Federal Budget Commentary
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INTRODUCTION

The Federal Government's 2017–18 Budget gives Canadians a taste of what they might expect over the next couple of years: attempted efficiencies, closed tax loopholes, steady deficits, and a touch of caution. Budget 2017 outlines only $200 million in net new spending, but also an increase to the deficit of more than $5 billion for 2017–18, partly due to commitments from the previous budget, reduced revenues and increased general expenses.

The projected deficit for 2017–18 is $28.5 billion, declining to $18.8 billion by 2021–22 (including an annual $3 billion contingency fund). However, if the government's strong growth scenario plays out, we could see a much smaller deficit between $5 and $8 billion by 2021. Instead of planning to eliminate the deficit as previously proposed, the government says it will maintain a balanced net debt-to-GDP ratio of around 31 per cent over the next five years. There are no changes to corporate or personal income tax rates or the small business deduction threshold and no changes to capital gains taxation. In addition, the government did not address in the Budget a number of tax issues it has discussed since Budget 2016, indicating it will release more details on its plans to limit tax-planning strategies later this year. Concerns over potential changes to taxes, trade agreements and regulations in the United States have no doubt caused Canada's Federal Government to reconsider its own tax strategy.

The Budget proposes to address a range of tax loopholes and inefficiencies, including: eliminating billed-basis accounting for certain professionals, preventing tax avoidance through straddle transactions, eliminating the tax deduction for home relocation loans, applying tax-avoidance rules to Registered Education Savings Plans (RESPs) and Registered Disability Savings Plans (RDSPs), eliminating the additional deduction for gifts of medicine, preventing Canadian life insurers from using foreign branches to avoid tax, repealing the tax exemption for insurers of farming and fishing property, and eliminating the Public Transit Tax Credit.

In order to advance the twin goals of reducing tax evasion and improving compliance, the government plans to give the Canada Revenue Agency an additional $523.9 million over the next five years. The government anticipates a five-fold return on its investment, hoping the CRA will recover $2.5 billion for its efforts.

We can expect to see more substantial proposals for change as the year progresses. The government has clearly signaled that it will be looking for additional ways to prevent tax avoidance.

BUSINESS INCOME TAX MEASURES

The Budget makes no changes to corporate tax rates. In addition, no changes are made to eligibility for the small business rate.

Tax Planning Using Private Corporations

The government's review of federal tax expenditures highlighted issues in respect of tax planning strategies available to owners of private corporations. The government feels that these strategies can result in high-income individuals gaining unfair tax advantages not available to other Canadians. As the Budget papers indicate, measures have been put in place over the years to limit the scope of certain of these arrangements. However, the government is of the opinion that such measures have not always been as effective as desired. Accordingly, the government is further reviewing the use of private corporation tax planning strategies that may reduce the personal tax of high-income earners in a manner considered inappropriate. In particular, the government has identified the following strategies for review:

- Income sprinkling — causing income that would be taxable to an individual at a high rate to be realized by, and therefore taxed in the hands of, a family member subject to a lower marginal tax rate, commonly achieved through dividends or capital gains
- Holding of portfolio investments — corporate tax rates on ordinary business income are generally much lower than personal rates; retaining income in a private corporation can therefore facilitate accumulation of a larger pool of funds for investment
- Conversion of regular income into capital gains — causing income that would normally be paid to the shareholder as salary or dividend to be converted to capital gains, taxed at a significantly lower tax rate

As part of its review of this area, the government will also examine current legislation that may have inappropriate tax consequences in connection with genuine business transactions between family members, including inter-generational transfers of family businesses. In the coming months, a paper will be released that will review these issues in detail and provide proposed policy responses.

Billed-Basis Accounting

Members of designated professions (accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of their work in progress (WIP) in computing their income. Where this election is made, a tax deferral is achieved as the costs associated with the WIP are deducted as incurred whereas the revenue is recognized only when the WIP is actually billed to clients.

The Budget proposes to eliminate the WIP exclusion over a two-year period, effective for taxation years beginning after March 21, 2017. For the first affected taxation year, WIP will be valued at 50 per cent of the lesser of its cost and fair market value and must be recognized for tax purposes and not excluded from income. For subsequent years, WIP, valued at the lesser of its cost and fair market value, must be recognized for tax purposes and cannot be excluded from income.

These provisions will require a determination of the cost of the WIP, which may not be readily available.

Meaning of Factual Control

There are two main definitions of control for tax purposes — de jure or legal control and de facto or factual control. Some provisions rely on de jure control whereas others rely on de facto control.

De facto control is broader than legal control and takes into account influence, that, if exercised, would result in control in fact of a corporation. It is particularly relevant for purposes of determining whether or not corporations are associated and therefore required to share the annual $500,000 small business deduction limit and certain other limits.

