TAXTALK

2016 FEDERAL BUDGET HIGHLIGHTS

On March 22, 2016, Federal Finance Minister Bill Morneau presented the 2016 Federal Budget. Titled "*Growing the Middle Class*".

The major changes contained in the budget include the elimination of certain tax credits such as income splitting for couples with children, the Child Fitness Tax Credit, the Children's Art Credit and the Education Tax Credit and Textbook Tax Credit. As expected, a new Canada Child Benefit was introduced. There were no changes introduced to the capital gains inclusion rate or the stock option deduction.

The budget keeps the small business tax rate at 10.5% on the first $500,000 of business income. Furthermore, the budget precludes the multiplication of the small business deduction in certain partnership and corporate structures. As well, the budget repeals the eligible capital property regime, which will be replaced with the new capital cost allowance class. The use of life insurance polices to distribute amounts tax free to shareholders has also been tightened up.

The tax highlights of the budget are as follows:

PERSONAL TAX MEASURES

Personal Income Tax Rates

On December 7, 2015, the government announced that it will reduce the personal income tax rate in the second bracket from 22% to 20.5% in the 2016 taxation year. A new top tax bracket of 33% on taxable income over $200,000 will be introduced as well.

Based on the 2016 Federal and Ontario budgets, the top combined marginal rates for individuals in 2016 are set out in the following table:

Type of Income	Over $220,000
Eligible dividends	39.34%
Non-eligible dividends	45.30%
Capital gains	26.76%
Salary and other income	53.53%

Tax-Free Savings Account ("TFSA")

The government also returned the TSFA contribution limit to $5,500 (from $10,000) and promised to index the limit to inflation.

Canada Child Benefit ("CCB")

The non-taxable Canada Child Benefit (CCB) will replace the Canada Child Tax Benefit (CCTB) and Universal Child Care Benefit (UCCB) assistance programs effective July 1, 2016.

Akin to the CCTB and UCCB, the new CCB will provide financial assistance in the form of monthly payments to families with children under the age of 18. A maximum benefit of $6,400 will be provided for each child under the age of 6 and $5,400 for children aged 6 to 17. These maximums begin to phase out where the adjusted family net income is between $30,000 and $65,000. The phase-out rates in this threshold range from 7% for a one-child family up to 23% for a family with 4 or more children. Once adjusted family net income exceeds $65,000, any remaining benefit is phased out at slower rates ranging from 3.2% to 9.5%.

The budget broadens the definition of an eligible individual for purposes of the CCB to include an Indian within the meaning of the *Indian Act* provided that all other criteria under the definition are met.

Also beginning July 1, 2016, the children's special allowance is proposed to be increased to the same level as the CCB so that families with children in child protection agencies are treated consistently.

Family Tax Cut

For the 2016 taxation year and beyond, the budget proposes to eliminate the Family Tax Cut Credit that currently permits limited income splitting for couples with at least one child under the age of 18.

This credit allows a higher-income earning spouse or common-law partner to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner in order to reduce the couple's combined tax liability by a maximum of $2,000.

Children's Fitness and Arts Tax Credits

The government proposes to halve the maximum eligible expenditures on which the 15% refundable Children's Fitness and Art Tax Credits can be claimed in the 2016 taxation year, and will eliminate the credits in 2017.

In particular, the budget proposes to reduce the Children's Fitness Credit maximum eligible amount from $1,000 to $500 in 2016 and eliminate it in 2017. The maximum eligible amount for the Children's Arts Tax Credit would be reduced from $500 to $250 in 2016 and, again, eliminated in 2017.

Education and Textbook Tax Credit

Effective January 1, 2017, the budget proposes to eliminate the 15% non-refundable Education and Textbook Tax Credits. Unused education and text book credits carried forward from prior to 2017, will remain available to be claimed in 2017 and subsequent years.

Teacher and Early Childhood Educator School Supply Tax Credit

The budget proposes to introduce the new Teacher and Early Childhood Educator School Supply Tax Credit, a 15% refundable credit based on the amount of expenditures, up to a maximum of $1,000, made for eligible supplies purchased on or after January 1, 2016.

The credit is available to eligible educators who are teachers or early childhood educators that hold a valid certificate recognized by the province or territory in which they are employed. The credit cannot be claimed on expenditures claimed under any other provision of the *Income Tax Act*.

