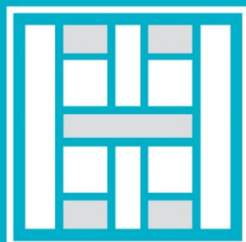

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ACCOUNTANTS & BUSINESS ADVISORS

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CPA CANADA FEDERAL BUDGET COMMENTARY

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INTRODUCTION

In order to offer targeted tax reductions for small businesses, seniors, and families with children; to increase spending for the military, public and national security, public transit, and for the Canada Revenue Agency (CRA) to address tax avoidance and evasion; and to eke out a $1.4 billion surplus in 2015–16 and small increases over the following years, the Federal Government will reduce its $3 billion contingency fund to $1 billion over the next three years.

Finance Minister Joe Oliver previously predicted surpluses of $6.4 billion for 2015–16, and $10.3 billion by 2018–19, but those hopes sank with plunging oil prices. Oliver's modest updated surplus projections are $1.7 billion in 2016–17, $2.6 billion in 2017–18, $2.6 billion in 2018–19, and $4.8 billion in 2019–20. For 2014–15, Oliver will mark a deficit of $2 billion in the Federal Government's books.

Small and Medium Businesses, Seniors and Families with Kids to See Most Relief

Many businesses should benefit from the Government's promises, but small and medium businesses in particular have reasons to be happy. Besides lowering their taxes, the Budget promises to reduce bureaucracy and penalties. For instance:

- New employers who qualify will only need to remit source deductions quarterly;
- To simplify interactions with different levels of government, the use of Business Numbers as common identifiers will be expanded;
- The CRA will expand online taxpayer services, improve plain-language communications, and continue the Liaison Officer Initiative; and
- The penalty for repeated failure to report income will now apply only if a taxpayer fails to report at least $500 of income in the current year and any of the three preceding tax years.

Money for women and young entrepreneurs, and research and innovation, should also promote small business and the economy.

Seniors will benefit from various commitments, such as reducing the mandatory minimum withdrawals from Registered Retirement Income Funds (RRIFs) at the age of 71, introducing the Home Accessibility Tax Credit for $10,000 of eligible home improvements, extending Employment Insurance benefits for employees on caregiver leave to six months, and increasing TFSA contributions to $10,000 per year. These measures should have broad appeal and application for elder Canadians.

For families, the proposed measures seem positive, but critics argue that they favour those with medium and high incomes. The Universal Child Care Benefit will increase by $60 per month for children under 18. The Family Tax Cut will allow couples with children under 18 to split their incomes for a tax credit of up to $2,000. The Child Care Expense Deduction and Children's Fitness Tax Credit maximums will increase.

The Government's commitment from last year to consult the public every two years for ideas on improving services and reducing bureaucracy for small businesses, will be a small step toward the goal of tax efficiency.

BUSINESS INCOME TAX MEASURES

Reduced Small Business Tax Rate

Currently, Canadian-controlled private corporations with less than $15 million of taxable capital benefit from a federal small business tax rate of 11% on active income earned in Canada up to $500,000 per year, versus 15% on any excess. The Budget proposes to reduce the low tax rate to 9% by 2019, phased in as follows:

- 10.5% starting on January 1, 2016;
- 10.0% starting on January 1, 2017;
- 9.5% starting on January 1, 2018; and
- 9.0% starting on January 1, 2019 onward.

The reduction is prorated for companies with off-calendar year-ends. This measure could save small business up to $10,000 a year in federal corporate tax. Adjustments have been made to the dividend tax credit regime for the purpose of maintaining the same level of combined corporate and personal tax rate, as indicated below.

Dividend Tax Credit (DTC) Adjustment for Non-eligible Dividends

The Budget proposes to change the gross-up percentage and dividend tax credit rate on non-eligible dividends annually starting in 2016, with the changes to be fully phased in by 2019. When looking at the integration of the proposed small business tax rate and the changes to the DTC regime, the after-tax cash retained when receiving non-eligible dividends will be about the same, year over year, as highlighted below.

