2017 FEDERAL BUDGET

INTRODUCTION

Finance Minister Bill Morneau delivered the government's 2017 federal budget on March 22, 2017, and on the surface the tax measures are not as bad as what was expected by many in the tax community. There was speculation in the weeks leading up to the budget that the government would target businesses and high income-earners by increasing the capital gains inclusion rate, modifying stock option benefits, or adding further restrictions to the small business deduction. The good news is none of these items were affected in the budget.

Unfortunately, there are little if any positive changes in this budget in terms of taxation, however, we continue to see adverse tax measures affecting private corporations. In the coming months the government will be reviewing common tax planning strategies of private corporations such as income splitting (referred to as "income sprinkling" in the budget), holding passive portfolio investments and converting regular income into capital gains. There are also tax measures directed against professionals such as doctors, lawyers and accountants. Where last year's budget restricted utilization of the small business deduction for many professionals, this year's budget introduces changes to the taxation of work in progress.

In addition, several personal credits and deductions were eliminated including the public transit credit and the home relocation loan deduction. The three credits relating to family care giving were consolidated into a single amount, but will not be available to everyone who benefits from the existing credits.

In this budget commentary, we provide an overview of the proposed tax changes and how they will impact Canadian businesses and individuals.

CORPORATE AND BUSINESS

Tax Planning Strategies Involving Private Corporations

The government will be reviewing the use of tax planning strategies that reduce the personal taxes of high-income earners. Some examples listed in the budget include:

- Income splitting with lower income family members using private corporations
- Holding passive portfolio investments inside a private corporation
- Converting a private corporation's regular income into capital gains

No specific changes have been announced, but the government plans to release a paper setting out the nature of these issues and proposed policy responses "in the coming months".

In order to discourage money laundering, terrorist financing and tax evasion, the government announced that it will be undertaking measures to obtain better transparency of legal persons, legal arrangements and beneficial ownership situations. For example, this could include identifying the actual shareholders of companies and the actual owners when assets are held in trust.

CORPORATE AND BUSINESS, cont'd

Forcing Professionals to Pay Tax on Their Work In Progress (WIP)

Currently, certain designated professionals are allowed to elect to only be taxed on amounts that have been billed and to defer being taxed on unbilled work in progress until the work is invoiced.

The Budget will now require designated professionals (accountants, dentists, lawyer, medical doctors, veterinarians, and chiropractors) to include in income the lower of cost and fair market value of their work in progress and pay tax on it immediately. Professionals with a December year-end will get a one year reprieve. For the first taxation year beginning after March 22, 2017, 50% of this amount will have to be included in income with 100% included in succeeding years.

Meaning of Control

Tax legislation recognizes two forms of control of a corporation: de jure (legal) control and de facto (factual) control. For example, the factual control test is used to determine whether two or more Canadian Controlled private corporations are associated for the purposes of sharing the small business deduction on the first $500,000 of active business earnings, and for determining the preferential SR&ED tax credits.

The budget proposes to broaden the meaning of de facto control to:

- Take any factor relevant in the circumstances into consideration during the determination of whether a particular individual has direct or indirect influence that could result in control of a corporation if exercised; and
- Not require or be limited to a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability.

The change is effective for taxation years beginning on or after March 22, 2017.

Clean energy generation equipment: Geothermal energy

The budget expands Classes 43.1 and 43.2 under the Capital Cost Allowance ("CCA") regime to include geothermal equipment that is used primarily for the purpose of generating heat or a combination of heat and electricity. In addition, the budget proposes to allow geothermal heating to be considered an eligible thermal energy source for use in a district energy system, and to allow expenses incurred for the purpose of determining the extent and quality of a geothermal resource, and the cost of all geothermal drilling, for electricity and heating projects to qualify as a Canadian renewable and conservation expense.

The measures will apply in respect of property acquired for use on or after March 22, 2017 that has not been used or acquired for use before that day.

CORPORATE AND BUSINESS, cont'd

Canadian Exploration Expense: Oil and Gas Discovery Wells

Expenditures related to drilling or completing a discovery well are currently classified as Canadian Exploration Expenses ("CEE") which may be deducted in full in the year incurred. These expenditures will be reclassified as Canadian Development Expenses ("CDE") which may only be deducted at a 30% declining balance rate. These changes will also apply to expenditures incurred to build a temporary access road to, or in preparing a site in respect of, a discovery well.

