Wealth Management

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# 2017 Federal Budget

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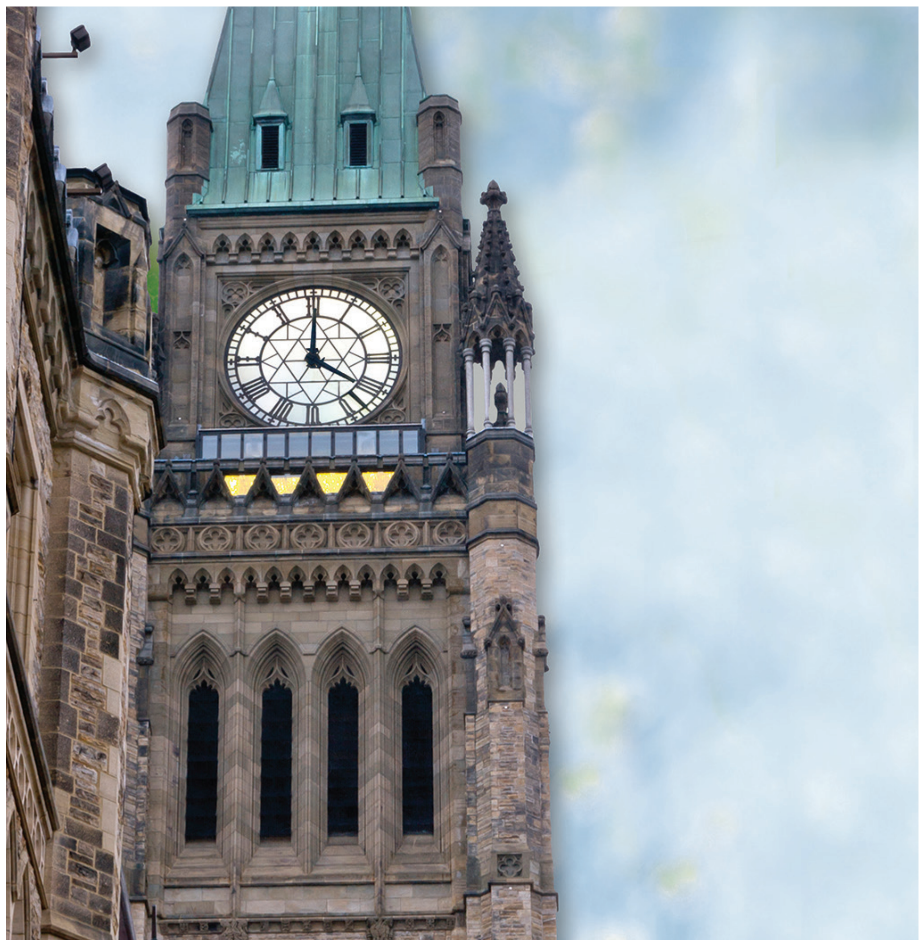

## Key tax measures that may have a direct impact on you

# 2017 Federal Budget – March 22, 2017

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

The Liberal government's Federal Minister of Finance, Bill Morneau, delivered the 2017 federal budget on March 22, 2017. The budget contains numerous tax measures, many of which are not significant in nature.

The budget does not propose a change to the current capital gains inclusion rate of 50%.

*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 Canada Revenue Agency (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

### Tax credit changes

- **Mineral exploration credit** – The budget proposes to extend eligibility for the tax credit for one year, to flow-through share agreements entered into on or before March 31, 2018.

- **Public transit credit** – The budget proposes to eliminate this credit effective July 1, 2017. The cost of public transit passes for public transit use after June 30, 2017 will no longer be eligible for the credit.

- **Disability tax credit (DTC)** – The budget proposes to add nurse practitioners to the list of medical practitioners that could certify eligibility for the DTC. It will apply to DTC certifications made on or after March 22, 2017.

- **Medical expense credit** – The budget proposes to clarify the application of the medical expense tax credit for individuals who require medical intervention in order to conceive a child. This measure will apply to the 2017 and subsequent tax years. An individual will also be entitled to elect for this measure to apply for any of the immediately preceding ten taxation years on their personal tax return.

- **First-time donor's credit** – The budget confirms that the first-time donor's credit will expire, as planned, after 2017.

- **Tuition credit** – The budget proposes to make the tuition tax credit available for fees paid to a university, college or other post-secondary institution in Canada for occupational skills courses that are not at the post-secondary level. For example, this may include training in a second language. The credit will be available only where the course is taken for the purpose of providing the individual with skills (or improving the individual's skills) in an occupation and the individual has reached the age of 16 before the end of the year. This measure will apply to eligible tuition fees for courses taken after 2016. The budget also proposes the individual in the circumstances described above will meet the definition of a "qualifying student", for the purposes of the tax exemption for scholarship and bursary income, if they otherwise meet the conditions to be a "qualifying student". This measure will apply to the 2017 and subsequent taxation years.

