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FEDERAL BUDGET 2016 - INCREMENTAL, NOT FUNDAMENTAL TAX CHANGES

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On March 22, 2016 the Minister of Finance tabled Budget 2016, the first budget of the current government's mandate. As telegraphed by the title, "Growing the Middle Class," Budget 2016 contains a variety of measures to assist families, youth, students, the unemployed, seniors, First Nations communities and the environment. Consistent with previous rumours, an important component of the government's plan is to facilitate economic growth by improving Canada's infrastructure. Budget 2016 proposes $120 billion of infrastructure spending over 10 years. The result of these and other proposed fiscal measures is a $29.4-billion deficit for the 2016-17 fiscal year.

Although Budget 2016 proposes changes to address perceived tax leakage, it does not propose increased tax rates beyond those previously announced in December 2015.

Budget 2016 measures intended to enhance the integrity of the tax system include preventing tax avoidance through the use of certain partnership and corporate structures and addressing the long-standing proposal to change the eligible capital property (**ECP**) regime. Further, Budget 2016 proposes to increase international co-operation and integration with a view to protecting Canada's tax base from international tax planning arrangements. A few perennial favourites included in Budget 2016 are the extension of the mineral exploration tax credit for another year, as well as additions to the categories of clean-tech equipment benefitting from accelerated capital cost allowance (**CCA**).

Perhaps most newsworthy is what is not included in Budget 2016. Contrary to initial speculation, Budget 2016 does not propose to increase the capital gain inclusion rate and does not touch on the preferential tax treatment of employee stock options.

Taxpayers will be relieved that the new government chose to make incremental rather than fundamental changes to Canada's tax system.

Cross-Border Surplus Stripping

A Canadian corporation can make a tax-free distribution by way of return of capital up to the amount of the paid-up capital (**PUC**) of the shares of the corporation. By way of contrast, a return of capital in excess of PUC is generally treated as a deemed dividend and subject to Canadian withholding tax. Because of the potential for abuse, the Income Tax Act (**ITA**) includes an anti-surplus stripping rule in section 212.1 intended to prevent non-residents from entering into certain transactions targeted at extracting retained earnings in excess of PUC free of Canadian tax. When applicable, this anti-surplus stripping rule results in a deemed dividend to the non-resident or a reduction of PUC.

Subsection 212.1(4) contains an exception to this anti-surplus-stripping rule. The exception applies where the non-resident corporation is "sandwiched" between two Canadian corporations and the non-resident corporation sells the shares of the lower-tier Canadian corporation to the upper-tier Canadian corporation in order to unwind the sandwich structure. The exception has been used by certain non-resident corporations who reorganize their corporate group to qualify for the exception in order to artificially increase the PUC of shares of their Canadian subsidiaries.

Budget 2016 proposes to deny the use of the exception in subsection 212.1(4) in cases where a non-resident owns shares of the upper-tier Canadian corporation, directly or indirectly, and the non-resident does not deal at arm's length with the upper-tier Canadian purchaser corporation. The proposed amendments to section 212.1 of the ITA will also address situations where it may be uncertain whether consideration has been received by a non-resident from the upper-tier Canadian corporation for the disposition of shares of the lower-tier Canadian corporation. The proposals will effectively deem the non-resident to receive non-share consideration from the upper-tier Canadian corporation equal to the fair market value (**FMV**) of the shares of the lower-tier Canadian corporation.

The new anti-avoidance rule will apply in respect of dispositions occurring on or after March 22, 2016. As well, the Canada Revenue Agency (**CRA**) might apply the general anti-avoidance rule to challenge prior transactions which it believes misuse subsection 212.1(4).

back to top...

Debt Parking to Avoid Foreign Exchange Gains

Under the ITA income must generally be computed in Canadian dollars. This necessitates the conversion of amounts denominated in a foreign currency to Canadian dollars. As a result, a foreign exchange gain or loss may be realized on the repayment of a debt denominated in a foreign currency if the foreign currency has fluctuated relative to the Canadian dollar.

Some taxpayers have entered into transactions referred to as debt-parking transactions in order to avoid realizing a foreign exchange gain on the repayment of a foreign currency debt. For example, a debtor might enter into an arrangement where a non-arm's length party acquires the debt from the original creditor for a price equal to its principal amount. The original creditor would be repaid, but the new creditor, which is a friendly party, would allow the debt to remain outstanding to avoid the debtor realizing a foreign exchange gain.

The ITA has debt-parking rules to help ensure that the debt forgiveness rules are not avoided in transactions like this. However, under the debt-parking rules the debt is deemed to be repaid for an amount equal to the cost of the debt to the new creditor. Although the debt-parking rules deem the foreign currency debt to have been settled at the time of the acquisition by the new creditor, any foreign exchange gain realized on the debt is not taken into account.

Budget 2016 proposes rules whereby accrued foreign exchange gains on foreign currency debt will be realized when the debt becomes a parked obligation. To do this, the debtor will be deemed to have realized the gain that would apply if it had repaid a principal amount of the debt equal to:

- Where the debt becomes a parked obligation as a result of its acquisition by the current holder, the amount for which the debt was acquired; and
- In other cases, the FMV of the debt.

For this purpose a foreign currency debt will become a parked obligation at any time where:

- At that time, the current holder of the debt does not deal at arm's length with the debtor or, where the debtor is a corporation, has a significant interest in the corporation; and
- At any previous time, a person who held the debt dealt at arm's length with the debtor and, where the debtor is a corporation, did not have a significant interest in the corporation, typically being shares having 25 per cent or more of the votes or value.