An exception will allow drilling expenditures to continue to receive CEE treatment where:

- The well has been abandoned
- The well has not produced within 24 months, or
- Minister of Natural Resources certifies that the relevant costs associated with drilling the well are expected to exceed $5 million and it will not produce within 24 months.
- The expense relates to certain early stage surveying

These changes will apply to expenses incurred after 2018 (including specific 2019 expenses caught under a look-back rule). The changes do not apply to expenses actually incurred before 2021 where the taxpayer has entered into a written commitment before March 22, 2017 to incur those expenses.

Reclassification of Expenses Renounced to Flow-Through Share Investors

The budget proposes to remove the ability of eligible small oil and gas corporations to treat the first $1M of CDE as CEE. The change is effective in respect of expenses incurred after 2018 (including specific 2019 expenses caught under a look-back rule). The change does not apply to expenses incurred after 2018 and before April 2019 that are renounced under a flow-through share agreement entered into after 2016 and before March 22, 2017.

Timing of Recognition of Gains and Losses on Derivatives

The budget proposes to introduce an elective mark-to-market regime for derivatives held on income account (i.e. derivates where the gain is taxed as business earnings as opposed to a capital gain). An election will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election will remain effective indefinitely unless revoked with CRA approval.

An eligible derivative will be any derivative held on income account that meets certain conditions, e.g. the derivative is valued in accordance with accounting principles at its fair value in a taxpayer's audited financial statements or otherwise has a readily ascertainable fair market value.

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

CORPORATE AND BUSINESS, cont'd

Timing of Recognition of Gains and Losses on Derivatives, cont'd

The budget also introduces a new anti-avoidance rule to target straddle transactions that allow taxpayers to selectively realize gains and losses on derivatives. The stop-loss will apply to any loss realized on a position entered into on or after March 22, 2017.

Investment Fund Mergers

The reorganization of an investment fund can be done on a tax-deferred basis in limited circumstances. The budget proposes to extend the ability to reorganize in a tax-deferred manner to switch fund corporations and segregated funds effective January 1, 2018 for segregated funds and March 22, 2017 for switch fund corporations.

Investment Tax Credit for Child Care Spaces

The budget proposes to eliminate the investment tax credit for child care spaces.

Additional Deduction for Gifts of Medicine

The budget proposes to eliminate the additional deduction for gifts of medicine. No other changes are proposed on the general income tax treatment of donations made by corporations to registered charities.

Farming and Fishing Changes

Effective for years beginning after 2018, the budget proposes to eliminate the tax exemption that was available to insurers of farming and fishing properties.

Currently farmers delivering products to operators of elevators are able to defer the recognition of income until the year the cash is received for amounts reflected in cash purchase tickets issued by the operator. With private operators replacing the role of the Canadian Wheat Board, the government has announced that it will undertake consultations on the matter.

Personal Income Tax

Tuition Tax Credit

The budget proposes to allow certain occupational skills courses offered by post-secondary institution to qualify for the tuition credit. The course must provide the individual with skills (or improve the individual's skills) in an occupation. Additionally, the individual must have attained the age of 16 before the end of the

Personal Income Tax, cont'd

Tuition Tax Credit

year. The rules regarding the tax exemption for scholarship or bursary income are also extended to these students.

Public Transit Tax Credit

The budget will eliminate the public transit tax credit, effective on July 1, 2017.

Consolidation of Caregiver Credits

There a number of caregiver credits available for individuals caring for dependents, seniors and persons with disabilities. These include the family caregiver tax credit, the infirm dependent credit, and the caregiver credit. The budget proposes to replace these credits with a single new Canada Caregiver Credit:

- $6,883 in respect of infirm dependants who are parents/grandparents, brothers/sisters, aunts/uncles, nieces/nephews, adult children of the claimant or of the claimant's spouse or common law partner; and
- $2,150 in respect of an infirm dependent spouse or common-law partner in respect of whom the individual claims the spouse or common-law partner amount, an infirm dependant for whom the individual claims an eligible dependant credit, or an infirm child who is under the age of 18 years at the end of the tax year.

The credit is reduced to the extent that the dependent's net income exceeds 16,163 (the amount will be indexed each year).

Two major differences between this new credit and its predecessors are:

- The credit is no longer available in respect of non-infirm seniors; and
- The credit does not require the dependent to live with the caregiver.

The credit will first apply to the 2017 taxation year.

National Child Benefit Supplement

Budget 2016 introduced the Canada Child Benefit, replacing the previous child benefit system. A national child benefit supplement was introduced to assist the provinces and territories in calculating adjustments to social assistance and child benefit amounts. The repeal of this supplement was delayed one year to July 1, 2018.

