Minister of Finance, Bill Morneau, delivered the Liberal Government's budget on March 22, 2016. The budget focuses on growing the economy, creating jobs and strengthening the middle class.

Many of the budget's tax measures are aimed at tightening perceived loopholes or inequalities in various aspects of the tax system. Several budget changes have been proposed to prevent tax evasion and improve tax compliance. The budget proposes to provide the Canada Revenue Agency (CRA) with significant financial support to improve its ability to collect outstanding tax debts.

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Prior to implementing any strategies, individuals should consult with a qualified tax advisor, legal professional or other applicable professional.

While it has been the long-standing practice of the CRA to allow taxpayers to file their tax returns based on proposed legislation, a taxpayer remains potentially liable for taxes under current law in the event that a budget proposal is not ultimately passed. Therefore, if proposed legislation does not become law, it is possible that the CRA may assess or re-assess your tax return based on existing legislation. It is recommended that you consult a professional tax advisor to assist you in assessing the costs and benefits of proceeding with specific budget proposals as they relate to you.

Personal Tax Changes

Restoring the Age of Eligibility for Old Age Security (OAS)

The budget proposes to cancel the scheduled increase of the age of eligibility for OAS, guaranteed income supplement (GIS) and allowance benefits. In the 2012 budget, it was announced that starting on April 1, 2023, the age of eligibility for OAS and GIS would be increased from age 65 to 67 and the age of eligibility for allowance benefits from age 60 to 62. Other OAS changes announced in 2012, such as the ability to defer taking OAS for an increased OAS benefit, have not been changed.

Switch Fund Shares

Canadian mutual funds can be in the legal form of a trust or a corporation. Many of these mutual fund corporations are organized as "switch funds". Investors of switch funds are able to exchange shares of one class of the mutual fund corporation for shares of another class in order to switch their economic exposure between the mutual fund corporation's different funds without realizing a disposition for tax purposes. This deferral benefit is available to investors of switch funds but not available to taxpayers who invest in mutual fund trusts or directly in securities.

To ensure the appropriate recognition of capital gains, the budget proposes to deem the exchange of shares of a mutual fund corporation that results in the investor switching between funds, to be a disposition at fair market value for tax purposes. The measure will not apply to switches where the shares received in exchange differ only in respect of management fees or expenses to be borne by investors and otherwise derive their value from the same portfolio or fund within the mutual fund corporation (e.g., the switch is between different series of shares within the same class).

This measure will apply to dispositions of shares that occur after September 2016.

Linked Notes

A linked note is a debt obligation where the return on the note is linked to the performance of one or more reference assets or indices. Therefore, the return is variable and can only be determined, generally, shortly before maturity.

Investors are to accrue the maximum amount of interest payable on a prescribed debt obligation in a given taxation year. Generally, investors take the position that there is no accrual of interest on the linked note prior to the maximum amount of interest becoming determinable. Instead, the full amount of the return on the note is included in income in the year the return is determinable (at maturity).

For investors who take the position that there is no accrued interest prior to maturity date, they can sell the note prior to maturity and realize a capital gain on the return on the note if they hold the note as capital property. As a result, the investor reports 50% of the return as taxable income rather than 100% of the return.

The budget proposes to treat any gain realized on the sale of a linked note as interest that accrued on the note. If the note is denominated in a foreign currency, foreign currency fluctuations will be ignored for the purposes of calculating the gain. Where a portion of the return on the linked note is based on a fixed rate of interest, any portion of the gain that is reasonably attributable to market interest rate fluctuations will be excluded.

This measure will apply to dispositions of linked notes that occur after September 2016.

Consequential Changes Due to the New Higher Personal Tax Rate

The budget proposes to make changes to other tax rules that either use or are affected by the introduction of the top personal tax rate of 33%. The budget proposes to:

- Provide a 33% charitable donation tax credit (on donations above $200) to trusts that are subject to the 33% tax rate on all of their taxable income;
- Apply the new 33% tax rate on excess employee profit sharing plan contributions;
- Increase the tax rate on personal services business income earned by corporations from 28% to 33%; and
- Amend the recovery tax rule for qualified disability trusts to refer to the 33% tax rate.