Certain exceptions will be provided to ensure that foreign currency debt does not become a parked obligation as a result of a bona fide commercial transaction where one of the main purposes was not to avoid a foreign exchange gain.

Additional relief will be provided to financially distressed debtors. For example, in the case of a Canadian resident corporate debtor, a rule will ensure that the combined federal and provincial taxes payable on a deemed foreign exchange capital gain will not result in corporation's liabilities exceeding the FMV of its assets.

This measure will apply to a foreign currency debt that meets the conditions to become a parked obligation on or after March 22, 2016. There may also be an exception where there is a written agreement entered into before that date.

back to top...

Extension of the Back-to-Back Rules to

Royalties

Budget 2014 introduced back-to-back loan rules that applied for purposes of both the thin capitalization regime and certain withholding tax provisions. These anti-avoidance rules provide that where an intermediary is interposed between a Canadian borrower and certain related non-resident lenders to circumvent application of the thin capitalization rules, the intermediary will be ignored and the back-to-back loan provisions would deem the loan to be between the Canadian borrower and the non-resident lender, thus making the thin capitalization rules applicable to the loan. Related withholding tax rules introduced by Budget 2014 require the rate of withholding to be equal to the rate that would otherwise have applied to interest paid to the related non-resident lender (assuming it is greater) rather than to the intermediary.

Extension to royalty payments

Budget 2016 introduces an extension of these rules to apply to back-to-back arrangements involving royalty payments. The ITA generally imposes a 25 per cent withholding tax on cross-border payments of rents, royalties or similar payments. The 25 per cent withholding tax rate is often reduced by an applicable tax treaty. Taxpayers therefore may interpose an intermediary located in a favourable treaty country for the payment of royalties.

Under the new rules, where a Canadian taxpayer makes a royalty payment to a person resident in a treaty country (the intermediary) under the terms of a lease, licence or similar agreement, the intermediary has an obligation to pay an amount to another non-resident under the terms of a lease, licence or similar agreement, and the payments are established in reference to each other or are interconnected in some way, the withholding tax rules currently in place in respect of interest payments will also apply to the royalty payments. The applicable withholding tax rate will be the rate on royalties paid to the ultimate non-resident recipient (assuming it is greater) rather than to the intermediary. These rules will apply to royalty payments made after 2016.

Character Substitution Rules

Budget 2016 also proposes to extend the back-to-back rules to prevent avoidance of the higher withholding tax rate by substituting payments that are economically similar to interest and royalties as part of a back-to-back arrangement between an intermediary and a non-resident. These rules will also apply to payments made after 2016.

Extension to Shareholder Loans

The ITA contains shareholder benefit rules that generally apply where a Canadian corporation makes a loan to a shareholder or a related party and the loan remains outstanding for more than one year after the end of the taxation year in which it was made. If the loan was made to a non-resident, the amount of the benefit is deemed to be a dividend subject to withholding tax. Similar to the back-to-back loan rules outlined above, Budget 2016 introduces back-to-back rules that will apply where an intermediary is interposed between a Canadian corporation and a shareholder or related party: the Canadian corporation will be deemed to have made the loan directly to the shareholder rather than to the intermediary, such that the shareholder benefit provisions will apply in respect of the loan. These rules will apply to loan arrangements in place on March 22, 2016.

back to top...

Base Erosion Profit Shifting

Following the release of the report Addressing Base Erosion and Profit Shifting (**BEPS**) in February 2013, the Organisation for Economic Co-operation and Development (**OECD**) and G20 countries quickly adopted a 15-point action plan to address BEPS. BEPS generally refers to tax planning arrangements undertaken by multinational enterprises (**MNEs**) which, although often using legal means, exploit the interaction between domestic and international rules to minimize tax. One of the main objectives of the OECD with the BEPS project was to ensure that an MNE's profits be allocated based on the location of the economic activities which generate profits and the location where value is created. On October 5, 2015, after more than two years of work, the OECD released its final reports with recommendations from the BEPS project.

Upon the release of the OECD's recommendations, the tax community's focus turned to whether these recommendations would be endorsed, in whole or in part, by tax administrations around the world. Whether the BEPS project will ultimately be declared a success will hinge on how widespread and consistently its recommendations are adopted. At the November 2015 G20 Leaders' Summit, Canada and the other G20 members endorsed the OECD's BEPS recommendations. Budget 2016 provides a more detailed update on the implementation of some of these recommendations.

Country-By-Country Reporting - Transfer Pricing Documentation

One of the most talked about recommendations put forward by the OECD is the requirement for MNEs to provide country-by-country (**CbC**) reporting of their transfer pricing arrangements. Transfer pricing refers to the price at which goods, services and intangibles are transacted across international borders by parties who are not dealing with each other at arm's length. Under transfer pricing rules a transfer price must be consistent with the arm's length principle, that is, the transfer price should be a price that arm's length parties would have negotiated. The objective of the CbC reporting requirement is to provide tax administrations with better information for conducting risk assessments of transfer pricing situations.

Pursuant to the transfer pricing rules in subsection 247(4) of the ITA, a Canadian taxpayer that enters into a non-arm's length transaction with a non-resident of Canada must prepare documentation which explains and substantiates the transfer price for that transaction. Subsection 247(4) currently does not require a Canadian taxpayer to maintain much of the information that the OECD's final report on BEPS is recommending for CbC reporting.