Recent jurisprudence essentially restricted control in fact to circumstances where the potential controller has an enforceable right to change the board of directors or its powers or can exercise influence over shareholders who have the right and ability to make such changes. The Budget proposes to effectively override the case law. For taxation years beginning after March 21, 2017, all factors relevant in the particular situation, not just those that meet the criteria set out in the recent jurisprudence, shall be included in assessing whether or not de facto control is present.

Distribution of T4 Information Slips

Effective for 2017, employers will not be required to obtain express consent from employees to electronically distribute T4s (Statement of Remuneration Paid). Privacy policy safeguards specified by the Minister of National Revenue will be required to be in place before an employer can electronically distribute T4s without employee consent.

Timing of Recognition of Gains and Losses on Derivatives

Derivatives are sophisticated financial instruments whose value is derived from the value of an underlying security. The Budget proposes two measures that clarify the timing of the recognition of gains and losses from derivatives held on income account.

In the past, there was uncertainty as to whether taxpayers could mark to market their derivatives held on income account under the general principles of profit computation. A recent Federal Court of Appeal decision allowed the use of the mark-to-market method for a taxpayer which was not a financial institution on the basis that it provided an accurate picture of the taxpayer's income.

To provide certainty regarding the choice of using the mark-to-market method, the Budget proposes an elective mark-to-market regime for derivatives held on income account so that taxpayers will be allowed to mark to market all of their eligible derivatives for taxation years beginning after March 21, 2017. Once made, the election will remain effective for all subsequent years unless revoked with the consent of the Minister of National Revenue.

A straddle transaction is one in which a taxpayer concurrently enters into two or more positions, often derivative positions, that are expected to generate equal and offsetting gains and losses on account of income. In order to obtain a tax deferral, the position with the accrued loss would be disposed of in one taxation year to realize the loss and the offsetting position with the accrued gain would be disposed of to realize the gain in the following taxation year. In addition, the taxpayer could attempt to indefinitely defer the recognition of the gain by entering into successive straddle transactions.

The Budget proposes to introduce a specific anti-avoidance "stop-loss" rule, which will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain inherent in an offsetting position. This proposal will apply to any loss realized on a position entered into after March 21, 2017.

Investment Fund Mergers

Mutual Funds

Mutual funds can be structured as either corporations or trusts. The Income Tax Act (ITA) currently contains provisions that facilitate the merger of mutual funds on a tax-deferred basis. Two mutual fund trusts can be merged into one or a mutual fund corporation can be merged into a mutual fund trust. The current rules do not provide for the reorganization of a mutual fund corporation into multiple mutual fund trusts.

"Switch mutual fund corporations" are structured with multiple classes of shares that are each traced to a pool or fund of assets of the corporation. Investors switch underlying funds by exchanging one class of shares for another. The benefits of such structures were eliminated in the 2016 Budget by deeming the share exchanges to be fair market value dispositions.

The Budget proposes to allow the tax-deferred restructuring of a switch corporation into multiple mutual fund trusts. In order to qualify, in respect of each class of shares of the switch corporation, all or substantially all (generally interpreted as 90 per cent or more) of the assets allocable to that class must be transferred to a mutual fund trust and the shareholders of that class must become unit holders of the trust. This measure will be applicable to qualifying reorganizations occurring on or after March 22, 2017.

Segregated Funds

Segregated funds are life insurance policies that have many of the characteristics of mutual fund trusts. Unlike mutual fund trusts, segregated funds cannot currently merge on a tax-deferred basis.

The Budget proposes to allow tax-deferred mergers of segregated funds under rules similar to those for mutual fund trusts. The Budget also proposes that non-capital losses in segregated funds arising in taxation years beginning after 2017 will be able to be carried over to apply against income of other years under the normal rules (back 3 years and forward 20 years). Loss application will be restricted after a segregated fund merger.

To give the life insurance industry the opportunity to comment on the proposed new rules, the merger rules will be applicable for mergers carried out after 2017.

Clean Energy Generation Equipment

Capital cost allowance (CCA) classes 43.1 and 43.2 provide for accelerated CCA on clean energy generation equipment. The Budget expands the assets qualifying for these classes to include geothermal energy equipment used primarily for the purpose of generating heat or a combination of heat and electricity and certain equipment in district energy systems that use geothermal heating as an energy source.

Canadian renewable and conservation expenses may be deducted in the year incurred, carried forward indefinitely for use in future years or transferred to investors through a flow-through share mechanism. The Budget proposes to include expenses incurred to determine the quality and extent of geothermal resources and the cost of geothermal drilling for electricity and heating projects in this category.

The measures are applicable for new property acquired for use and expenses incurred after March 21, 2017.

Resource Measures

Expenditures in respect of drilling or completing a discovery well, including building access roads to or preparing the site for such wells, are currently classified as Canadian exploration expense (CEE, fully deductible in the year incurred). The Budget proposes to classify these expenditures as Canadian development expense (CDE, deductible on a 30 per cent declining-balance basis).

