2017 Federal Budget

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The March 22, 2017 federal budget (the "Budget") included a number of tax measures that will impact Canadian taxpayers. Rather than summarize every tax measure included in the Budget document, this report, which was prepared from within the Budget lock-up today in Ottawa, will focus on some of the tax measures that are of most interest to individuals and small business owners.

"Boutique" Tax Credits

"Boutique" tax credits or deductions, sometimes described as "tax expenditures", refer to government spending to encourage certain programs and behaviours, such as public transit and post-secondary education, or that target certain segments of the population, such as parents, seniors or pensioners. These expenditures are administered through the tax system and are often delivered in the form of tax credits.

These credits have proliferated in recent years and fill up an entire page of the tax return. There are credits for volunteer firefighters, search and rescue volunteers, as well as first-time home buyers. Last year's federal budget announced the elimination of four of the credits, which you may see for the last time when you fill out your 2016 tax returns: the children's fitness and arts credits, as well as the education and textbook credits for students.

A week after last year's budget, Mr. Morneau announced a review of the "tax expenditures in the code … (to make) sure they are all consistent with our approach to tax fairness".

The Budget proposes the elimination of further credits and deductions. However, as part of a "good news" story, the Budget also proposes expanding certain credits. Note that we might see more changes to the tax credit system, as the government had previously indicated that their review would not be completed in time for the Budget.

Tax Credit / Deduction Eliminations

Public Transit Tax Credit

This 15% non-refundable tax credit is available against the cost of certain public transit passes. Effective July 1, 2017, it is proposed that the Public Transit Tax Credit will be eliminated. Instead, the government will allocate funds to improve public transit.

Home Relocation Loan Deduction

When an employer grants a home purchase loan to an employee in circumstances where the employee has relocated in order to accommodate a relocation of employment, a deduction may be available to offset the taxable benefit (or a portion thereof) arising from the low interest nature of the loan. Due to concern that this deduction disproportionately benefits those the government defines as wealthy, it is proposed that this deduction be eliminated effective for the 2018 and subsequent years.

Investment Tax Credit for Child Care Spaces

Currently a 25% non-refundable tax credit is available for certain costs to create or expand child care spaces. Again due to the government's view that there is low uptake for this credit and that it did not materially increase child care spaces, it is proposed that the credit be eliminated for expenditures incurred on or after March 22, 2017. There will, however, be transitional rules applying to expenditures incurred before 2020 pursuant to written agreements entered into before March 22, 2017. The government has announced plans to allocate funding to assist with an increase in affordable child care spots.

Non-Accountable Expense Allowances for MPPs and Certain Municipal Office-Holders

The tax exemption for such allowances will be eliminated. For 2019 and subsequent taxation years a non-accountable allowance paid to these officials will be included in income. It is notable that the tax exemption for similar allowances paid to federal MPs had previously been eliminated.

Gifts of Medicine

Under current rules, where a corporation makes a gift of medicine to a charity, they are eligible to claim an additional deduction for the donation. The government indicated in the Budget documents that there was low usage of this measure and, therefore, it is proposed to be eliminated with respect to gifts of medicine made on or after March 22, 2017.

Tax Credit Expansions

Disability Tax Credit

In order to claim the disability tax credit, a person must first be certified as eligible for the tax credit. The Budget proposes that effective for disability tax credit certifications made on or after March 22, 2017, nurse practitioners can now make this certification.

Medical Expense Tax Credit

The 15% medical expense tax credit is currently available for certain costs incurred by individuals with a medical condition of infertility. The Budget proposes extending the availability of the medical expense tax credit for 2017 and subsequent years to eligible expenses incurred by those who may not have a medical infertility condition but nonetheless incur costs for medical treatments to conceive a child.

Caregiver Tax Credit

Currently those providing "caregiving" to another are potentially eligible to claim three different tax credits: the infirm dependent tax credit, the caregiver credit and the family caregiver tax credit. The Budget proposes simplifying the credit system for caregivers, by replacing these three credits with one new credit entitled the "Canada Caregiver Credit". This will be effective for the 2017 and subsequent taxation years.

The Budget documents indicate that the overall amount of the credit available will not change under this new regime. It should be noted that the Canada Caregiver Credit will not be available in respect of senior family members who reside with their adult children but are not infirm dependents.