	2015	2016	2017	2018	2019 and onward
Gross-up %	18.000%	17.000%	17.000%	16.000%	15.000%
Federal DTC rate	11.017%	10.522%	10.021%	9.512%	9.030%
Top marginal federal tax rate on non-eligible dividends	21.220%	21.620%	22.206%	22.606%	22.965%
Effective federal tax rate	29.886%	29.850%	29.985%	29.958%	29.899%

Quarterly Source Deduction Remittance for Some New Employers

New employers are required to withhold and remit source deductions on a monthly basis for at least their first year of operations. If the new employer has a perfect remittance record after the first year, and has total average monthly withholdings of less than $3,000, the employer may be eligible to remit quarterly.

The Budget proposes that for 2016 onward, new employers with total average monthly withholdings of less than $1,000 can automatically remit quarterly. The typical employer that would benefit from this measure would be one that has annual salary expenditures of about $43,500 or less (depending on the employer's province of residence) in the year. This measure could benefit start-up companies and new employers of caregivers.

Eligible Capital Property Regime Reform

In the 2014 budget, the Government first announced its intent to "reform" the eligible capital property regime by repealing the current regime and folding it into the capital cost allowance system. The Government continues to hear from stakeholders and has yet to issue legislation.

The Budget announced the Government's plans to first release detailed draft legislation for stakeholder comments prior to its inclusion in a bill. This is welcome news for businesses that are contemplating the sale of business assets, including goodwill, as some have speculated that the new measures would not be as favourable to Canadian-controlled private corporations as the current rules. However, one cannot be certain what the final legislation will look like.

Active Business versus Investment Business and the Small Business Deduction

To benefit from the lower corporate tax rate for income under $500,000, Canadian-controlled private corporations would need to generate income from an active business in Canada. The definition of active business excludes businesses that derive their income from a "specified investment business". Generally a specified investment business is a business that derives its income from property and does not employ more than five full-time employees in the business.

The Government has commenced a consultation period to determine whether to amend the definition of a specified investment business. The Budget used the example of self-storage facilities and campgrounds as businesses that might qualify for the lower corporate tax rate under an amended definition, without employing more than five full-time employees. Comments can be emailed to the Government at business-entreprise@fin.gc.ca, until August 31, 2015.

Accelerated Capital Cost Allowance for Manufacturing and Processing Machinery and Equipment

The Budget proposes that certain equipment purchased after 2015 and before 2026, primarily for use in Canada for the manufacturing and processing of goods for sale or lease, would be included in a new capital cost allowance (CCA) class. New class 53 will be subject to a CCA rate of 50% of the declining-balance, subject to the half-year rule.

PERSONAL TAX MEASURES

Tax-Free Savings Account (TFSA)

The current annual contribution limit of $5,500 is being increased to $10,000 effective January 1, 2015. However, the annual contribution limit will no longer be indexed to inflation.

Personal Taxation of Non-Eligible Dividends

The Business Taxation section of this Budget commentary provides the details of the proposed changes to the personal taxation of non-eligible dividends from private Canadian companies that will be made in conjunction with the proposed reductions to the corporate tax rate on small business income.

Repeated Failure to Report Income Penalty

Currently, a federal penalty is imposed where a taxpayer fails to report all of their income in their tax return for a taxation year and had also failed to report an amount of income in any of their prior three taxation years. This penalty is currently 10% of the income not reported. In addition, there can be a provincial penalty calculated in a similar manner.

The Budget proposes, for 2015 and subsequent years, to reduce this penalty since the penalty can be disproportionate to the actual associated tax liability, particularly for lower-income individuals. The penalty would only apply if the unreported income was at least $500 in the year. In addition, the amount of the penalty would be the lesser of 10% of the unreported amount and an amount equal to 50% of the difference between the understatement of tax related to the omission and the amount of any tax paid, for example, by way of withholding tax.

Transfer of Education Credits - Effect of the Family Tax Cut

The previously announced Family Tax Cut rules prevent transferred education credits from being included in the Family Tax Cut calculation. Consequently, the value of the Family Tax Cut could be reduced for couples who transfer education credits between themselves. The Budget proposes to revise the Family Tax Cut for 2014 and subsequent years to ensure that these couples receive the appropriate value of the Family Tax Cut. The CRA will automatically reassess affected taxpayers for 2014, once the enacting legislation receives Royal Assent, to ensure that they receive any additional benefits to which they are entitled under the Family Tax Cut.