The modifications will have no implication to the calculation of the Canada Child Benefit.

Personal Income Tax, cont'd

Home Relocation Loans Deduction

Currently when an employee receives an eligible home purchase loan with the interest lower than the prescribed rate, he or she is subject to a taxable benefit on the difference in rates and could be entitled to an offsetting deduction equal to the benefit on a loan up to $25,000.

The budget will eliminate the deduction in respect of eligible home relocation loans.

Electronic Distribution of T4 Information Slips

Commencing with T4's issued for 2017, employers will be allowed to distribute T4 information slips electronically to current active employees without having to obtain express consent from those employees in advance. But the employer will be required to have sufficient privacy safeguards, specified by the Minister of National Revenue, in place before the distribution.

Employers will still be required to provide paper T4s to employees who do not have confidential access to view or print their T4s or who requested paper copies.

Mineral Exploration Tax Credit

The 15% Mineral Exploration Tax credit is extended to flow-through share agreements entered into on or before March 31, 2018.

Allowances for Members of Legislative Assemblies and Certain Municipal Officers

Budget 2017 proposes to require that non-accountable allowances paid to certain officials be included in income. This measure will apply to taxation years after 2018.

The types of officials affected by these changes include elected members of provincial and territorial legislative assemblies and officers of incorporated municipalities; elected officers of municipal utilities boards, commissions, corporations or similar bodies; and members of public or separate school boards or of similar bodies governing a school district.

Ecological Gifts Program

The budget proposes a number of measures "in order to better protect gifts of ecologically sensitive land".

First, where eco-gifts are transferred between organizations for consideration, Budget 2017 proposes that the transferee of the property be subject to the 50-per-cent tax if the transferee changes the use of the property, or disposes of the property, without the consent of the Environment and Climate Change Canada (ECCC). Second, the Minister of ECCC has the ability to determine whether proposed changes to the use of

Personal Income Tax, cont'd

Ecological Gifts Program, cont'd

lands would degrade conservation protections. Third, the requirement for the Minister of ECCC to approve recipients is extended, on a gift-by-gift basis, to municipalities and municipal and public bodies performing a function of government. Fourth, private foundations are no longer permitted to receive eco-gifts. Additional changes are proposed specifically for Quebec.

GST/HST AND EXCISE TAX MEASURES

The budget proposes the following changes:

- Extending the GST/HST Free treatment of drugs to Nalaxone which is a drug used to treat opioid overdoes;
- Requiring all providers of ride sharing services (e.g. drivers for Uber and Lyft) to register for GST purposes to be consistent with the requirement that taxi drivers have to register regardless of the level of revenues they earn with this requirement taking effect July, 1, 2017;
- Elimination of the GST/HST rebate available to non-residents on the accommodation portion of eligible tour packages. This is applicable as of March 22, 2017 with the exception of tour package/accommodations supplied before January 1, 2018 where all the consideration was paid before January 1, 2018;
- A number of changes to tobacco taxation replacing the current 10.5% surtax on profits with a number of changes to the excise duty on tobacco products which are effective March 23, 2017; and
- A 2% increase in the excise duty payable on alcohol products effective March 23, 2017 and providing for an adjustment based on the Consumer Price Index on April 1 of each year starting in 2018.

OTHER MEASURES

The budget announced various other measures as follows:

- An ongoing expression of willingness to discuss and put into effect direct taxation arrangements with interested Aboriginal governments (more than 50 have been entered into so far) and support for direct taxation agreements between provinces and territories with Aboriginal governments.
- Extension of base erosion (income shifting) rules to foreign branches of life insurers.
- Changes to rules of origin to allow for apparel products imported from least developed countries (e.g. Haiti) to qualify for duty-free treatment upon importation to Canada.
- Changes to the Special Import Measures Act and related trade remedy regulations to be consistent with World Trade Organization rules. Changes are also being made to allow producers to file complaints against trade and business practices specifically intended to avoid trade remedies, allow interested parties to request that Canada Border Services Agency (CBSA) undertake a formal review to determine if a specific product falls within the scope of a trade measure remedy, and to enhance the ability of the such parties to monitor and appeal ongoing enforcement actions. Unions will be allowed to be interested parties. CBSA will have greater discretion when assessing the reliability of prices in the exporting country and where there are distortions, the CBSA will be able to use alternative approaches.

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