Simplifying the Caregiver Credit System (2017)

Current Credits		
Infirm Dependent Credit • Income phase-out range: $6,902 — $13,785 • Maximum credit amount: $6,883	**Caregiver Credit** • Income phase-out range: $16,163 — $20,895 • (For persons with infirmities / disabilities: $16,163 — $23,045) • Maximum credit amount: $4,732 (if infirm $6,882)	**Family Caregiver Tax Credit** • Income phase-out range: variable • Maximum credit amount: $2,150

Proposed New Credit

Canada Caregiver Credit

- Income phase-out range: $16,163 — $23,046
- Maximum credit amount: $6,883 (spouses / common-law partners and minor children: $2,150)

Source: 2017 Budget Plan, *Building a Strong Middle Class*.

Tuition Tax Credit

Currently, the 15% tuition tax credit is not available with respect to occupational skills courses offered by a university or college that are not at the post-secondary level. The Budget proposes extending the eligibility for these credits to such skills courses taken after 2016. For instance, this could include courses taken to improve numeracy or literacy to improve job skills.

Mineral Exploration Tax Credit for Flow-Through Shares

As has been done in previous years, the Budget proposes extending this tax credit for another year.

Canada Savings Bonds Being Eliminated

After more than 70 years, Canadians will be saying goodbye to a once-popular option for investing. First introduced in 1946 as a "safe and easily accessible investment option", Canada Savings Bonds reached their peak in popularity in the mid-1980s. Currently, however, they represent less than one percent (about $5 billion) of total federal market debt. Since the program is no longer seen as a cost-effective source of funds for the Government, sales of new Canada Savings Bonds will be discontinued in 2017.

More information regarding the phasing out of the Canada Savings Bonds Program is provided in Annex 2 of the Federal Budget Plan: Building a Strong Middle Class[1] and in the Canada Savings Bonds Program Announcement: Questions and Answers[2].

RDSPs and RESPs

Currently, most registered plans such as RRSPs, RRIFs, and TFSAs are subject to strict anti-avoidance rules. The Budget proposes extending these rules to Registered Disability Savings Plans ("RDSPs") and Registered Education Savings Plans ("RESPs").

Firstly, the Budget proposes that the prohibited investment regime, which generally limits investments to those that are "arm's length" in nature, apply to RDSPs and RESPs. Holding a prohibited investment results in penalty taxes. Secondly, the advantage rules will now apply to RDSPs and RESPs. These rules levy penalties where an advantage is extended to the holder, subscriber or annuitant of such registered plan. For instance, swaps will result in heavy penalty taxes for these plans, similar to the case for RRSPs, RRIFs and TFSAs.

Unless specific transitional rules apply to a particular transaction, this measure will be effective for transactions occurring, or investments acquired after March 22, 2017. It is important to note that included in the definition of "transactions occurring" is investment income generated after March 22nd on an investment acquired before March 22nd. Similar to the transitional relief provided when the advantage rules were first extended to RRSPs and RRIFs, there will be a method to distribute this income from the RDSP or RESP in certain circumstances to avoid the imposition of penalty taxes. The income would then be subject to tax in the individual's hands at his or her marginal tax rate.

Changes for Private Corporations

Business owners and professionals (including practicing members of professions such as law, medicine, engineering, architecture and accounting) who incorporate have often been able to realize certain tax advantages, such as tax deferral. The Budget introduced two measures that will specifically impact private corporations.

Work-in-Progress

The first of these measures eliminates the ability for certain professionals to compute their income on a "billed-basis". Generally, in calculating income for tax purposes, the value of work in progress ("WIP") must be included. However, certain designated professionals such as accountants, dentists, lawyers, doctors, veterinarians and chiropractors, could elect to exclude the WIP, and instead only recognize income when it was billed. The concern of the government was that this permitted a tax deferral, as costs associated with the WIP could be expensed in a year prior to the income being included. The Budget proposes eliminating the ability to make this election, effective for taxation years that begin on or after March 22, 2017. Transitional rules will apply.

Control of a Corporation

Secondly, as a response to the recent court decision of *McGillivray Restaurants*, the Budget proposes including a definition that clarifies the factors to be considered in determining whether one has factual control over a corporation.

By way of background, there are two ways to control a corporation for tax purposes. One can have legal control — the right to elect the majority of the board of directors of the corporation. As well, one can have factual control — where one has "directly or indirectly in any manner whatever" influence, that, if exercised, would result in control in fact of the corporation.

The decision in *McGillivray Restaurants* limited the breadth of factors to be considered in determining whether a person or group of persons has factual control. The Budget clarifies that this determination should take into consideration all factors that are relevant in the circumstances.