Streamlined Foreign Reporting Requirements - T1135

To reduce the compliance burden on taxpayers the Budget proposes to increase the threshold for the detailed foreign reporting required by the current form T1135 from $100,000 of cost to $250,000. The details with respect to this proposal are provided in the International section of this Budget commentary.

Home Accessibility Tax Credit

The Budget proposes a new Home Accessibility Tax Credit which can provide tax relief on a non-refundable basis of 15% on up to $10,000 of eligible expenditures each calendar year, per qualifying individual per eligible dwelling. This tax credit would apply to 2016 and subsequent years.

A qualifying individual is a person who is 65 or older by the end of the year or is eligible for the disability tax credit in the particular year. An eligible individual can also claim this new tax credit in respect of a qualifying individual if he or she claims the spouse or common-law partner amount, the eligible dependant amount, the caregiver amount or infirm dependant amount for the qualifying individual. Consequently, an eligible individual can include a spouse or common-law partner of the qualifying individual or a parent, grandparent, child, grandchild, brother, sister, aunt, uncle, niece or nephew of the qualifying individual or of the qualifying individual's spouse or common-law partner.

An eligible dwelling must be the principal residence of the qualifying individual. Eligible expenditures are required to either allow the qualifying individual to gain access to or be more mobile or functional within the dwelling, or to reduce the risk of harm to the qualifying individual within the dwelling. The improvements must be of an enduring nature and be integral to the eligible dwelling. For example, eligible expenditures would include wheelchair ramps, walk-in bathtubs, wheel-in showers and grab bars. Expenditures which would not qualify include those whose primary purpose is to improve or maintain the value of the dwelling; routine repairs, maintenance, gardening, housekeeping or security; or costs of financing the renovation.

Since this new tax credit will not be reduced by any other tax credits or grants, an eligible individual will be able to claim both the Home Accessibility Tax Credit and the Medical Expense Tax Credit, in respect of the same expenditure.

Registered Retirement Income Fund (RRIF) - Minimum Withdrawals

For 2015 and subsequent years, the Budget proposes to reduce the minimum amount required to be withdrawn from a RRIF each year for persons aged 71 to 94. This reduction would result from reducing the nominal rate of return assumption from 7% to 5% and from increasing the inflation index from 1% to 2%. For example, at age 72, the withdrawal amount would drop for that year from 7.48% to 5.4%. Consequently, RRIF holders would have greater flexibility to leave more funds in their RRIF for a longer period of time before these funds must be withdrawn.

To ensure that the proposal applies to all of 2015, RRIF holders who withdraw more than the reduced 2015 minimum amount during 2015 will be able to deduct, in 2015, the re-contribution of the excess made by February 29, 2016.

Registered Disability Savings Plans (RDSPs) - Legal Representation

Budget 2012 introduced a temporary measure, until the end of 2016, to allow a qualifying family member (parents, spouses and common-law partners) to become the plan holder of a RDSP for an adult individual who lacks the capacity to enter into a contract. Since some of the provinces and territories require additional time to deal with this legal issue, the Budget proposes to extend this temporary measure until the end of 2018.

Lifetime Capital Gains Exemption for Qualified Farming or Fishing Property

The Budget proposes to increase the lifetime capital gains exemption for qualified farming or fishing property from the current indexed amount of $813,600 in 2015 to $1 million. This proposal applies to dispositions of qualified farming or fishing property on or after Budget Day.

In addition, for future years, the exemption will be the greater of $1 million and the indexed exemption available on capital gains from the disposition of “qualified small business corporation shares”.

INTERNATIONAL

Multinational Enterprises

The Government is concerned about the ability of multinationals to shift income from high-tax jurisdictions where business activity actually takes place, to low-tax jurisdictions. In the 2014 budget, the Government asked for input from interested parties in this regard, with a view "to ensure tax fairness and better protect the Canadian tax base while maintaining an internationally competitive tax system". The Government is still considering what steps to take.