- **Canada Caregiver credit** – The budget proposes to replace the infirm dependant credit, the caregiver credit, and the family caregiver tax credit with a new Canada Caregiver Credit for 2017 and subsequent years. The new credit amount (to be indexed annually to inflation) will be $6,883 in respect of infirm dependants who are parents/grandparents, brothers/sisters, aunts/uncles, nieces/nephews, or adult children of the caregiver or of the caregiver's spouse or common-law partner, or $2,150 in respect of an infirm dependant spouse or common-law partner in respect of whom the caregiver claims the spouse or common-law amount, an infirm dependant for whom the caregiver claims an eligible dependant credit, or an infirm child who is under the age of 18 years at the end of the tax year. The new credit will be income-tested and reduced dollar-for-dollar when the dependant's net income rises above $16,163 (in 2017, to be indexed annually). The dependant will not be required to live with the caregiver in order for the caregiver to claim the new credit.

Special rules apply in cases where an individual claims a spouse or common-law partner amount or an eligible dependant amount in respect of an infirm family member. In addition, the Canada Caregiver Credit will no longer be available in respect of non-infirm seniors who reside with their adult children.

## Expanding Employment Insurance (EI) benefits

### Caregiver benefits

Currently, EI benefits are available to eligible caregivers in cases where a loved one is gravely ill and at significant risk of death, or where a child is critically ill or injured.

To better support caregivers, the budget proposes to create a new EI caregiving benefit available for up to 15 weeks. The new benefit will cover a broader range of situations where individuals are providing care to an adult family member who requires significant support in order to recover from a critical illness or injury.

### Parental benefits

To help working parents navigate the challenges that come with a growing family, the budget proposes to make EI parental benefits more flexible. Proposed changes will allow parents to choose to receive EI parental benefits over an extended period of up to 18 months at a lower benefit rate of 33% of average weekly earnings. EI parental benefits will continue to be available at the existing benefit rate of 55% over a period of up to 12 months.

The budget also proposes to allow women to claim EI maternity benefits up to 12 weeks before their due date, extended from the current standard of 8 weeks.

## Anti-avoidance rules for registered plans

Registered Education Savings Plans (RESPs) help families accumulate savings for a child's post-secondary education. Registered Disability Savings Plans (RDSPs) allow persons with disabilities, and their families, to better save for their future. RESPs and RDSPs are tax-assisted registered plans in that grants and bonds that are received from the government as well as investment income that accumulates in these plans are only taxable when withdrawn.

There are a number of anti-avoidance rules that currently exist for other tax-assisted registered plans such as Tax-Free Savings Accounts, Registered Retirement Savings Plans, and Registered Retirement Income Funds. These rules help ensure that the plans do not provide excessive tax advantages and include:

- the advantage rules, which help prevent the exploitation of the tax attributes of a registered plan (e.g., by shifting returns from a taxable investment to a registered plan);
- the prohibited investment rules, which generally ensure that investments held by a registered plan are arm's length "portfolio" investments; and
- the non-qualified investment rules, which restrict the types of investments that may be held by a registered plan.

The budget proposes to extend the anti-avoidance rules described above to RESPs and RDSPs to improve consistency of the tax rules that apply to investments in registered plans. These proposals are not expected to have an impact on the vast majority of RESP and RDSP holders, who typically invest in ordinary portfolio investments.

Subject to certain exceptions (described below), this measure will apply to transactions occurring and investments acquired after March 22, 2017. It will also apply to income generated after March 22, 2017 on previously acquired investments.

The exceptions to this effective date are as follows:

- The advantage rules will not apply to swap transactions undertaken before July 2017. Swap transactions undertaken to ensure that an RESP or RDSP comply with the new rules will be permitted until the end of 2021; and
- Subject to certain conditions, a plan holder may elect by April 1, 2018 to pay regular income tax (in lieu of the advantage tax) on distributions of investment

income from an investment held on March 22, 2017 that becomes a prohibited investment as a result of this measure.

### Elimination of the home relocation loans deduction

An eligible home relocation loan is a loan that an individual uses to acquire a new residence where they start work at a new location. This new residence must be at least 40 km closer to their new work location than the old residence. If an individual receives this loan because of their employment, and the interest rate on the loan is below the CRA prescribed rate, that individual is deemed to have received a taxable benefit equal to the difference between the two rates. Currently, an individual may deduct the value of any portion of the benefit that is in respect of an eligible home relocation loan.

The budget proposes to eliminate the deduction in respect of eligible home relocation loans for benefits arising in the 2018 and subsequent taxation years.