Budget 2016 proposes to implement CbC reporting, presumably by amending subsection 247(4), in accordance with the OECD's recommendations for large MNEs with total annual consolidated group revenue of €750 million or more. Such MNEs will be required to file a CbC report with the MNE's parent entity's tax administration. A CbC report will include the global allocation, by country, of key details of the MNE, including: revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each subsidiary.

Where the parent entity of a qualifying MNE is resident in Canada, it will be required to file a CbC report with the CRA within one year of the end of the relevant fiscal year. CbC reporting will be required for taxation years that begin after 2015.

Jurisdictions which receive a CbC report from an MNE will automatically exchange the report with all other jurisdictions in which the MNE operates, provided that the other jurisdictions have implemented CbC reporting, have a legal framework in place for automatic exchange of information, and have entered into a competent authority agreement relating to CbC reporting.

Given the initial concerns regarding the burden which may be placed on MNEs to comply with CbC reporting, the proposals in Budget 2016 are limited to large MNEs and only require the filing of one CbC report per MNE. This may appease some of the initial concerns expressed by the tax community. Also, since the parent companies of many MNEs are not resident in Canada, most Canadian companies which currently have to comply with subsection 247(4) will not be the entity which is required to file a CbC report.

Revised OECD Guidance

The arm's length principle is found in all of Canada's bilateral tax treaties and is mandated by section 247 of the ITA. The OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**OECD Guidelines**), which Canada adheres to, provide guidance on the application of the arm's length principle. Some of the recommendations arising from the BEPS final reports include revisions to the OECD Guidelines, notably with respect to the interpretation of the arm's length principle. These revisions should be applied by the CRA since they are consistent with the CRA's current interpretation and application of the arm's length principle.

Even though the Government of Canada states in Budget 2016 that "the clarifications provided in the revisions generally support the [CRA]'s current interpretation and application of the arm's length principle," this is a very controversial subject in the international tax community. The OECD and Government of Canada view these revisions as clarifying in nature while many view the revisions, at least in part, as representing a fundamental change to the arm's length principle from the existing OECD Guidelines. This has been the subject of much discussion in the international tax community. Taxpayers whose existing structures contain transfer pricing methodologies which are inconsistent with the new revisions should seek proper tax counsel on how to rectify.

There is still followup work being performed by BEPS participants to develop a threshold for a proposed simplified approach to low value-adding services, as well as to clarify the definition of risk-free and risk-adjusted returns for minimally functional entities (i.e., "cash boxes"). The CRA will not adjust its administrative practices with regard to these two issues until the followup work is complete.

Treaty Shopping

Treaty shopping was one of the OECD's main concerns when it commenced the BEPS project. Treaty shopping arises where tax treaty benefits are obtained by involving an additional jurisdiction in an international transaction (for example, by creating an intermediary holding company to earn income or gains in a treaty country in order to obtain benefits under a tax treaty that country has entered into).

The BEPS project proposed minimum standards to address treaty abuse such as requiring countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The OECD recommends two treaty anti-abuse approaches: a principal purpose test and a limitation of benefits rule.

The principal purpose test targets transactions for which one of the principal purposes is to obtain treaty benefits in a way that is not in accordance with the object and purpose of the treaty. A limitation of benefits rule provides a series of tests that must be satisfied in order to qualify for treaty benefits.

Budget 2016 confirms the Government of Canada's intention to adopt the OECD's treaty abuse minimum standard, using either one of the two approaches (which can already be found in some of Canada's treaties).

A multilateral instrument is currently being developed by more than 90 participating countries to streamline the implementation of treaty-related BEPS recommendations. Canada is participating in the development of this multilateral instrument which is expected to be completed in 2016. The multilateral instrument is a tax treaty which will modify provisions of existing treaties if both parties to a treaty sign the instrument. Consequently, in order to implement the treaty abuse minimum standards, amendments to Canada's existing treaties will be achieved through bilateral negotiations, or through the use of this multilateral instrument, or by a combination of the two.

As some may recall, in Budget 2013 the Government of Canada announced its intention to consult on possible measures that would protect the integrity of Canada's tax treaties. Following that announcement, the government released a consultation paper on treaty shopping in August 2013 and then Budget 2014 included a formal proposal for a domestic Canadian anti-treaty shopping rule. In a news release on August 29, 2014, the Government of Canada announced that "After engaging in consultations on a proposed anti-treaty shopping measure, the Government will instead await further work by the [OECD] and the Group of 20 (G-20) in relation to their [BEPS] initiative." It would appear, based on statements in Budget 2016, that the Government has put to rest any ideas of introducing a domestic Canadian anti-treaty shopping rule.

Exchange of Tax Rulings

In an effort to increase transparency, the BEPS project developed a framework for the automatic exchange of tax rulings between tax administrations. These exchanges are generally limited to rulings associated with an area of concern for the BEPS project, such as rulings related to preferential regimes, cross-border unilateral advance pricing arrangements, rulings giving a downward adjustment to profits, permanent establishment rulings and conduit rulings.

Budget 2016 confirms that the CRA will commence to exchange tax rulings in 2016 with other jurisdictions which have committed to the BEPS treaty abuse minimum standard. Such information will be subject to confidentiality provisions and therefore will be protected in the same manner as taxpayer information.

back to top...