This change is very important as it will impact when corporations are considered to be associated and must share the small business deduction limit. The small business deduction allows a corporation to pay federal tax at a rate of 10.5% on active business income up to a limit of $500,000, rather than the general corporate rate of 15%. Both of these corporate tax rates are substantially lower than the top federal marginal personal tax rate of 33%, and as a result, a federal tax deferral advantage can be achieved by leaving the after-tax business income inside the corporation as opposed to paying it out immediately. However, there is a larger deferral available for income that qualifies for the small business deduction. Provincial taxes also apply and there is generally also a tax deferral advantage at the provincial level.

Review of Tax Planning Strategies Involving Private Corporations

The Budget documents also stated that the government is currently reviewing tax planning strategies involving private corporations. The government has indicated that these strategies include:

- Sprinkling income using private corporations, which can reduce income taxes by causing income that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates (or who may not be taxable at all).
- Holding a passive investment portfolio inside a private corporation, which may be financially advantageous for owners of private corporations compared to otherwise similar investors.
- Converting a private corporation's regular income into capital gains, which can reduce income taxes by taking advantage of the lower tax rates on capital gains.

The government plans to issue a paper in the coming months outlining the perceived issues in more detail, as well as proposed policy responses. As such, we may see further changes coming to the taxation of private corporations.

Derivatives

Mark-to-Market Rules

Under current rules, only financial institutions regularly include income on derivative instruments on a mark-to-market basis — including the unrealized income or loss on a derivative on a yearly basis. For other taxpayers, there was uncertainty as to whether this income or loss instead had to be reported on a realization basis — when the income or loss is actually realized, when the derivative is sold or expires.

A recent court decision did permit a taxpayer that was not a financial institution to utilize the mark-to-market method on the basis that it provided a more accurate picture of the taxpayer's income.

In order to provide more certainty on this issue, the Budget proposes introducing, for taxation years that begin on or after March 22, 2017, a formal election procedure to permit taxpayers to mark-to-market certain derivative instruments, so long as they are held on income account and not capital account. To ensure consistency, the practice must be consistently followed once the election is made. To revoke the election for a subsequent year, approval from the Canada Revenue Agency (CRA) will be required.

Straddle Transactions

The Budget also includes a measure targeting taxpayers who purchase one or more derivative instruments that result in equal and offsetting gains and losses. The Budget documents refer to these as "Straddle Transactions" because they straddle at least one year end.

The strategy of concern was one under which the derivative in a loss position would be recognized in the current year, but the offsetting derivative in a gain position would not be realized until the next taxation year. This permitted a deferral of the gain for tax purposes, and allowed the loss to be applied against other income in the current year.

For example, assume that in November of 2017 Bob purchases an option to buy gold in May of 2018. Bob also purchases an option to sell the same amount of gold. At the end of 2017, one of these options will be in a gain position, and one will be in a loss position, depending on how the price of gold has moved. Bob would sell the option at a loss at the end of 2017, but not dispose of the option that is in an unrealized gain position until 2018.

So, Bob will have realized the loss in one year but not have to include the gain until the next year.

Stop-loss rules are proposed that would not allow the loss to be deducted in these circumstances until the gain is realized. This will be effective for derivatives entered into on or after March 22, 2017.

Mutual funds and financial institutions will be exempt from these rules, as will certain other qualifying transactions.

Private Foundations

Included in various tax measures regarding ecological gifts was a measure that proposes prohibiting private foundations from receiving gifts of ecological property. This was announced because of concern that conflicts of interest could arise in relation to these gifts. This change will be effective for gifts made on or after March 22, 2017.

Investment Fund Mergers

As a result of last year's budget measure eliminating the ability to switch on a tax-free basis between classes of a mutual fund corporation, mergers between classes of a mutual fund corporation and mutual fund trusts may be desirable to properly rationalize the number of funds. As the rules regarding tax deferred fund mergers are currently very limiting, the Budget proposes expanding the rules to permit each class of a mutual fund corporation to be merged into one or more mutual fund trusts on a tax deferred basis. To provide consistency, the Budget further proposes rules to permit mergers of segregated funds.

T4s

Effective for the 2017 and subsequent tax years, it is proposed that T4s will be permitted to be issued electronically without the employer first being required to receive the express consent from the employees. In order for this to be permitted, safeguards required by CRA must be in place. Paper copies must be provided to employees who specifically request them.

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[1] The Federal Budget Plan, *Building a Strong Middle Class* is available online at http://budget.gc.ca/2017/docs/plan/budget-2017-en.pdf

[2] Canada Savings Bonds Program Announcement: Questions and Answers are available online at http://www.csb.gc.ca/csb-program-announcement-questions-answers/