### Ecological gifts program

The ecological gifts program provides a way for Canadians with ecologically sensitive land to contribute to the protection of Canada's environmental heritage. Under this program, certain donations of ecologically sensitive land or easements, covenants and servitudes on such land (ecogifts), are eligible for special tax assistance, for example a donation tax credit for individual donors. The budget proposes that private foundations no longer be permitted to receive ecogifts. This measure will apply in respect of transactions that occur on or after March 22, 2017.

### Electronic distribution of T4 information slips

The budget proposes to allow employers to distribute T4s electronically to current active employees without having to obtain express consent from these employees in advance. An employer will be required to have sufficient privacy safeguards in place (which will be specified by the Minister of National Revenue) to ensure the information remains confidential before electronic T4s can be sent without express consent. Employers will be required to issue paper copies to employees who request them. This measure will apply in respect of T4s issued for the 2017 and subsequent taxation years.

## BUSINESS TAX CHANGES

### Tax planning using private corporations

The budget identifies the following strategies involving private corporations where the federal Government feels that high-income earners have gained unfair tax advantages:

- **Dividend sprinkling** – this strategy involves directing income (e.g., dividends or capital gains) that would otherwise be taxed in the hands of an individual at a high tax rate to family members who are subject to a lower tax rate or who may not be taxable at all.

- **Holding a passive investment portfolio inside a private corporation** – this strategy may be financially advantageous for owners of private corporations compared to otherwise similar investors. This is due to the fact that corporate income tax rates are generally much lower than personal tax rates allowing for the higher accumulation of earnings that can be invested in a passive portfolio.

- **Converting a private corporation's regular income into capital gains** – Income is normally paid out of a private corporation in the form of salary or dividends to business owners, which is subject to tax at the recipient's personal tax rate. In contrast, only 50% of capital gains are included in income, resulting in a significantly lower effective tax rate on income that is converted from dividends or salary to capital gains.

The Government is further reviewing the use of these tax planning strategies and intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.

### Billed-basis accounting

Certain designated professions (i.e. accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of work in progress (WIP) in computing their income. This election effectively allows income to be recognized when the work is billed. Billed-basis accounting enables taxpayers to defer tax by permitting the costs associated with WIP to be expensed without the matching inclusion of the associated revenues.

The budget proposes to eliminate the ability for designated professionals to elect to use billed-basis accounting. This measure will apply to taxation years that begin on or after March 22, 2017.

To reduce the immediate tax impact, a transitional period will be provided to phase in the inclusion of WIP into income.

### Meaning of factual control

The Income Tax Act (Act) recognizes two forms of control of a corporation, de jure (legal) and de facto (factual) control. Determining control is important to ensure that certain corporate tax preferences are not accessed inappropriately. For example, in addition to legal control, factual control is used to determine whether two or more Canadian-controlled private corporations are "associated". Associated corporations, among other things, must share the $500,000 federal small business deduction limit which provides a lower corporate tax rate on active business income.

Legal control of a corporation generally entails the right to elect the majority of the board of directors of the corporation. Factual control of a corporation exists where a person has direct or indirect influence, where if exercised, the person would have control over the corporation. In order to determine if factual control exists, all of the relevant factors must be considered. A recent court decision held that in order for a factor to be considered when determining whether factual control exists, it must include a legally enforceable right and ability to effect a change to the board of directors or its power, or to exercise influence over the shareholder or shareholders who have that right and ability. The budget proposes to amend the Act to clarify that factors that may be considered in determining whether factual control exists do not have to include a legally enforceable right and ability to effect a change to the board of directors or its power.

This measure will apply in respect of taxation years that begin on or after March 22, 2017.

## Canadian exploration expense – oil and gas discovery wells

Expenditures associated with drilling an oil or gas well that results in the discovery of a previously unknown petroleum or natural gas reservoir are currently treated as a Canadian exploration expense (CEE) which may be deducted in full in the year incurred. Expenditures associated with drilling a well, other than a discovery well, are generally treated as a Canadian development expense (CDE) which is deducted at a rate of 30% per year on a declining-balance basis. Flow-through share agreements allow corporations to renounce CEE and CDE to investors, who can deduct the expenses in calculating their own taxable income (at a 100% rate for CEE or a 30% rate per year on a declining balance for CDE).

The budget proposes that expenditures related to drilling or completing a discovery well (including a temporary access road or site preparation) generally be classified as CDE instead of CEE. This means that for these oil and gas flow-through expenses, additional years will now be required to fully deduct the expenses being renounced. For example, if CEE will now be reclassified as CDE then it will take six years to deduct approximately 88% of the CDE compared to CEE which is fully deductible in the year it is incurred. Note that there will still be some oil and gas drilling expenses that continue to qualify as CEE if certain criteria are met.

