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CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

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# CPA CANADA FEDERAL BUDGET COMMENTARY

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# Budget 2016 Tax Highlights

On March 22, 2016 Finance Minister, Bill Morneau, introduced the first Liberal budget in more than a decade, forecasting deficits of $5.4 billion and $29.4 billion for 2016 and 2017 respectively. Budget 2016 introduced significant changes for personal and corporate tax measures.

The highlights of Budget 2016 are detailed below. **For a more in-depth analysis we invite you to register for our Hot Topics Breakfast Seminar on April 8, 2016**. Contact your Manning Elliott advisor for more information.

## Key Personal Measures

As noted in the government's December 2015 update, the second marginal income tax rate has decreased from 22 per cent to 20.5 per cent and a new top tax rate of 33 per cent has been added for incomes above $200,000.

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

Beginning July 2016, the new Canada Child Benefit (CCB) will provide up to $6,400 for each child under age 6 and up to $5,400 for children aged 6–17. Only families with incomes below $30,000 per year will receive the full benefit. The CCB will replace the Canada Child Tax Benefit and Universal Child Care Benefit.

The family tax cut credit for families with at least one child under 18 at home and the children's fitness and arts tax credits will also be eliminated.

## MEASURES THAT WERE NOT INTRODUCED

The Budget did not propose a number of measures that were either specifically mentioned in earlier government documents or that were speculated about in the community.

A statement made by the current Liberal government during the fall election campaign indicated that the 50 per cent reduction in the amount included in income in connection with certain stock option benefits would be limited to $100,000 of benefits realized in a particular year. The Budget made no mention of this measure.

There was speculation that the portion of a capital gain that would be taxable would be increased above the present 50 per cent inclusion rate. No such measure was introduced.

There was also speculation that the income earned by certain service corporations (such as professional corporations) would not be eligible for the small business deduction (SBD) unless the corporation had a certain minimum number of employees. No such measure was introduced.

The April 2015 Budget proposed an exemption from capital gains tax with respect to certain dispositions of private company shares and real estate where the cash proceeds are donated to a charity within 30 days after the disposition and the private company shares or real estate are sold to a purchaser who deals at arms-length with both the donor and donee. This proposal has been dropped.

## BUSINESS INCOME TAX MEASURES

### Small Business Tax Rate

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

The related dividend gross-up of 17 per cent for other than eligible dividends and the dividend tax credit of 21/29 of the gross-up will remain for 2016 and subsequent taxation years. Consequently, the prior proposals to further increase the SBD rate and reduce the related small business tax rate for 2017 and subsequent taxation years, along with the consequential changes to the dividend gross-up and dividend tax credit, will not be going ahead.

### Multiplication of the Small Business Deduction

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

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

Similar rules will apply where a CCPC provides services or property to certain private corporations rather than to a partnership as in the above example. The income so earned by the CCPC will be ineligible for the SBD where, at any time during the year, the CCPC, one of its shareholders or a person who does not deal at arm's length with such a shareholder has a direct or indirect interest in the private corporation.

These proposals generally apply to taxation years which begin on or after Budget Day. In addition, these proposals do not apply to a CCPC all or substantially all of the active income of which is from providing services or property to arm's-length persons other than the partnership.

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

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

## Tax on Personal Services Business Income

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

## Consultation on Active versus Investment Income

The consultation resulting from the 2015 Budget to review the circumstances in which income from property should qualify as active business income was completed in August 2015. The Budget did not introduce any changes to these rules.

## Eligible Capital Property

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

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

Note that each of the provinces imposes its own provincial rate. So, for example, in Ontario, the rate applicable to the small business income portion would be 7.50 per cent (50 per cent of 15.0 per cent) and 13.25 per cent (50 per cent of 26.5 per cent) on the non-small business portion; in British Columbia, the rate applicable to the small business income portion would be 6.50 per cent (50 per cent of 13.0 per cent) and 13.00 per cent (50 per cent of 26.0 per cent) on the non-small business portion.

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

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

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

Transitional rules will transfer December 31, 2016 CEC pool balances to Class 14.1. For 10 years, pre-2017 balances will be depreciated at the rate of 7 per cent of the declining balance per annum. Small businesses will benefit from more generous write-offs for minor expenditures.

For example, the first $3,000 of the cost of incorporation will be deductible as a current expense.

## Accelerated Capital Cost Allowance

The Budget proposes to expand CCA Classes 43.1 and 43.2 to include electric vehicle charging stations and electric energy storage equipment acquired on or after Budget Day that would otherwise be included under CCA Class 8. This would provide tax deferral as Classes 43.1 and 43.2 provide for CCA at rates of 30 per cent and 50 per cent, respectively, on a declining-balance basis, while Class 8 only provides a declining-balance rate of 20 per cent.

Charging stations that supply less than 90 kilowatts of power would be included in Class 43.1, while stations that supply 90 kilowatts or more would
be included in Class 43.2.

Electric energy storage equipment that is part of an electricity generation system that is eligible for Class 43.1 or 43.2 will be included in the same class as the system. Standalone electrical storage equipment may also be eligible for Class 43.1 or 43.2 treatment if certain criteria are met.

2016. Also, these rules would apply to emission allowances acquired in taxation years ending after 2012 if so elected by a taxpayer. Due to the high volatility of such allowances, inventory valuation under the lower of cost and net realizable method would not be permitted.

# PERSONAL TAX MEASURES

## Top Marginal Tax Rate — Further Consequential Amendments

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

The Budget proposes consequential amendments further to those already included in Bill C-2 which was tabled on December 9, 2015. These include the following:

- Personal services business income earned by corporations will be subject to a 33 per cent tax rate, up from the previous rate of 28 per cent;
- A reduction of the “relevant tax factor” under the foreign affiliate rules from 2.2 to 1.9;

- On donations in excess of $200, a 33 per cent donation tax credit will be available to trusts that are subject to the 33 per cent rate on all their taxable income;
- Excess contributions to employee profit sharing plans will be subject to the 33 per cent tax rate.

The above amendments are proposed to take effect in the 2016 taxation year.

## Canada Child Benefit

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

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

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

## Family Tax Cut Credit

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

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

## Children's Fitness and Arts Tax Credits

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

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

## Education and Textbook Tax Credit

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

## Teacher and Early Childhood Educator School Supply Tax Credit

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

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

## Northern Residents Deductions

The Budget proposes to increase the maximum Northern Resident Deduction from $8.25 to $11 per day for each member of a household that resides in a Northern Zone for at least six consecutive months beginning or ending in a particular taxation year. In cases where only one member of a household claims the deduction, the increase is proposed to be from $16.50 to $22 per day.

Taxpayers resident in an Intermediate Zone can only deduct half of the aforementioned amounts.

## Mineral Exploration Tax Credit

Eligibility for the Mineral Exploration Tax Credit is proposed to be extended for one year under the Budget. That is, the credit will apply to flow-through share agreements entered into on or before March 31, 2017.

## Labour-Sponsored Venture Capital Corporation (LSVCC) Tax Credit

The Budget proposes to reestablish the 15 per cent tax credit for a purchase of shares of a provincially registered LSVCC for the 2016 taxation year and beyond. However, the Budget does not reestablish the tax credit for a federally registered LSVCC; the credit will remain at 5 per cent in 2016 and will be eliminated in 2017.