Taxation of Switch Fund Shares

General provisions in the ITA provide that the exchange of convertible corporate securities are deemed not to be a disposition. Mutual fund corporations (or investment corporations) referred to as "switch funds" take advantage of those provisions by offering to their investors multiple classes of shares, each providing for exposure in different funds. Where an investor modifies its asset exposure by switching investments between different classes of shares, the exchange is completed on a tax-deferred basis.

Budget 2016 proposes amendments that will result in the investors switching investments in mutual fund corporations (or investment corporations) being considered to have disposed of the investments at FMV. The proposed amendments will not apply where the shares received only differ in respect of management fees or expenses to be borne by the investors and otherwise derive their value from the same portfolio or fund within the mutual fund corporation (i.e., 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.

back to top...

Derivative Valuation

The Tax Court of Canada recently held that certain derivatives held by a taxpayer on income account could be considered inventory of the taxpayer. The ITA provides that inventory held by a taxpayer at year-end may be valued at the lower of cost and FMV. These rules allow a taxpayer to deduct decreases in value prior to the disposition of a derivative while only forcing recognition of increases in value on actual disposition. Budget 2016 proposes to exclude certain derivatives (i.e. a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a similar agreement) from the application of the inventory valuation rules, while maintaining the status of such property as inventory. A related rule will ensure that taxpayers are not able to value derivatives using the lower of cost and market method under the general principles for the computation of profit for tax purposes. This measure will apply to derivatives entered into on or after March 22, 2016.

back to top...

Sales of Linked Notes

Linked notes are debt obligations where the return is linked to the performance of a reference asset such as a basket of stocks, a stock index, a commodity, a currency or units of an investment fund. In general, the full amount of the return on the note is included in income when it becomes determinable, generally close to maturity. Where a note that is capital property is disposed of prior to the time the return becomes determinable, the "accrued return" can be considered a capital gain, only 50 per cent of which is included in income.

Budget 2016 proposes amendments so that any gain realized on the sale of a linked note will be deemed to be interest that has accrued on the note. Where the note is denominated in a foreign currency, foreign currency fluctuations will be ignored for the purpose of calculating this gain. Where a portion of the return on the note is based on a fixed interest rate, any portion of the gain reasonably attributable to market interest rate fluctuations will also be excluded.

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

back to top...

Combating the Multiplicity of Small Business

Deductions

There was some speculation that Budget 2016 would limit the use of Canadian-controlled private corporations (**CCPC**), and limit access to the corresponding preferential federal tax rate of 10.5 per cent on the first $500,000 of active business income through the small business deduction (**SBD**). The perception was that certain professionals were using CCPCs to unduly reduce their tax burden. In general, Budget 2016 leaves the CCPC regime intact and continues to apply the 10.5 per cent rate to incorporated businesses using the SBD. However, Budget 2016 takes aim at partnership and corporate structures that were used to multiply the SBD, including structures used by many professionals.

The ITA contains rules to limit the multiplication of the SBD through the use of a partnership of CCPCs that were not otherwise associated. Under these rules, each of the corporate partners would be obliged to share one SBD. However, structures were developed to work within the existing rules to achieve a multiplication of the SBD. Generally, this was achieved by having the relevant CCPC provide services for partnership business as an independent contractor rather than as a partner, with the result that the CCPC was entitled to a full SBD.

To address this type of tax planning Budget 2016 proposes to extend the "specified partnership income" rules in the ITA to partnership structures in which a CCPC provides 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. Affected CCPCs will be deemed to be members of the partnership and no longer be entitled to the full SBD.

A similar rule is proposed to deal with multiplication of the SBD through corporate structures. Generally, the proposed rule will deny the SBD to income earned by a CCPC through the provision of property or services to a private corporation in which the CCPC, a shareholder of the CCPC, or a non-arm's length person holds a direct or indirect interest in the recipient of the property or services. However, the private corporation can elect to "share" its SBD with the CCPC, so that the income from such property or services can benefit from the SBD. This is consistent with the theme of the proposal to prevent the multiplicity of SBDs, but not otherwise restrict the SBD.

One interesting aspect of this proposal is the fact that the CRA has issued many advance income tax rulings approving the partnership structures described above. Apparently, the Department of Finance has concluded that these structures offend the policy of the SBD rules. It seems equally clear that the Department of Finance is fully aware that such structures have been implemented extensively by professional services firms.

back to top...

Avoidance of the Business Limit and the Taxable Capital Limit

The existing associated corporation rules in the ITA are relevant for both the $500,000 business limit and the $15 million taxable capital limit to CCPCs. The rules are intended to strike a balance between allowing different family members to carry on businesses through separate CCPCs, each eligible for the full SBD, and addressing tax planning arrangements used by a single economic group for purposes of multiplying access to the SBD.

Under the current rules, two corporations which would otherwise not be associated are deemed to be associated if each of the corporations is associated with the same third corporation. There is an exception to this deemed association rule if the third corporation is not a CCPC or elects not to be a CCPC. In this situation, the third corporation cannot claim the SBD, but each of the other two corporations may claim the full SBD subject to their own taxable capital limit.

The exception to the deemed association rule does not affect the associated corporation status for the purpose of another rule that treats a CCPC's investment income as active business income eligible for the SBD if that income is derived from the active business of an associated corporation. Accordingly, two corporations may not be associated for the purpose of claiming the maximum SBD, but nevertheless have the ability to treat investment income that one receives from the other as active business income.