This measure will apply to expenses incurred by oil and gas companies after 2018. However, the measure will not apply to expenses actually incurred by oil and gas companies before 2021 where they have, before March 22, 2017, entered into a written commitment to incur those expenses.

## Reclassification of expenses renounced to flow-through share investors

An eligible small oil and gas corporation can currently treat up to $1 million of CDE as CEE when renounced to shareholders under a flow-through share agreement. Flow-through share agreements allow a corporation to renounce CEE or CDE that it incurs, after the agreement date, to investors, who can then deduct the expenses in calculating their own taxable income. This rule allows CDE which is deducted at a rate of 30% per year on a declining-balance basis, to be converted to CEE which is 100% deductible by the investors against their taxable income.

The budget proposes to no longer permit eligible small oil and gas corporations to treat the first $1 million of CDE as CEE. This measure will apply in respect of expenses incurred by small oil and gas corporations after 2018, with the exception of expenses incurred after 2018 and before April 2019 that are renounced under a flow-through share agreement entered into after 2016 and before March 22, 2017.

## Timing of recognition of gains and losses on derivatives

### Elective use of the mark-to-market method

In the past, there was uncertainty as to whether taxpayers could mark-to-market their derivatives held on account of income under the general principles of profit computation. A recent decision of the Federal Court of Appeal allowed a taxpayer that was not a financial institution to use the mark-to-market method on the basis that it provided an accurate picture of the taxpayer's income. To provide a clear framework for exercising the choice of using the mark-to-market regime, the budget proposes to introduce an elective mark-to-market regime for eligible derivatives held on income account. Something is held on income account if on its disposition the individual would recognize regular income and not a capital gain. The election will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election remains effective for all subsequent years unless revoked with the consent of the Minister of National Revenue.

An eligible derivative will be any derivative held on income account that meets certain conditions, including that the derivative is valued at its fair value in a taxpayer's audited financial statements in accordance with accounting principles or, in any other case, has a readily ascertainable fair market value. Eligible derivatives could include a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or similar agreements that meet certain conditions.

If the election is made, the taxpayer will be required to annually include in computing its income the increase or decrease in value of its eligible derivatives.

This election will be available for taxation years that begin on or after March 22, 2017.

### Straddle transactions

The budget proposes to introduce a specific anti-avoidance rule that targets straddle transactions.

A simple example of the type of transaction that the government intends to target with this anti-avoidance rule is where a taxpayer concurrently enters into two or more derivative positions that are expected to result in equal and offsetting gains and losses on account of income. Shortly before the taxpayer's taxation year-end, the taxpayer disposes of the position with the accrued loss and realizes the loss. Shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain and realizes the gain. This allows the taxpayer to claim a deduction in respect of the realized loss against other income in the earlier taxation year and defer the recognition of the offsetting gain until the following taxation year or some other future taxation year. The taxpayer is able to take advantage of the loss and defer the gain even though economically, the two positions are offsetting. In some cases the taxpayer could potentially defer the recognition of the gain indefinitely by entering into successive straddle transactions.

A stop-loss rule proposed by the budget will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. A gain in respect of an offsetting position would generally be unrealized where the offsetting position has not been disposed of and is not subject to mark-to-market taxation. For the purposes of the stop-loss rule, a position will generally be defined as including any interest in actively traded personal properties (e.g. commodities), as well as derivatives and certain debt obligations. An offsetting position will generally be a position that has the effect of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the position.

There are a number of exceptions to the application of the stop-loss rule, notably for positions held by a financial institution (as defined for the purposes of the mark-to-market rules), or by a mutual fund trust or mutual fund corporation.

This measure will apply to any loss realized on a position entered into on or after March 22, 2017.

## Investment fund mergers

### Merger of switch corporations into mutual fund trusts

The budget extends the potential for investment fund companies to reorganize mutual fund corporations, structured as switch corporations, into multiple mutual fund trusts on a tax-deferred basis. This measure will apply to qualifying reorganizations initiated by investment fund companies that occur on or after March 22, 2017.

### Segregated fund mergers

Segregated funds are life insurance policies that have many of the characteristics of mutual fund trusts. Currently, it is not possible for segregated funds to merge on a tax-deferred basis. To provide consistent treatment between mutual fund trusts and segregated funds, the budget proposes to allow insurers to effect tax-deferred mergers of segregated funds. This measure will apply to mergers of segregated funds after 2017.

## STATUS OF PREVIOUSLY ANNOUNCED TAX MEASURES

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

- Measures announced on October 3, 2016 to improve fairness in relation to the principal residence exemption;
- The measure announced in the 2016 federal budget on information-reporting requirements for certain dispositions of an interest in a life insurance policy; and
- Legislative proposals released on September 16, 2016, relating to income tax technical amendments.

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