This measure will apply to expenses incurred after 2018, including those incurred in 2019 that could have been deemed incurred in 2018 under the "look-back" rule. Expenses incurred before 2021 pursuant to a written commitment to incur the expenses entered into before March 22, 2017, will still qualify as CEE.

Eligible small oil and gas corporations will no longer be able to treat their first $1 million of CDE as CEE. This measure will apply to expenses incurred after 2018, including those incurred in 2019 that could have been deemed incurred in 2018 under the "look-back" rule. Expenses incurred after 2018 and before April 2019 that are renounced to investors under a flow-through share agreement entered into after 2016 and before March 22, 2017, will be exempt from the new rules.

Child Care Space Investment Tax Credit

The Budget eliminates the investment tax credit for child care space expenditures incurred after March 21, 2017. Expenditures incurred before 2020 pursuant to written agreements entered into before March 22, 2017 will still be eligible for the investment tax credit.

Farming and Fishing Property Insurers

The Budget eliminates the tax exemption for farming and fishing property insurers. This exemption is based on the proportion of their gross premium income earned from insuring such property. This measure is effective for taxation years beginning after 2018.

Consultation on Cash Tickets

The Budget institutes a consultation on the tax deferral available in respect of deferred cash purchase tickets for deliveries of listed grains by farmers. Interested parties should submit their comments to the government by May 24, 2017.

PERSONAL INCOME TAX MEASURES

The Budget did not propose a number of changes that were the subject of heavy speculation. In particular, the capital gains inclusion rate will not increase and remains at 50 per cent. A dollar limit is not imposed on the employee stock option deduction and thus it will continue to be calculated as half the stock option benefit amount.

Personal income tax rates will not increase under the Budget.

Tuition Tax Credit

Effective January 1, 2017, the Budget proposes to expand the types of courses that are eligible for the Tuition Tax Credit.

The Tuition Tax Credit can currently be claimed with respect to occupational skills courses taken at a non-post-secondary institution. In contrast, the credit cannot be claimed for similar non-post-secondary level courses taken at a college or university.

The Budget proposes to allow the Tuition Tax Credit to be claimed in the latter instance and, further, to allow the scholarship exemption for bursaries related to such courses, provided that all other conditions for the exemption are met.

Simplifying the Caregiver Credit System

The existing Caregiver Credit, Infirm Dependent Credit and Family Caregiver Tax Credit each have different eligibility rules. The Budget proposes to simplify these existing credits by replacing them with a single new, non-refundable credit, the Canada Caregiver Credit. This credit will provide tax relief of up to 15 per cent of $6,883 (in 2017) for expenses for care of dependent relatives with infirmities, and up to 15 per cent of $2,150 (in 2017) for expenses for care of a dependent spouse/common-law partner or minor child with an infirmity. There is no requirement for the dependent to live with the caregiver to claim the credit.

This new credit will start to be reduced when the dependent's net income is above $16,163 (in 2017, indexed to inflation for taxation years after 2017).

Disability Tax Credit - Certification by Nurse Practitioners

The Budget proposes to allow nurse practitioners to certify impairments for purposes of the Disability Tax Credit. This measure will be effective for certifications made after March 21, 2017.

Medical Expense Tax Credit - Fertility-Related Expenses

For the 2017 taxation year and beyond, the Budget proposes to clarify the types of fertility-related expenses that are eligible for the Medical Expense Tax Credit. In particular, persons who require medical intervention to conceive, even if not infertile, will explicitly be allowed to claim the credit for expenses that would generally be eligible for someone who has an infertility condition.

Mineral Exploration Tax Credit for Flow-Through Share Investors

Eligibility for the Mineral Exploration Tax Credit is proposed to be extended for one year under the Budget. The credit will apply to flow-through share agreements entered into on or before March 31, 2018.

Public Transit Tax Credit

The Public Transit Credit is proposed to be eliminated under the Budget for transit use after June 30, 2017.

Home Relocation Loans Deduction

The Budget proposes to eliminate the home relocation loans deduction for benefits realized on January 1, 2018, and beyond. Accordingly, an individual who receives a loan from their employer that qualifies as an eligible home relocation loan will no longer be entitled to offset any imputed interest benefit in the 2018 taxation year and beyond.

Anti-avoidance Rules for Registered Plans

The anti-avoidance rules that currently exist for Registered Retirement Savings Plans and Tax-Free Savings Accounts are proposed to be extended to RESPs and RDSPs under the Budget. These changes will apply to transactions occurring after March 22, 2017, with the following exceptions.

The advantage rules will not apply to swap transactions occurring on or before June 30, 2017. Further, the proposed changes will not apply to swap transactions undertaken on or before December 31, 2021, where the purpose of the transaction is to ensure that the RESP or RDSP complies with the advantage or prohibited investment rules.