Budget 2016 proposes amendments to ensure that investment income derived from an associated corporation's active business will be ineligible for the SBD and will be taxed at the general corporate income tax rate where the exception to the deemed association rule applies. In addition, where the deemed association rule applies, the third corporation will continue to be associated with each of the other corporations for the purpose of applying the $15 million taxable capital limit.

These measures will apply to taxation years that begin on or after March 22, 2016.

back to top...

Consultation on Active versus Investment Business

Budget 2015 announced a review of the circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income eligible for the SBD. The CRA has published guidance on this issue, and a significant body of case law has developed related to the factors that are relevant in making that determination. Budget 2016 announced that the Department of Finance has completed its review of this matter and does not propose to modify the applicable rules.

back to top...

Elimination of Eligible Capital Property Regime

Budget 2016 proposes to eliminate the eligible capital property regime and to replace it with a new CCA class. This measure was first proposed in Budget 2014 and was the subject of a public consultation.

Current Regime

Currently, capital expenditures may qualify as ECP where they are incurred in respect of intangible property for the purpose of earning income from a business and are not deductible as a current expense or incurred to acquire an intangible property that is currently depreciable under the CCA rules. Under the ECP regime, 75 per cent of an eligible capital expenditure is added to the taxpayer's cumulative eligible capital (**CEC**) pool in respect of the business and is deductible at a rate of seven per cent per year on a declining-balance basis. Similarly, 75 per cent of an eligible capital receipt (generally, a capital receipt for rights or benefits of an intangible nature that is received in respect of a business, other than a receipt that is included in income or is proceeds of disposition of a capital property) received by a taxpayer is deducted from the relevant CEC pool. If the balance of the CEC pool becomes negative as a result of such deduction, the amount of the negative balance must be included in the taxpayer's income as recaptured CEC. Once all of the previously deducted CEC has been recaptured, any excess receipt (an ECP gain) is included in income from the business at a 50 per cent inclusion rate, akin to the inclusion rate for a capital gain.

By contrast, the CCA regime permits discretionary deductions in respect of the cost of depreciable capital property of a taxpayer. The amount of CCA that may be deducted by a taxpayer is based on prescribed rates applied on a declining-balance basis to the undepreciated capital cost of the property. Different types of depreciable property are assigned to various classes in the Regulations and have their own prescribed maximum rates of depreciation. The disposition of depreciable capital property could give rise to income in the form of recaptured depreciation (or, a loss on income account) and/or a capital gain (or capital loss).

Proposed Rules

Budget 2016 proposes to create a new class of depreciable property. Expenditures of the type currently added to the CEC pool at a 75 per cent inclusion rate will instead be added to a new CCA Class 14.1 pool at a 100 per cent inclusion. The rate of depreciation of a Class 14.1 pool will be five per cent on a declining-balance basis. The existing CCA rules will generally apply, including rules relating to recapture and the so-called "half-year" rule. The application of the half-year rule will be disadvantageous to taxpayers as it will limit their ability to claim CCA deductions in the year of acquisition.

Budget 2016 proposes special rules for goodwill and expenditures and receipts that do not relate to a specific property. These rules recognize that most but not all expenditures and receipts that would be eligible capital expenditures or receipts under the current ECP regime relate to the acquisition or disposition of property and, consequently, such amounts would result in an adjustment to the undepreciated capital cost of the new Class 14.1 pool when the property is acquired or disposed of. These special rules provide that such expenditures or receipts will be accounted for by adjusting the capital cost of the goodwill of the business and, consequently, the undepreciated capital cost of the new Class 14.1. Every business of a taxpayer will be considered to have goodwill associated with it, even if there had not been an expenditure to acquire goodwill.

Transitional Rules

Budget 2016 proposes transitional rules to transfer a taxpayer's CEC balance as of January 1, 2017 (including for taxpayers whose taxation year straddles January 1, 2017) to the new Class 14.1 pool. For the first 10 years thereafter, the depreciation rate for the new CCA class will be seven per cent in respect of expenditures incurred before January 1, 2017.

Certain qualifying receipts that are received after the implementation of the proposed rules that relate to property acquired, or expenditures otherwise made, before the implementation time will reduce the balance of the new CCA class by an amount equal to 75 per cent of such receipt. However, the total amount of such qualifying receipts that may be deducted at the reduced rate would be limited to the total amount that could have been received by a taxpayer prior to triggering the ECP gain under the ECP regime. This rule ensures that receipts do not result in excess recapture when applied to reduce the balance of the new CCA class.

Budget 2016 also proposes special rules to simplify the transition for small businesses, including allowing a deduction for CCA, in respect of expenditures incurred before 2017, equal to the greater of $500 per year and the amount otherwise deductible for that year. As well, a separate business deduction will be provided for incorporation expenses up to $3,000. Budget 2016 provides that this measure will not impact the application of GST/HST in this area.

back to top...

Mineral Exploration Tax Credit

Budget 2016 proposes to extend the flow-through mining tax credit that has been in place for a number of years. Annual extensions of this 15 per cent federal tax credit have been a feature of federal budgets since 2007.

The credit will be available to purchasers of flow-through shares under flow-through share agreements entered into on or before March 31, 2017. It will available only in respect of a certain subset of Canadian exploration expenses relating to specified kinds of surface or "grassroots" exploration.

Flow-through funds raised by mining exploration companies on or before March 31, 2017, can be expended on eligible expenditures prior to the end of 2018, and under the "look-back" rule, can be renounced to purchasers for deduction and this 15 per cent credit in 2016.