BUSINESS TAX MEASURES

Reduced Small Business Tax Rate

The federal small business reduction will remain at 17.5% for 2016 and subsequent taxation years, which provides for a federal small business tax rate of 10.5%, down from 11.0% in 2015. Of course, the provincial rate must be added to determine the actual rate.

The prior proposals to further increase the SBD rate and reduce the related small business tax rate for 2017 and subsequent taxation years, along with the consequential changes to the dividend gross-up and dividend tax credit, will not be going ahead.

Multiplication of the Small Business Deduction

The current specified partnership income rules are intended to prevent the multiplication of the SBD where a corporate partnership is utilized since each corporate partner is only entitled to an SBD equal to its share of the partnership's active business income multiplied by $500,000. Structures have been implemented to circumvent these rules through the utilization of a separate Canadian-controlled private corporation (CCPC) which is not a member of the partnership. Such corporation (which would be owned by the shareholder of one of the corporate partners or by a person who is not at arm's-length with the shareholder) would be paid by the partnership for services provided.

The budget proposes to deem this separate CCPC to be a member of the partnership, which in effect, causes the active income earned by this CCPC from services billed to the partnership to still be subject to its prorated share of the annual SBD.

Similar rules will apply where a CCPC provides services or property to certain private corporations rather than to a partnership as in the above example. The income so earned by the CCPC will be ineligible for the SBD where, at any time during the year, the CCPC, one of its shareholders or a 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 generally apply to taxation years which begin on or after budget day. In addition, these proposals do not apply to a CCPC all or substantially all of the active income of which is from providing services or property to arm's-length persons other than the partnership.

Currently, certain investment income, such as rent or interest, earned by a CCPC, from an associated CCPC that deducts the payments from its own active income, is treated as active income rather than investment income. In addition, two CCPCs, which are not normally associated with each other, are considered to be associated by being associated with the same "third" corporation. Although these two CCPCs can elect not to be associated for SBD purposes, the above rule which treats certain investment income to be active rather than passive still applies.

The budget proposes to retain the character of the investment income in the hands of the recipient as investment income rather than deeming it to be active income where the "third company" election not to be associated is utilized. In addition, where the "third company" election not to be associated is utilized, the third company will continue to be associated with each of the other two CCPCs for purposes of applying the $10–15 million taxable capital limit for SBD purposes.

Tax on Personal Services Business Income

Effective January 1, 2016, the federal tax rate on personal services business income will be increased by 5% (from 28% to 33%) to correspond with the increase in the top federal marginal personal tax rate to 33% on taxable income over $200,000 for 2016 and subsequent years. The rate increase will be prorated for taxation years which straddle January 1, 2016.

Distributions Involving Life Insurance Proceeds

Currently, where a policyholder disposes of their interest in a life insurance policy to a non-arm's-length person (to a corporation for example), the policyholder's proceeds are deemed to be equal to the cash surrender value (CSV) of the policy at the time notwithstanding the fact that the fair market value (FMV) of the policy, and therefore the consideration received by the transferor, might be higher. The policyholder would be taxable only to the extent that the CSV exceeds the adjusted cost basis of the policy at the time; any excess of the FMV of the policy over the CSV is not currently taxable. In addition, this excess of FMV over the adjusted cost basis can later be effectively extracted through the corporation's CDA. Similar concerns arise in the partnership context and where a policy is contributed to a corporation as capital.

The budget proposes that the policyholder's proceeds in the above scenario would be the FMV of the policy rather than its CSV. Consequently, any excess of the FMV over the adjusted cost basis would be taxable. This measure will apply to dispositions on or after budget day.

The budget also proposes to amend the CDA rules for private corporations and the adjusted cost basis computation for partnership interests where the interest in the policy was disposed of before budget day for consideration in excess of the CSV of the policy. This amendment, which in essence amounts to retroactive taxation, will reduce the addition to the corporation's CDA or adjusted cost base of an interest in a partnership by the amount of such excess which will result in tax when the funds are withdrawn from the company. Consequently, additional funds would be required to pay these taxes, a cost not anticipated when the policy was transferred to the company. This measure will apply in respect of policies under which policy benefits are received as a result of deaths occurring on or after budget day.