In addition, an RESP or RDSP plan-holder may elect by April 1, 2018, not to pay advantage tax on the distribution of investment income from an investment that was held on March 22, 2017, but instead pay regular personal income tax.

Allowances for Members of Legislative Assemblies and Certain Municipal Officers

The Budget proposes to include non-accountable allowances paid to certain officials in their income, beginning in the 2019 taxation year.

CHARITIES AND NON-PROFIT ORGANIZATIONS

Ecological Gifts Program

The Budget proposes the following measures to protect gifts of ecologically sensitive property made after March 21, 2017:

- The 50 per cent tax which applies where the use of ecologically sensitive land is changed, or the property is disposed of, without the consent of Environment and Climate Change Canada (ECCC), will be extended to situations where the land is transferred between organizations for consideration and the transferee changes the use of the property or disposes of it without the consent of ECCC.
- The requirement for ECCC to approve recipients of ecological gifts will be extended, on a gift-by-gift basis, to municipalities and municipal and public bodies performing a function of government.
- Private foundations are no longer permitted to receive ecogifts.
- The donation of personal servitudes will qualify as ecological gifts, provided certain conditions are met (e.g., the servitude must run for at least 100 years).

Gifts of Medicine

The additional corporate deduction for gifts of medicine from their inventory is eliminated for such gifts made after March 21, 2017.

First-Time Donor's Super Credit

The Budget confirms the expiration of the First-Time Donor's Super Credit, as planned, after 2017.

INTERNATIONAL

Offshore Income from Insuring Canadian Risks

The ITA contains rules (the FAPI rules) that are intended to tax investment income earned by a "controlled foreign affiliate" of a Canadian taxpayer when it is earned, rather than when it is repatriated to Canada.

The FAPI rules deem certain types of business income to be investment income so that it is taxed in Canada immediately, as if it were investment income. Among these rules is one that deems income earned from the insurance and reinsurance of Canadian-source risks by a foreign affiliate (generally a corporation) of a Canadian-resident taxpayer, to be investment income. However, these rules do not apply to similar types of income earned by a foreign branch of a Canadian life insurer.

The Budget introduces rules similar to the FAPI rules to tax such branch income of Canadian life insurers as it is earned, where it comprises 10 per cent or more of all branch income.

Also, the Budget introduces specific anti-avoidance provisions to prevent the circumvention of both the existing FAPI rules and the new branch provisions.

Lastly, provisions will be introduced to prevent avoiding the rules described above by entering into arrangements that attempt to substitute income from insuring foreign-source risks for income from insuring Canadian-source risks.

These changes will be effective for taxation years commencing on or after March 22, 2017.

Base Erosion and Profit Shifting (BEPS)

The 2016 Budget indicated the government's desire to prevent the erosion of the Canadian tax base by shifting income offshore. In this regard, the Budget indicates that, in addition to the insurance provisions described above, the government will continue to pursue various initiatives, such as the modification of existing tax treaties to further this end.

SALES TAX, EXCISE TAX AND OTHER MEASURES

Opioid Overdose Treatment Drug — Naloxone

When Health Canada began allowing Naloxone to be dispensed without a prescription, the drug's historical GST/HST exemption was technically lost. The Budget proposes to include Naloxone on the list of GST/HST-free non-prescription drugs to restore its GST/HST-free status.

Taxi and Ride-Sharing Services

To ensure that the GST/HST applies consistently to taxi services and ride-sharing services, effective July 1, 2017, the definition of a taxi business will be amended to require providers of ride-sharing services to register for the GST/HST and charge tax on their fares in the same manner as taxi operators.

Elimination of Non-Resident GST/HST Rebate for Tour Package Accommodations

The GST/HST rebate available to non-resident individuals and tour operators in respect of the accommodation portion of eligible tour packages will be repealed effective March 23, 2017, subject to a transitional exemption in respect of eligible tour packages supplied and paid for prior to January 1, 2018.

Tobacco and Alcohol Taxation

Effective March 23, 2017, the Budget proposes to repeal the 10.5 per cent surtax on manufacturers of tobacco products with a coordinated increase to the excise duty rates on tobacco.

Excise duties on alcohol products are proposed to be increased by two per cent, effective March 23, 2017, with annual indexing of rates thereafter.

Custom Tariff and Special Import Measures

The Budget proposes a number of amendments to the Special Import Measures Act and related regulations which are intended to strengthen Canada's trade remedy system and ensure that it is aligned with Canada's obligations under World Trade Organization rules.

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CONTACT US

245 Fairview Mall Drive
Suite 600
Toronto, Ontario
M2J 4T1

Phone: 416.496.2900
Fax: 416.496.0559
E-mail: info@liptonllp.com
Web: www.liptonllp.com

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