The measure is intended as an additional stimulus to surface exploration in Canada. Similar tax measures are in place in Ontario, British Columbia, Manitoba and Saskatchewan.

back to top...

Expanding Tax Support for Clean Energy

In keeping with the Government of Canada's commitment to combat climate change, Budget 2016 contains tax measures to incentivize green energy initiatives and to clarify or enact tax rules specific to the clean energy sector.

Electric Vehicle Charging Stations

Budget 2016 proposes to expand the types of clean energy generation and conservation equipment that are eligible for accelerated CCA under classes 43.1 and 43.2 (30 per cent and 50 per cent, respectively). Electric vehicle charging stations, which are currently eligible for CCA at a rate of 20 per cent, will be included in class 43.1 or 43.2, depending on whether the power threshold is greater or less than 90 kilowatts of continuous power. Eligible equipment is to include equipment downstream of an electricity meter, owned by an electricity utility and used for billing purposes or owned by the taxpayer to measure electricity generated by the taxpayer, provided that more than 75 per cent of the annual electricity consumed is used to charge electric vehicles. This measure will apply in respect of property acquired for use on or after March 22, 2016, that has not been used or acquired for use before that time.

Electrical Energy Storage

Certain kinds of electrical energy storage equipment are currently eligible for accelerated CCA when ancillary to generation technologies that are themselves eligible for accelerated CCA. Stand-alone electricity storage equipment is not currently eligible and generally a CCA rate of only 20 per cent applies. Budget 2016 proposes two changes. First, a clarification and expansion of the range of electricity storage equipment that is eligible for accelerated CCA on the basis of it being ancillary to eligible generation equipment. Second, stand-alone electricity storage property is proposed to be eligible for accelerated CCA under class 43.1 (30 per cent) provided that the round trip efficiency of the equipment (the degree to which energy is maintained in the conversion process) is greater than 50 per cent. This measure is to apply in respect of property acquired for use on or after March 22, 2016 that has not been used or acquired for use before that time.

Emissions Trading Regimes

Acknowledging that several provinces have introduced, or are proposing to introduce, emissions trading regimes, Budget 2016 proposes specific tax rules to clarify the treatment of emissions allowances and the consequences of transactions under such regimes (although no draft legislation was released with Budget 2016).

Under an emissions trading regime, a government may impose an obligation on a regulated emitter to deliver emissions allowances to the government, with the amount of the allowances determined by reference to the amount of emissions of a regulated substance (such as greenhouse gases) produced. These allowances may be purchased by an emitter in the market or at auction, earned in relation to emissions reduction activities, or provided by the government at a reduced rate or at no cost. Currently, as there are no specific tax rules relating to emissions trading regimes, the tax consequences are determined under general tax principles.

Budget 2016 notes two concerns raised by stakeholders, including the character of an emissions allowance as property with an enduring value (entitling the emitter to tax depreciation over a period of time), as well as the potential for double taxation when an allowance is provided by a government for no consideration. Double tax can arise since the value of an allowance is recognized by the emitter as income, but without a corresponding adjustment to the cost amount of the allowance to reflect the income inclusion. Budget 2016 proposes specific rules to address these concerns.

First, rules are proposed to treat emissions allowances as inventory, although the emitter will be unable to value allowances using the "lower of cost or FMV" method. Second, under the proposed rules the receipt of a "free" allowance will not result in an income inclusion. Third, the proposed rules would limit the deduction in respect of an accrued emissions obligation to the extent that the obligation exceeds the cost of any emissions allowances that the emitter has acquired and that can be used to settle the obligation. Each year that the emitter claims a deduction in respect of an emissions obligation, the emitter will quantify its deduction based on the cost of emission allowances that it has acquired and which can be used to settle its emissions obligation, plus the FMV of any emissions allowances that it still needs to obtain to fully satisfy its obligation. Applying a form of reserve approach, where a deduction is claimed in respect of an emissions obligation that accrues in one year (for example, 2017) and that will be satisfied in a subsequent year (for example, 2018), the amount of the deduction is to be brought back into income in the subsequent year (2018) and the emitter will be required to evaluate the deductible obligation again each year, until the obligation is ultimately satisfied. Finally, if the emitter disposes of an emissions allowance otherwise than in satisfaction of an obligation under the emissions allowance regime, any proceeds received in excess of the emitter's cost, if any, for the allowance will be included in computing income.

These measures are to apply to emissions allowances acquired in taxation years beginning after 2016 and, on an elective basis, to emissions allowances acquired in taxation years ending after 2012.

back to top...

GST/HST and Excise Tax Measures

Budget 2016 provides welcome relief from the GST/HST for various sectors, but also narrowed and qualified relief for others.

Qualification as a "financial institution"

A taxpayer that qualifies as a "financial institution" for GST/HST purposes is subject to more rigorous reporting and compliance obligations than are other taxpayers. There is a revenue threshold of $1,000,000 for qualifying as a financial institution, where the particular revenues are from interest or a separate fee or charge from an advance, the lending of money or the granting of credit. This may include interest earned on a deposit with a bank or another financial institution. Budget 2016 proposes to exclude interest income in respect of demand deposits, as well as GICs and term deposits of less than one year in determining whether the $1,000,000 threshold is met. This rule is effective for taxation years of a person that begin after March 22, 2016, and to the fiscal year of a person that includes March 22, 2016.