These measures will apply to the 2016 and subsequent taxation years. The increase to the charitable donation tax credit will be limited to donations made after the 2015 taxation year. In the case where personal services business income earned by a corporation is earned in a taxation year that straddles 2015 and 2016, the rate increase will be prorated.

The measure will also extend the proposed 33% charitable donation tax credit in Bill C-2 (which applies to donations made after 2015) to be available for donations made by a graduated rate estate during a taxation year of the estate that straddles 2015 and 2016.

Canada Child Benefit

There are currently two federal benefits, the Canada child tax benefit (CCTB) and the universal child care benefit (UCCB), that provide financial assistance to families with children under age 18.

To simplify existing child benefits and ensure help is better targeted to those who need it the most, the budget proposes to replace the CCTB and UCCB with a new Canada Child Benefit beginning July 1, 2016. The Canada Child Benefit will be income-tested and phased out as shown in the table.

	Phase out rates		Eliminated when income reaches	
	$30,000 -	Over		
Number of children	$65,000	$65,000	< age 6	age 6 -17
1	7.0%	3.2%	$189,000.00	$157,000.00
2	13.5%	5.7%	$207,000.00	$172,000.00
3	19.0%	8.0%	$222,000.00	$185,000.00
4	23.0%	9.5%	$250,000.00	$208,000.00

The child disability benefit of $2,730 per month will remain but be phased out for families with incomes above $65,000 and at the same rates as the Canada Child Benefit.

Income Splitting Credit (Family Tax Cut)

A non-refundable income-splitting tax credit is available to couples with at least one child under 18 years of age. It was introduced to allow a higher–income spouse or common-law partner to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner to reduce the family's total income tax liability by up to $2,000. The budget proposes to eliminate the Family Tax Cut for 2016 and subsequent taxation years.

Education and Textbook Tax Credits

Currently, students are eligible for three non-refundable tax credits. The budget proposes to eliminate the education and textbook credits. The education tax credit is 15% of $400 per month for full-time students and 15% of $120 for part-time students. The textbook tax credit is 15% of $65 per month for full-time students and 15% of $20 for part-time students. The tuition tax credit which is 15% of the amount of eligible tuition fees paid will still be available to students.

Changes will be made to ensure that other income tax provisions that rely on eligibility for the education tax credit, such as tax exemption for scholarship income, will be unaffected by its elimination.

This measure will apply beginning January 1, 2017. Unused education and textbook credit amounts carried forward from prior years will remain available to be claimed in 2017 and subsequent years.

Children's Fitness and Arts Tax Credits

The budget proposes to phase out the children's fitness and arts tax credits by reducing the 2016 maximum eligible amounts from $1,000 to $500 for the children's fitness tax credit and from $500 to $250 for the children's arts tax credit. The children's fitness tax credit will remain refundable. Both credits will be eliminated beginning 2017. The supplemental amounts for children eligible for the Disability Tax Credit will remain at $500 for 2016.

Labour-Sponsored Venture Capital Corporations (LSVCCs) Tax Credit

The budget proposes to restore the LSVCC tax credit to 15% for share purchases of provincially registered LSVCCs prescribed under the Income Tax Act for the 2016 and subsequent taxation years. The LSVCC tax credit was previously reduced and scheduled to be eliminated in 2017.

Mineral Exploration Tax Credit

The budget proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2017.

Enhancing the Canada Pension Plan (CPP)

In December 2015, the Government began discussions with provinces and territories on enhancing the CPP. In the coming months, the Government will launch consultations to give Canadians an opportunity to share their views on enhancing the CPP.