Automatic Exchange of Information for Tax Purposes

In November 2014, Canada and the other G-20 countries endorsed a new common reporting standard for automatic information exchange. Canada proposes to implement the common reporting standard on July 1, 2017, allowing a first exchange of information in 2018. At that time, financial institutions will be required to have procedures in place to identify accounts held by non-residents and to report the required information to the CRA. Information will be exchanged reciprocally with other jurisdictions when appropriate safeguards are in place and exchange agreements have been formalized.

Foreign Reporting - T1135

Canadian resident individuals, corporations and trusts and certain partnerships must currently file form T1135 to report "specified foreign property" with a total cost of at least $100,000 at any time in the year.

The CRA is developing a simplified form, for use in 2015 and beyond, where the total cost of the specified foreign property throughout the year is less than $250,000. The current reporting requirements will continue to apply where the total cost of the specified foreign property is $250,000 or more at any time in the year.

Withholding for Non-resident Employers

Canada taxes the employment income of non-residents that is earned in Canada. Most tax treaties contain provisions that may exempt such income from Canadian tax in prescribed circumstances. Current Canadian law requires that non-resident employers must withhold source deductions even if the employment income is expected to be exempt from Canadian tax pursuant to a treaty. It has been possible for non-residents to obtain waivers in such circumstances but the system has generally been inefficient.

The Budget proposes to provide an exemption from withholding where a qualifying non-resident employer remunerates a qualifying non-resident employee after 2015.

A qualifying non-resident employer:

- Must be resident in a treaty country;
- Must not carry on business in Canada through a Canadian permanent establishment of the employer in its fiscal period that includes the time of the payment; and
- Must be certified by the Minister of National Revenue at the time of the payment.

Employers that are partnerships must satisfy the additional condition that at least 90% of the partnership's income for the fiscal period that includes the time of the payment must be allocated to residents of a treaty country.

Qualifying non-resident employers will continue to be responsible for Canadian reporting obligations in connection with amounts paid to its employees and for withholding tax where a non-resident employee is found to not have met the conditions described below. However, the employer will not be penalized for its failure to withhold if, after exercising due diligence, it had no reason to believe that, at the time of the payment, the employee did not meet the requisite conditions.

A qualifying non-resident employee:

- Must be exempt from Canadian tax under a treaty in connection with the payment; and
- Must not be in Canada for 90 days or more in any 12-month period that includes the time of the payment.

CHARITIES AND NON-PROFIT ORGANIZATIONS

Donations Involving Private Corporate Shares or Real Estate

The Budget proposes to provide an exemption from capital gains tax with respect to certain dispositions of private company shares and real estate where the cash proceeds from the disposition are donated to a charity within 30 days after their disposition and the private company shares or real estate are sold to a purchaser who deals at arm's length with both the donor and the donee. In broad terms, anti-avoidance provisions can deny the exemption if the donor re-acquires the property within five years of the disposition. This proposal is to be effective for dispositions after 2016.

Investments in Limited Partnerships by Registered Charities

Currently charitable organizations and public foundations are permitted to engage in business if the activities qualify as a related business. Private foundations are not permitted to engage in any business activities. Partners, including limited partners, are considered to be carrying on the business carried on by the partnership. Consequently, since many limited partnerships do not carry on a business which would be related to the activities of a particular charity or public foundation, few charitable organizations and public foundations and no private foundations can hold an interest in a limited partnership.

Since limited partnerships can provide a wider range of investment opportunities, the Budget proposes to amend the Income Tax Act (ITA) to generally allow a registered charity to invest in a limited partnership by providing that a registered charity will not be considered to be carrying on a business solely because it invests in a limited partnership. However, the registered charity will be required to own 20% or less of the limited partnership and the charity must deal at arm's length with each general partner of the limited partnership. This measure applies in respect of investments in limited partnerships which are made on or after Budget Day.

Gifts to Foreign Charitable Foundations

The Budget proposes to allow foreign charitable foundations to be registered as qualified donees in Canada if they receive a gift from the Government and are pursuing disaster relief, urgent humanitarian aid, or are carrying on activities in the national interest of Canada. This measure will apply on Royal Assent.

SALES AND EXCISE TAX MEASURES

The Budget does not contain any significant GST/HST or excise duty measures. However, the Budget proposes administrative amendments to the ITA concerning assessments and the sharing of confidential taxpayer information, which would be paralleled by similar amendments to the ETA and the Excise Act, 2001.