Cross-border Insurance

In response to years of advocacy from the insurance sector, Budget 2016 provides welcome relief to insurers from their requirement to self-assess for GST/HST on ceding commissions and the margin for risk transfer in relation to cross-border reinsurance. These measures apply from November 16, 2005, when the self-assessment obligation was first imposed. In addition, there is to be a one year window from Royal Assent to allow insurers to request a reassessment of GST/HST paid on these amounts, as well as any related penalties and interest.

Call centres for non-residents

Budget 2016 provides explicit GST/HST zero-rating for call centre services, where the service consists of providing technical or customer support to individuals by means of telecommunications such as telephone, email or web chat. The relief will apply if it can reasonably be expected that the support is primarily provided to individuals outside of Canada, where the service is paid for by a non-resident person that is not GST/HST registered. The zero-rating will apply after March 22, 2016, and to historic supplies where the supplier did not charge, collect or remit the GST/HST.

Relief on donations to charities

When a donor receives property or services on a donation to a charity, the charity may be required to collect GST/HST on the amount of the donation unless one of small number of exemptions or exclusions apply. Budget 2016 proposes to harmonize the GST/HST treatment with the existing income tax treatment to allow the charity to only charge the GST/HST on the value of the property or services provided by the charity after March 22, 2016, similar to the principle behind the "split-receipting" rules under the ITA. There is to be historic relief where the value of the property or services was less than $500 (which should address most situations), as well as the application of relief for supplies made between December 21, 2002 (when the ITA split-receipting rules came into effect) and March 22, 2016, where GST/HST collection on a split-receipting basis was applied.

Related party relief

Budget 2016 proposes to amend the relief on related party transactions to enhance the requirement to meet the closely-related test. The test has required 90 per cent or greater ownership by value and number of the voting shares of a related corporation. This test is to be made more stringent by requiring that the right to vote not be restricted with respect to subject matter, nor be delegated to another person by contract. This measure will generally apply as March 22, 2017. It also will apply as of March 23, 2016, to related party elections under section 150 and section 156 of the Excise Tax Act that are filed after March 22, 2016, with effect as of a day after March 22, 2016.

Diesel fuel for heating and generating electricity

In addition, Budget 2016 narrowed relief from the federal excise tax on diesel fuel used as heating oil, and eliminated the relief for diesel fuel used to generate electricity. The relief for diesel fuel used for heating will only apply to heating in homes and buildings, and not to industrial processes. The relief for diesel fuel will apply to diesel fuel delivered or imported before July 2016 where it is used, or intended to be used after June 2016, and to fuel delivered or imported after June 2016.

Administrative measures

Finally, Budget 2016 also provides some new administrative measures, some more strict and others more lenient.

Budget 2016 proposes two enhancements to the security and collection rules in the Excise Act, 2001. Budget 2016 proposes to increase the maximum amount from $2,000,000 to $5,000,000 for security required for manufacturers to obtain a tobacco licence and "duty-paid" stamps. This change will be effective on the later of the day following Royal Assent to the legislation enacting the new collection proposal (see below) or June 22, 2016. In addition, although the CRA generally may not take collection actions when a dispute is pending under Excise Act, 2001, Budget 2016 proposes to give the CRA authority to require security for payment of assessed amounts and penalties in excess of $10,000,000. Further, if security is not provided, Budget 2016 proposes that the CRA may have the authority to collect an amount equal to the security required.

Budget 2016 also proposes to reduce reporting for builders of new residential housing, where the housing was grand-parented on the introduction of or increase to the HST. The proposal is to limit the reporting requirement to housing of $450,000 or greater and relief from penalties for historic non-compliance with reporting. This measure will apply for any reporting period of a person that ends after March 22, 2016. In addition, where builders make an election between May 1, 2016, and December 31, 2016, the measure will also apply to any supply of grand-parented housing for which the federal component of the HST became payable on or after July 1, 2010.

back to top...

Personal Income Tax Measures

Budget 2016 contained no changes to personal income tax rates since the Government of Canada had already announced changes to personal tax rates on December 7, 2015. At that time the rate for the top federal marginal tax bracket (over $200,000) increased to 33.0 per cent and the tax rate for the second federal marginal tax bracket decreased from

22.0 per cent to 20.5 per cent. However, a number of consequential amendments to the ITA were announced in Budget 2016 as a result of the increase in the top federal marginal tax rate. These amendments include the application of the new 33 per cent top rate to:

- Excess employee profit sharing plan contributions;
- Personal services business income earned by corporations;
- The capital gains refund mechanism for mutual fund trusts in the formulas that are used in computing refundable tax; and
- The recovery tax rule for qualified disability trusts.

Another consequence of the change in the top marginal rate is an amendment to the definition of "relevant tax factor" in the foreign affiliate rules, which reduces the relevant tax factor from the current 2.2 to 1.9.

The biggest changes in Budget 2016, based on their estimated fiscal impact, are the elimination of the income splitting credit and changes to child benefit payments. The income splitting credit announced by the previous government in Budget 2015 will be eliminated in 2016. In an effort to consolidate and apply a more targeted approach, the Government of Canada also proposes to consolidate the Canada Child Tax Benefit (which includes a base benefit, the national child benefit supplement and the child disability benefit) and the Universal Child Benefit into a new "Child Tax Benefit" effective July 2016. In most cases, depending on age and number of children, the base payment under the Child Tax Benefit will be slightly higher for low income families than the current smorgasbord of benefit payments, but is phased out gradually for families with adjusted family net income over $30,000.