Business Tax Changes

Small Business Tax Rate

Small businesses benefit from a reduced federal corporate income tax rate of 10.5% on the first $500,000 of qualifying active business income earned by a Canadian-controlled private corporation (CCPC). Gradual reductions in the small business tax rate are currently legislated for 2017, 2018 and 2019. However, the budget proposes that the small business tax rate remain at 10.5% after 2016.

Consequently, to preserve the integration of the personal and corporate income tax systems, the budget also proposes to maintain the current gross-up factor and dividend tax credit (DTC) rate applicable to non-eligible dividends. The gross-up factor applicable to non-eligible dividends will remain at 17% and the corresponding DTC rate at 10.5% of the grossed-up dividend amount.

Multiplication of the Small Business Deduction

The small business deduction reduces the federal corporate income tax rate applying to the first $500,000 per year of qualifying active business income of a CCPC. There is a requirement to allocate the annual eligible income limit of $500,000 among associated corporations. Where a business is carried on through a partnership, the members of the partnership share one $500,000 limit in respect of that business. In addition, there are rules that are intended to prevent the multiplication of access to the small business deduction. The budget proposes changes to address concerns about partnership and corporate structures that multiply access to the small business deduction.

An example of how a partnership may have been used to multiply access to the small business deduction is where a shareholder of a CCPC is a member of a partnership and the partnership pays the CCPC as an independent contractor under a contract for services. As a result, the CCPC claims a full small business deduction in respect of its active business income earned in respect of the partnership because, although the shareholder of the CCPC is a member of the partnership, the CCPC is not a member.

To address this tax planning, the budget proposes to extend the specified partnership income rules to partnership structures in which a CCPC provides, directly or indirectly, services or property to a partnership during a taxation year of the CCPC where, at any time during the year, 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. In this case the CCPC will be a deemed member of the partnership. A CCPC that is a deemed member of a partnership will have its active business income from providing services or property to the partnership deemed to be partnership active business income. In effect, the result of the proposed legislation is that the CCPCs that are deemed members or actual members of the same partnership will have to share one small business deduction.

Similar rules also apply where CCPCs are providing services or property to a private corporation instead of a partnership.

Generally, this measure will apply to taxation years that begin on or after March 22, 2016.

Eligible Capital Property

The eligible capital property (ECP) regime governs the tax treatment of eligible capital expenditures that are generally of an intangible nature. Eligible capital expenditures include the cost of goodwill when a business is purchased, licences, franchises and quotas of indeterminate duration.

The budget proposes to replace the ECP regime with a new class of depreciable property that will be subject to the capital cost allowance (CCA) rules.

Under the current system, 50% of the gain resulting from the sale of ECP is included as active business income. Under the proposed rules, the gain from the sale of ECP will be treated as capital gains. Capital gains are taxed at a higher rate than active business income in a CCPC. These proposed changes may, in effect, increase the taxes paid on the disposition of ECP by a CCPC.

Starting January 1, 2017, 100% of expenditures that would previously have been included in the CEC pool will be included in the new proposed CCA class.

To reduce the compliance burdens for businesses with relatively small eligible capital expenditures that arise solely due to incorporation expenses, the budget proposes to allow the business to deduct the first $3,000 of incorporation expenses as a current expense instead of having these expenses added to the new CCA class.

These measures will apply beginning January 1, 2017. Transitional rules apply to implement these new measures.

Life Insurance

Distributions Involving Life Insurance Proceeds

A death benefit from a life insurance policy is generally not subject to income tax. A private corporation may add only the portion of the death benefit received that is in excess of the adjusted cost base (ACB) of the policy to the capital dividend account (CDA) of the corporation. A private corporation may elect to pay a dividend as a capital dividend to the extent that the corporation's CDA has a positive balance. Capital dividends are received tax-free by shareholders.

Some taxpayers have structured their affairs so that the calculation of the amount that can be added to the CDA may not apply as intended, resulting in an artificial increase in a corporation's CDA balance. This allows the corporation to pay a larger tax-free capital dividend to its shareholders.

