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TAX LETTER

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FEDERAL BUDGET HIGHLIGHTS
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FEDERAL BUDGET HIGHLIGHTS

The Liberal government released its first Federal budget on March 22, 2016. Although some of the measures were previously proposed, many were new and some came as a surprise. The significant income tax measures and related proposals include the following:

- **Elimination of spousal income splitting:** The former Conservative government enacted a rule that allowed spouses (or common-law partners) to notionally transfer up to $50,000 of taxable income from one spouse to the other, in order to save a maximum of $2,000 in federal tax. The Liberals campaigned on a promise to eliminate this measure, and they did so in this budget, effective for 2016 and subsequent years.
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- **Increased child tax benefit:** The existing Canada Child Tax Benefit (CCTB) and the universal child care benefit (UCCB) will be replaced effective July 1, 2016 by a new Canada Child Benefit (CCB).

  The CCB will provide up to $6,400 per child under the age of 6 and $5,400 per child aged 6 through 17. The benefits will be reduced for adjusted family net income between $30,000 and $65,000 and reduced further for adjusted family net income over $65,000. The reduction rate also varies depending on the number of children in the family.

  The CCB will be paid monthly, it will not be taxable, and it will not be included in income for the purposes of certain federal income-tested programs, such as the Guaranteed Income Supplement, the Canada education savings grant, and the Canada disability savings grant. CCB benefits paid for the July 2016 to June 2017 benefit year will be based on adjusted family net income for the 2015 taxation year.

- **Reinstatement of LSVCC:** This was another expected measure, as it was proposed in the Liberals' election platform.

The former 15% credit on up to $5,000 of investments in labour-sponsored venture capital corporations (LSVCCs) is reinstated for 2016 and subsequent years. (The former government phased out the credit, and proposed to eliminate it entirely beginning in 2017.) However, the reinstatement applies only to provincially-registered LSVCCs and not federally registered LSVCCs.

- **New school supplies credit:** Again this was proposed in the Liberals' election platform. Teachers and early child educators will be able to claim a 15% refundable credit on up to $1,000 of their expenditures on "eligible supplies", which include construction paper, flashcards, items for science experiments, art supplies such as paper and paint, and stationery items. The credit is available for expenditures incurred in 2016 and later years.

- **Extension of mineral exploration credit:** This credit, which applies to certain mineral exploration expenses incurred by resource companies and renounced to investors in flow-through shares, has been extended annually in every Budget since 2003. This year is no exception, and the credit is extended by one year to flow-through share agreements entered into before April 2017.

- **Education and textbook credits:** These credits will be eliminated beginning in 2017. The tuition credit will remain in place. Unused education and textbook credits from 2016 and earlier can still be carried forward to 2017 and later years. In conjunction with the elimination of these credits, which are not income-tested, the government will increase the Canada Student Grant for low and middle-income families and part-time students, and increase the income limit at which former students must start repaying their Canada Student Loans. This proposal was also in the Liberals' election platform.

- **Children's Fitness and Arts credits:** These tax credits are reduced for 2016, and will be eliminated starting in 2017.

- **Small business tax rate:** In a surprise move that runs counter to what was in the Liberals' election platform, the federal small business tax rate on the first $500,000 of active business income earned by a Canadian-controlled private corporation (CCPC) will remain at 10.5%. The budget cancelled further reductions to 9% over two years that had been enacted by the previous Conservative government and would have taken effect from 2017 to 2019.

  For individual recipients of dividends out of such income, the "gross-up" will remain at 17% of the dividend and the federal dividend tax credit will remain at 21/29 of the gross-up amount for 2016 and subsequent years. The proposed changes in the gross up and dividend tax credit for 2017 through 2019 (as outlined in our April Tax letter) were therefore cancelled.

- **Partnerships and the small business deduction:** As noted above, the income threshold for the small business tax rate for CCPCs is $500,000. If various CCPCs are a member of a partnership, they must share the $500,000 limit with respect to the business income earned from the partnership (the "specified partnership limit" for each member), and each CCPC's share of the partnership income then forms part of that CCPC's overall $500,000 limit. To get around this rule and to avoid sharing the $500,000 limit, individual partners formed CCPCs that were not partners of their partnership; the CCPCs then entered into contracts with the partnership to provide services to the partnership. Since the CCPCs were not partners, they were not subject to the specified partnership limit and therefore each CCPC could earn up to $500,000 of income from the partnership that could be subject to the small business tax rate. Similar structures had various CCPCs providing services to a corporation in order to get around the specified partnership limit rules.

  The budget effectively provides that these structures will be subject to the specified partnership limit rules. This measure applies to corporate taxation years that begin after March 21, 2016, with some transitional rules. The measure particularly affects large partnerships such law and accounting firms and medical practices, in which the professional partners often set up such structures.