Budget 2016 further proposes to eliminate the education and textbook tax credit, children's fitness tax credit, and children's art tax credit in 2017. The latter two will be phased out with reduced amounts applying in 2016.

back to top...

Life Insurance

Budget 2016 introduces two measures targeting planning involving life insurance.

First, for life insurance policies owned by a private corporation, current rules provide that policy proceeds received on the death of an insured in excess of the adjust cost base (**ACB**) of the policy can be added to the capital dividend account and paid as a tax free capital dividend to shareholders. In a simple case, the ACB of an interest in a life insurance policy is equal to the cumulative premiums paid for the policy minus the net cost of pure insurance (the pure mortality cost of the policy).

Current rules lead to similar results where a life insurance policy is owned by a partnership: the policy proceeds net of the ACB of the policy are added to the ACB of the partnership interests and can be paid to partners free of tax.

If a policy is owned by one corporation and the beneficiary of the policy is another corporation, when the proceeds under the policy are paid to the beneficiary corporation there is no "grind" to the capital dividend account on account of the ACB of the policy since the beneficiary corporation has no ACB in the policy. Similar results obtain in the case of insurance policies owned by partnerships.

Budget 2016 regards this result as an artificial increase in the capital dividend account and ACB of the partnership interest. It introduces rules to limit the addition to the capital dividend account and ACB of the partnership interest to the policy proceeds net of the policy ACB, regardless of whether the corporation or partnership that receives the policy proceeds owns the policy.

The new provisions apply in respect of deaths occurring on or after March 22, 2016 and are accompanied by information reporting requirements applicable to corporations or partnerships receiving policy proceeds.

The second measure addresses planning involving transfers of life insurance policies. Under current rules, where a life insurance policy is transferred to a non-arm's length party, the transfer is deemed to occur at the policy's cash surrender value even though the cash surrender value may be considerably lower than the FMV and even though the actual proceeds received are equal to the FMV. Under current rules, transfers to non-arm's length corporations can be used to extract the surplus of the transferee corporation on a tax free basis and, when the insurance proceeds are paid to the transferee corporation, they (net of the ACB of the policy) can be paid out tax free to shareholders as a capital dividend.

Budget 2016 introduces measures to require the recognition of any proceeds or increase in PUC actually received on such transfers. The new measures apply to transfers that occur on or after March 22, 2016.

back to top...

Investing to Enhance Tax Fairness and

Administration

Budget 2016 includes measures to seek to improve the integrity of Canada's tax system and enhance fairness, while increasing revenues. Over the next five years, the CRA will receive $444.4 million to address tax evasion and aggressive tax avoidance through hiring extra auditors and specialists, developing robust business intelligence infrastructure, increasing verification activities and improving the quality of its investigations of criminal tax evaders. The expected five year "return on investment" from these initiatives was estimated to be $2.6 billion. Similarly, a further $351.6 million will be deployed over the next five years to improve the CRA's ability to collect outstanding tax debts, leading to an anticipated additional $7.4 billion collected.

Service enhancements may make things easier for taxpayers to resolve their disputes with the CRA. Enhancements include increased capacity to resolve taxpayer objections on a timely basis. This is welcome, as it currently can take up to one year before a CRA appeals officer is assigned to work on an objection. The CRA has also promised to revamp the structure, design and format of its correspondence to be more straightforward and easy to read. For taxpayers seeking access to their information from the CRA, $12.9 million over the next five years will be devoted to simplify the process, including providing a central website for submitting requests, backed up by a 30-day guarantee for personal information requests, failing which a written explanation for the delay will be provided to both the requester and the Privacy Commissioner. While that initiative is welcome in light of the significant delays typically associated with accessing CRA information, both the Access to Information Act and the Privacy Act already provide for a 30-day deadline for providing requested information and also require that the government provide notice in writing if the deadline cannot be met. It is therefore unclear how the "30-day guarantee" will be any different from the statutory guarantee.

back to top...

Status of Outstanding and Other Tax Measures

Budget 2016 confirmed the Government of Canada's intention to proceed with the common reporting standard established by the OECD to address international tax evasion and improve tax compliance. Further, the Government of Canada indicated that it intends to proceed with the legislative proposals to modify rules for estate donations and spousal and common-law partner (and similar) trusts. As a result, post-mortem tax planning should be re-evaluated in light of the Government of Canada's intention to implement these proposals.

Conservatives measures make a comeback in Budget 2016

Budget 2016 also confirmed the Government of Canada's intention to proceed with the majority of the tax measures that were proposed in Budget 2015 (with modifications that are not yet known) but not legislated before Parliament was dissolved in August, 2015. These include proposed amendments affecting: (i) the conversation of capital gains into tax-deductible inter-corporate dividends (section 55), (ii) synthetic equity arrangements, (iii) alternative arguments in support of an assessment, (iv) information sharing for the collection of non-tax debts, (v) the repeated failure to report income and (vi) an exception to payroll withholding requirements for qualifying non-resident employees.

It remains to be seen how the Department of Finance will modify the Budget 2015 tax proposals they plan to implement and whether they will take into consideration the numerous Joint Committee Submissions dealing with fundamental concerns of these tax proposals.

Aboriginal Tax Policy

The Government of Canada continues to express its willingness to enter into taxation arrangements with Aboriginal governments and has indicated that it supports and will facilitate direct taxation arrangements between provinces or territories and Aboriginal governments.

back to top...

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back to top...

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