The budget proposes to amend the Income Tax Act to ensure that the CDA rules for private corporations apply as intended. This measure will provide that the rules for calculating the amount to be added to the CDA apply regardless of whether the corporation that receives the policy benefit is a policyholder of the policy. The budget also proposes to introduce information-reporting requirements that will apply where a corporation is not a policyholder but is entitled to receive a policy benefit.

The budget proposes to apply similar rules to partnership interests.

This measure will apply to policy benefits received as a result of a death that occurs on or after March 22, 2016.

Transfers of Life Insurance Policies

Where a policyholder disposes of an interest in a life insurance policy to an arm's length person, the fair market value of any consideration received is included in computing the proceeds of disposition. In contrast, where a policyholder disposes of such an interest to a non-arm's length person, a special rule (the "policy transfer rule") deems the policyholder's proceeds of disposition, and the acquiring person's ACB, of the interest to be the cash surrender value of the policy.

Where the policy transfer rule applies, any consideration received by the policyholder in excess of the cash surrender value is not taxed as income under the rules. In addition, this excess will not be added to the ACB of the policy for the transferee. Where the policy benefit is received by a private corporation and the proceeds in excess of the policy's ACB is added to the corporation's CDA, an amount can be paid tax-free to that corporation's shareholders. Where this is the case, the amount of the excess is effectively extracted from the private corporation a second time as a tax-free, rather than as a taxable, amount.

The budget proposes amendments to the Income Tax Act to ensure that amounts are not inappropriately received tax-free by a policyholder as a result of a disposition of an interest in a life insurance policy. The proposed measure will, in applying the policy transfer rule, include the fair market value of any consideration received for an interest in a life insurance policy in the policyholder's proceeds of disposition and the acquiring person's cost. In addition, where the disposition arises on a contribution of capital to a corporation or partnership, any resulting increase in the paid-up capital in respect of a class of shares of the corporation, and the ACB of the shares or of an interest in the partnership, will be limited to the amount of the proceeds of the disposition.

This measure will apply to dispositions that occur on or after March 22, 2016.

The budget also proposes to amend the CDA rules for private corporations. This amendment will apply where an interest in a life insurance policy was disposed of before March 22, 2016 for consideration in excess of the cash surrender value. In this case, the amount of the policy benefit otherwise permitted to be added to a corporation's CDA, will be reduced by the amount of the excess. In addition, where an interest in a life insurance policy was disposed of before March 22, 2016 under the policy transfer rule to a corporation as a contribution of capital, any increase in the paid-up capital in respect of a class of shares of the corporation, and the ACB of the shares that may otherwise have been permitted will be limited to the amount of the proceeds of disposition.

This measure will apply in respect of policies under which policy benefits are received as a result of deaths that occur on or after March 22, 2016.

Other Measures

Strengthening International Tax Integrity

Internationally, Canada is actively engaged in coordinated multilateral efforts to address base erosion and profit shifting (BEPS) and to increase transparency through the automatic exchange of financial account information between tax authorities. The Government of Canada is acting on certain recommendations of the BEPS project and introducing a number of tax measures to protect the integrity of Canada's tax system and to protect Canada's revenue base.

Status of Outstanding Tax Measures

The budget confirms the Government's intention to proceed with the following tax and related measures, as modified, to take into account consultations and deliberations since they were announced:

- Legislative proposals for certain trusts and their beneficiaries (draft legislative proposals were released for comment on January 15, 2016);
- The conversion of capital gains into tax-deductible inter-corporate dividends (section 55); and
- The acquisition or holding of limited partnership interests by registered charities.

The budget also announces the Government's intention not to proceed with the measure announced in Budget 2015 that would provide an exemption from capital gains tax for certain dispositions of private corporation shares or real estate where cash proceeds from the disposition are donated to a registered charity or other qualified donee within 30 days.

The budget did not provide any changes to stock options that were mentioned in the Liberal's election platform. Therefore, the existing tax treatment continues to apply.

Please contact us for more information about the topics discussed in this article.

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