- **Taxing investors in "switch funds":** Mutual fund corporations can be structured such that investors in one class of shares in the corporation can "switch" them for another class without triggering a disposition for tax purposes. The switch essentially moves the investor to another fund within the corporation. Mutual fund trusts do not enjoy this advantage. To level the playing field, investors in mutual fund corporations who perform these switches after September 2016 will have a deemed disposition of the shares at fair market value.

- **Eligible capital property rules eliminated:** As proposed in the 2014 budget, the complicated rules for "eligible capital property" (ECP) will be eliminated. ECP is basically goodwill and certain other purchased intangibles. Under the new rules, such property will be depreciable property in a new class 14.1, depreciable at an annual rate of 5% on a declining balance basis, and subject to the regular capital cost allowance system. The new rules will apply beginning in 2017, with various transitional rules governing the move of existing ECP into Class 14.1.
- **Donations involving real estate and private company shares:** Last year's Conservative budget proposed that capital gains on these properties would be exempt to the extent the proceeds were donated to charity. The rule was proposed to apply beginning in 2017. This budget cancelled this proposal.

What was not in the budget?

Interestingly, the Liberal government backed off from an election campaign promise to fully tax employee stock option benefits exceeding $100,000 per year.

Under current rules, most stock option benefits are taxed like capital gains, in that only half of the benefits is included in income. Despite the campaign promise, this year's budget did not change the rules. Furthermore, the Minister of Finance indicated in a post-budget press conference that changes to the rules are not in the works. Various industries, and in particular the high tech industry which relies on employee stock options to attract talent, had lobbied the Minister to reverse the election campaign position and not change these rules. Evidently, that lobbying was effective.

THE CAPITAL GAINS EXEMPTION

Every individual who is resident in Canada has a capital gains exemption that exempts from taxation the capital gains from dispositions of certain types of property. Although the amount is often referred to as an "exemption", it is actually structured as a deduction in computing your taxable income.

Two types of property are eligible for the capital gains exemption: shares in a qualified small business corporation (QSBC), and qualified farm or fishing property.

The lifetime limit for capital gains from QSBC shares is currently $824,176, or $412,088 for taxable capital gains since only half of capital gains are taxed (2016 amounts). This lifetime amount is indexed annually to account for inflation. The lifetime limit for capital gains from dispositions of qualified farm or fishing property is $1 million, which is not currently indexed but will be indexed in conjunction with the QSBC limit, once the latter limit hits $1 million. However, the two limits are not cumulative. In other words, every dollar of exemption used for QSBC shares reduces the amount available for farming or fishing property, and vice versa.

QSBC shares

In general terms, a QSBC share at the time of the disposition must be a share of a "small business corporation", which is a Canadian-controlled private corporation ("CCPC"), all or substantially all of whose assets are comprised of

- assets used principally in an active business carried on primarily in Canada,
- shares or debt in other small business corporations with which it is "connected" (it either controls the other corporation or owns at least 10% of the shares (votes and value) of the other corporation), or
- any combination of the above.

The Canada Revenue Agency (CRA) takes the position that "all or substantially all" means 90% or more, and that "principally" or "primarily" means more than 50%. If the disposition occurs as a result of death (there is a deemed disposition of capital properties upon your death), the shares may qualify if the above criteria were met at any time within the 12 months before death.

In general terms, a CCPC is a private corporation resident in Canada that is not controlled by non-residents, public corporations, or a combination of the two.

There are also two holding period requirements for the shares. First, for the 24 months prior to the disposition by the taxpayer, the QSBC share must not have been owned by anyone other than the taxpayer or a related person. Second, throughout the 24-month period, more than 50% of the corporation's assets (on a fair market value basis) must have been comprised of assets used principally in an active business carried on primarily in Canada, or shares or debt in other CCPCs that met the same 50% threshold or in some cases the "all or substantially all" threshold. (The actual requirements are very technical in detail.)

ABILS reduce the exemption

The capital gains exemption that can be utilized in a particular year is reduced to the extent of allowable business investment losses (ABILs) claimed in the year or previous years. In general terms, an ABIL is one-half of a capital loss incurred on the disposition of a share or debt in a small business corporation; certain other conditions apply. Generally, an ABIL is deductible against any sources of income, rather than just taxable capital gains. (Allowable capital losses can normally only offset taxable capital gains.)

> **Example**
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> In 2016, you realize a taxable capital gain of $100,000 from the disposition of QSBC shares. You have more than $100,000 of your capital gains exemption remaining. In 2002, you claimed an ABIL of $30,000.
>
> Because of the $30,000 ABIL, only $70,000 of the taxable capital gain is eligible for the exemption. The remaining taxable capital gain of $30,000 will be included in your taxable income.

CNILs also reduce the exemption

The capital gains exemption that you can claim in a year is also reduced by your cumulative net investment loss (CNIL) as of the end of the year. The CNIL account is essentially the total of your investment expenses deducted in excess of your investment income, cumulatively for all years back to 1988.