Eligible Capital Property

The 2014 federal budget announced that the existing rules that related to both the acquisition and disposition of eligible capital property (ECP) (such as goodwill) would be reviewed.

At the present time, 75% of the cost of ECP is added to the cumulative eligible capital (CEC) pool which is amortized at the rate of 7% per annum of the declining balance. The proceeds of disposition of ECP are first credited to the CEC pool, if any, and previous deductions are recaptured. 50% of the balance is treated as active business income (and 50% falls into the CDA). The effective tax rate is therefore half of the small business rate and/or half of the general rate applicable to active business income.

Note that each of the provinces imposes its own provincial rate. So, for example, in Ontario, the rate applicable to the small business income portion would be 7.5% (50% of 15%) and 13.25% (50% of 26.5%) on the non-small business portion; in British Columbia, the rate applicable to the small business income portion would be 6.5% (50% of 13%) and 13% (50% of 26%) on the non-small business portion.

Ignoring the lack of a reserve for deferred proceeds on the sale of goodwill, this treatment has, initially, been more attractive than the result of treating the gain as a capital gain which is taxed at 50% of the high corporate rate applicable to investment income resulting in an effective rate of approximately 25%.

The budget introduces a new regime that will be effective on January 1, 2017.

The new rules will add 100% of the cost of what has heretofore been classified as ECP to a new capital cost allowance (CCA) class, Class 14.1, which will be depreciated at the rate of 5% of the declining balance per annum. 100% of the proceeds of disposition of this type of property will be credited to the pool in accordance with the existing rules applicable to dispositions of depreciable property.

Transitional rules will transfer December 31, 2016 CEC pool balances to Class 14.1. For 10 years, pre-2017 balances will be depreciated at the rate of 7% of the declining balance per annum. Small businesses will benefit from more generous write-offs for minor expenditures. For example, the first $3,000 of the cost of incorporation will be deductible as a current expense.

INTERNATIONAL TAX MEASURES

Transfer Pricing

Section 247 contains rules to ensure that cross-border charges among non-arm's length entities generally reflect prices that would be negotiated by arm's-length parties. In this regard, certain recommendations of an international study, the Base Erosion and Profit Sharing (BEPS) project, are consistent with existing CRA practices and require no Canadian changes at this time.

The budget proposes country-by-country reporting requirements that would allow inter-company pricing to be monitored more easily. The new rules will apply to taxation years that begin after 2015, but only to groups with consolidated revenues of at least €750 million.

Treaty Shopping

The BEPS project addressed "treaty shopping," i.e., the abuse of tax treaty networks whereby an international organization establishes a corporation in a second jurisdiction only for the purpose of taking advantage of a tax treaty between that second jurisdiction and a third jurisdiction.

The budget indicates that future Canadian tax treaties will contain anti-avoidance provisions to counter such abuses.

SALES AND EXCISE TAXES

A GST/HST on Donations to Charities

Under current GST/HST rules, if a person makes a donation and receives property or services in return, GST/HST generally applies on the full value of the donation. In contrast, the *Income Tax Act* allows for "split-receipting". This allows a charity to provide a donation receipt for the donation amount less any the value of any property or service received by the donor.

The budget proposes to introduce similar split-receipting rules for the Excise Tax Act (ETA*)*. Specifically, if a charity provides property or services and an income tax receipt may be issued for a portion of the donation, GST/HST applies only to the value of the property or services supplied to the donor.

This measure applies to supplies made after budget day. However, transitional relief is available for charities that did not collect GST/HST on the full value of donations for supplies made after December 20, 2002, and on or before budget day.

Eligible Capital Property

As noted above (see Business Income Tax Measures — Eligible capital property), the budget proposes to repeal the ECP regime and replace it with a new CCA class (Class 14.1), effective January 1, 2017. As a result, all ECP will become capital property under the *Income Tax Act*.

To ensure the application of GST/HST in this area is not affected, the budget proposes to amend the definition of capital property under the *ETA* to exclude property in new Class 14.1. Therefore, property that was ECP under the *Income Tax Act* will continue to be excluded from capital property for GST/HST purposes. The budget also makes consequential amendments to the Streamlined Accounting (GST/HST) Regulations.

These amendments will take effect on January 1, 2017.

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