Information-Sharing for the Collection of Non-Tax Debts

While the CRA collects debts under tax and non-tax programs, it is currently prohibited from using confidential taxpayer information to collect debts under non-tax programs. In an effort to simplify administration, the Budget proposes to allow officials within the CRA to share taxpayer information obtained under the ETA and the Excise Act, 2001, where such information would be used for the sole purpose of administering and enforcing non-tax debts under certain federal and provincial programs, such as amounts owing under the Canada Student Loans Act, the Apprentice Loans Act, or a provincial law granting financial assistance to post-secondary students. In addition, the sharing of taxpayer information under the ETA and the Excise Act, 2001 would be extended to certain programs where such information-sharing is already permitted under the ITA.

These amendments will take effect on the day the implementing legislation receives Royal Assent.

GST/HST Election for Joint Ventures

The 2014 Budget contained proposals to make the joint venture election provisions under section 273 of the Excise Tax Act available to any joint venture, provided the joint venture's activities are exclusively commercial and the participants engage exclusively in commercial activities. This election simplifies GST/HST compliance by allowing the participants to designate an operator who is responsible for accounting for GST/HST on supplies made by and acquired by the joint venture. Currently, the election is available only to joint ventures engaged in mining or prescribed activities such as real property construction.

The 2015 Budget confirms the Government's intention to introduce draft legislation in relation to these proposals.

ANTI-AVOIDANCE - SECTION 55

Subsection 55(2) of the ITA is an anti-avoidance provision that is intended to convert tax-free inter-corporate dividends into capital gains where the dividend was paid or deemed paid to reduce what should have been a capital gain.

For example, assume that a holding company ("Holdco") received an offer of $1 million for the shares of its wholly-owned subsidiary ("Opco"). Assume further that Opco's book equity was zero and that its only asset was unbooked goodwill worth $1 million. If the tax value to Holdco of its Opco shares was nominal, a sale of such shares for $1 million would result in Holdco realizing a capital gain of $1 million. If, instead, Opco were to pay a $1 million tax-free dividend to Holdco and Holdco were to lend the $1 million back to Opco, Holdco could sell the $1 million debt (tax value $1 million) for $1 million and the Opco shares for their now nominal value. Holdco would not realize a gain.

In such circumstances, the dividend would not meet the exceptions to subsection 55(2) for dividends out of "safe income", dividends subject to Part IV tax or dividends received in the course of a non-arm's length "butterfly". Therefore, subsection 55(2) would convert the otherwise tax-free inter-corporate dividend into a capital gain.

There is no current specific provision similar to subsection 55(2) that ignores the creation of an artificial capital loss. Prior to the Budget, the CRA had to rely on the general anti-avoidance rule (GAAR) to deny artificial capital losses. *Triad Gestco*, 2012 DTC 5156 (FCA), is an example of such a case. In order to increase the tax value of common shares, an individual subscribed for common shares of a corporation, for cash. In order to reduce the Fair Market Value (FMV) of the common shares, he then received a stock dividend in the form of preferred shares with a redemption value equal to the FMV of the common shares. He was taxed on a dividend equal to only the nominal paid-up capital (PUC) of the preferred shares so received. He then sold the common shares to a captive entity for their nominal FMV and incurred a capital loss. The court held that the GAAR denied the loss.

The Budget legislates the loss denial in circumstances such as those in *Triad Gestco* and also prevents similar abuses where dividends are received on or after Budget Day. Subsection 55(2) will apply where a dividend (or deemed dividend under subsection 84(3)) significantly reduces the FMV of any share as was the case in *Triad Gestco*. Subsection 55(2) will also apply where the dividend or deemed dividend significantly increases the cost of property owned by the dividend recipient unless the dividend is paid out of the "safe income" of the payer corporation.

Paragraph 55(3)(a) currently exempts from the operation of subsection 55(2), inter-corporate dividends received in many related-party transactions. Where such dividends are received on or after Budget Day, paragraph 55(3)(a) will no longer exempt actual dividends; only dividends deemed received under subsection 84(3) on a share redemption will be exempted. This brings paragraph 55(3)(a) into line with a similar rule in the non-arm's length "butterfly" rules of paragraph 55(3)(b) and related provisions.