Qualified farm or fishing property

As noted, the capital gains exemption also applies to gains from dispositions of qualified farm or fishing properties. In general terms, these properties include real property used in a farming business, a fishing vessel used in a fishing business, and shares in certain corporations and interests in partnerships that carry on a farming or fishing business in Canada. Various other criteria apply, including a holding period similar to that for QSBC shares.

RESERVES FOR RECEIVABLES

If you sell property, you are normally required to report the gain or profit in the year in which the proceeds of disposition become receivable. Therefore, you may be required to include the gain or profit in income in the year of disposition, even though you have not received all of the proceeds.

Fortunately, there are two reserves that apply in these circumstances. One is a capital gains reserve, which applies where the disposition of the property gives rise to a capital gain.

The second is an inventory reserve, which applies where the disposition is made in the course of a business of selling the property. Each reserve is deducted in computing the gain or profit. It is then added back in the next year, and a further may be claimed if proceeds are still owing at the end of that next year, subject to the limits described below.

Capital gains reserve

The maximum amount you can claim in a year is limited to the lesser of two amounts:

- a "reasonable reserve", which is usually the amount equal to (gain x proceeds due after the year / total proceeds); and
- a fraction amount, which varies depending on the year.

The fraction amount is: 4/5ths for the year of disposition, 3/5ths for the following year, 2/5 for the year following that, and 1/5 for the year after that. So the reserve can be claimed only for 4 years, which means that the gain may be spread out for a maximum of 5 years.

Example

In 2016, you sell a capital property and realize a $100,000 capital gain. You receive 1/3rd of the proceeds in 2016, with another third due in each of 2017 and 2018.

In 2016, you must initially report $100,000 as the capital gain. However, you can deduct a reserve equal to the lesser of ($100,000 x 2/3) and (4/5 of $100,000), or $66,667. So your capital gain will be reduced to $33,333, and half of that will be included in your income as a taxable capital gain.

In 2017, you add back your $66,667 reserve, and repeat the process to claim a reserve. Basically, in this simple example, you will be able to spread out the $100,000 gain ($50,000 taxable capital gain) over three years.

Inventory reserve

If you are in the business of selling the property, the reserve in any year is simply the "reasonable reserve" amount, which is (profit x proceeds due after the year / total proceeds). The reserve claimed in one year is added back in the next year, and the process continues if proceeds are still due after that next year. The reserve is normally available for only up to 3 years, which means the profit can be spread out over a maximum of 4 years.

The other "catch" for the inventory reserve is that, if the property is not real estate, it can be claimed only if part or all of the proceeds are due at least 2 years after the date of sale.

AROUND THE COURTS

Foreign rectification order not legally binding for Canadian income tax purposes

In certain cases, taxpayers can apply to a provincial superior court for a rectification order in respect of their transactions. If granted, the order will retroactively change the contracts or transactions to reflect the parties' intention if the relevant documents did not accurately reflect that intention. Rectification orders are normally sought

where the parties intended a transaction to occur in a more tax-beneficial manner than that provided under the documentation that was actually signed.

Where the rectification order is granted by a Canadian court of proper jurisdiction, the CRA is obligated to abide by its terms and accept the income tax treatment that applies to the rectified transaction.

In the recent *Canadian Forest Navigation* case, the taxpayer's foreign affiliate corporations in Barbados and Cyprus obtained rectification from courts in those countries, effectively re-characterizing dividends paid to the taxpayer as loans. That re-characterization, if valid, would have been beneficial for Canadian income tax purposes. The CRA did not accept the effect of the foreign rectification orders. The taxpayer and the CRA then brought a motion in the Tax Court of Canada, to rule on whether the rectification orders were legally binding on the CRA.

The Tax Court determined that the CRA was not legally bound by the foreign rectification orders. For the order to be legally binding, the orders would have to be affirmed by the Canadian provincial superior court. However, the Court held that, even without such affirmation, it was open to the taxpayer to present the foreign orders as factual evidence in the tax appeal regarding the characterization of the payments from the foreign affiliates. The court hearing the tax appeal could then determine how much weight to give to the orders.

Legal costs for payer of child support not deductible

Generally, the *recipient* of child support is allowed to deduct legal fees incurred in contesting or varying the support. The rationale behind the deduction is that the legal fees are incurred to protect the right to receive the child support, which is income from property, and legal fees to preserve such a right to income are normally deductible.

In the recent *Grenon* case, the taxpayer attempted to deduct legal fees incurred in contesting the amount of child support he was obligated to pay. He argued that, since the recipient of child support can normally deduct legal fees, it only made sense that the *payer* of child support should be entitled to deduct his legal fees as well. His position included a technical tax argument as well an argument under the *Charter of Rights and Freedom*.

Both the Tax Court of Canada and the Federal Court of Appeal dismissed the taxpayer's appeals. The Courts held that there were no provisions under the Income Tax Act that allowed the deduction. Furthermore, the taxpayer's *Charter* argument was not persuasive because the non-deduction of support did not discriminate against a defined group of individuals.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.