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# 2015 Federal Budget: Tax Highlights

As has been widely predicted, today's federal budget (Budget 2015) delivered a handful of tax "goodies" in the lead-up to the coming election. It also includes a number of important proposed changes to the corporate tax rules. They are noteworthy, although not as extensive as the corporate tax changes proposed in some recent budgets and are less likely to interfere with commercial aspects of most corporate transactions than some of those previous changes.

The principal tax changes announced in Budget 2015 of interest to the business community are summarized below.

- **Synthetic Equity Arrangements.** Budget 2015 includes "synthetic equity arrangement" proposals that will more clearly deny the inter-corporate dividend-received deduction when a Canadian corporation has hedged its long position in shares of Canadian companies by entering into a total return swap or other derivative with a Canadian tax-exempt or a non-resident person not subject to Canadian tax.

  The *Income Tax Act* generally permits a Canadian corporation in computing its taxable income to deduct dividends received from another Canadian corporation (often referred to as the "inter-corporate dividend deduction"). However, the inter-corporate dividend deduction is not available in respect of a dividend received on a share that is part of a "dividend rental arrangement". A dividend rental arrangement is an arrangement entered into by the corporate taxpayer whereby it may reasonably be considered that the main reason for entering into the arrangement is to enable it to receive the dividend, and under the arrangement someone other than the corporate taxpayer bears the risk of loss or enjoys the opportunity for gain or profit with respect to the share in any material respect.

  The definition of dividend rental arrangement is being amended to include "synthetic equity arrangements", which in effect removes the main reason test in the dividend rental arrangement definition where it applies. A synthetic equity arrangement will exist when the taxpayer (or a person that does not deal at arm's length with the taxpayer) enters into one or more agreements that have the effect of providing to a counterparty all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share. If a person that does not deal at arm's length with the taxpayer enters into such an agreement, a synthetic equity arrangement will be considered to exist if it is reasonable to conclude that the non-arm's-length person knew, or ought to have known, that this effect would result.

  An exception from the denial of the inter-corporate dividend deduction under this new rule is provided if a taxpayer can establish that no "tax-indifferent investor" has all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share by virtue of a synthetic equity arrangement or another equity derivative that is entered into in connection with the synthetic equity arrangement. A tax-indifferent investor is a person that is exempt from tax under the *Income Tax Act*, a non-resident person that does not receive amounts under the synthetic equity arrangement through a permanent establishment in Canada and certain trusts and partnerships that include such tax-exempt and non-resident persons. In effect, the proposals are targeting synthetic equity arrangements entered into with counterparties that do not pay Canadian income tax on the dividend-equivalent payments they received.

There are certain other exceptions to the rules, including for an agreement that is traded on a recognized derivatives exchange, unless it can reasonably be considered that the taxpayer knows, or ought to know, the identity of the counterparty to the agreement.

The proposed rules also include an anti-avoidance rule that will deem certain agreements that do not meet the definition of "synthetic equity arrangement" to be dividend rental arrangements if, among other things, one of the purposes of the series of transactions that includes these agreements is to avoid the measure.

This measure will apply to dividends that are paid or become payable after October 2015.

Budget 2015 also requests comments from stakeholders by August 31, 2015 as to whether this proposal should be expanded to deny the inter-corporate dividend deduction on dividends received by a taxpayer on a Canadian share in respect of which there is a synthetic equity arrangement, regardless of the tax status of the counterparty. Budget 2015 notes that this approach would have a broader scope, but it would eliminate some of the complexities.

- **Donation of Private Company Shares and Real Estate.** Budget 2015 proposals include an exemption from capital gains tax realized on certain dispositions of private corporation shares and real estate made after 2016 if the cash proceeds of sale are donated to a registered charity or other qualified donee. Currently, only donations to qualified donees of publicly traded securities and certain donations of ecologically sensitive land and certified cultural property are eligible for exemption from capital gains tax.

  The exemption will be available if cash proceeds from the disposition are donated to the qualified donee within 30 days of the disposition, and the private corporation shares or real estate are sold to a purchaser that deals at arm's length with both the donor and the qualified donee that receives the donation. The exempt portion of the capital gain will be based on the proportion of the cash proceeds donated to the total proceeds of disposition. However, the exemption will not apply (or will be reversed if previously claimed) if, within five years of the disposition, the donor (or a person not dealing at arm's length with the donor) directly or indirectly reacquires the property sold; or, in the case of shares, the donor (or a person not dealing at arm's length with the donor) acquires shares substituted for the shares that were sold or the shares of a corporation that were sold are redeemed and the donor does not deal at arm's length with the corporation at the time of the redemption.

- **Investment in Limited Partnerships by Charities.** Registered charities are subject to restrictions under the *Income Tax Act* concerning whether, and the extent to which, they may engage in business activities. These restrictions have traditionally limited the ability of certain charities to directly invest in partnerships, including limited partnerships, because a charity that holds an interest in a partnership could thereby be considered to carry on a business. Amendments to the *Income Tax Act* proposed by Budget 2015 would confirm that a registered charity will not be considered to be carrying on business solely because it acquires or holds an interest in a limited partnership, provided the charity, together with all non-arm's-length persons, holds 20% or less (by fair market value) of the interests in the limited partnership, and the charity deals at arm's length with each general partner of the limited partnership. This is a welcome development that is expected to facilitate access to a wider range of investment opportunities for charities, enabling diversification of their investment portfolios and providing the charitable sector with the flexibility to invest in limited partnerships as a means of structuring social impact investments. This measure is proposed to be effective as of April 21, 2015.

- **Captive Insurance.** Budget 2015 proposes new measures that extend the "foreign accrual property income" (FAPI) rules to ceding commissions earned by foreign affiliates from the ceding of Canadian risks to third parties. A ceding commission is a fee paid by a reinsurance company to its counterparty (the "cedant") to compensate the cedant for its administrative costs in respect of the ceded risks and/or for a percentage of the profits earned from the risks. For these purposes, a foreign affiliate's income from ceding Canadian risks (and FAPI) includes the difference between the fair market value of any consideration received for the ceding of Canadian risks and the foreign affiliate's cost in respect of such risks. This rule is intended to apply to transactions in which a foreign affiliate sells Canadian risks and receives foreign risks in consideration.

  These proposals expand on rules included in Budget 2014 that targeted "insurance swap" transactions. Prior to Budget 2014, income earned by a foreign affiliate from the insurance of Canadian risks was included in the foreign affiliate's FAPI if more than 90% of the foreign affiliate's gross premium revenue for the year (net of reinsurance ceded) was in respect of Canadian risks and risks of non-arm's-length persons (the 90% test). The "insurance swap" rules in Budget 2014 generally deemed foreign risks insured by a foreign affiliate to be Canadian risks for purposes of the 90% test if the foreign affiliate's risk of loss or opportunity for gain or profit from the foreign risks was determined in whole or in part by reference to the fair market value, revenue, income, loss, cash flow or similar criteria of another pool of risks, and more than 10% of that pool was Canadian risks.

  These proposals apply for taxation years of Canadian corporations beginning after April 21, 2015. Interested parties can comment on these rules until June 30, 2015.

- **Capital Gain Stripping: Subsection 55(2).** For the first time in many years Finance is proposing major changes to the form and substance of the anti-gain stripping rules in subsection 55(2) of the *Income Tax Act*, which recharacterize tax-exempt inter-corporate dividends as capital gains in certain cases when they exceed the "safe income" of the dividend payer. These rules are a cornerstone of the corporate tax regime and among the most difficult to interpret.

  The present rules can apply to recharacterize as a capital gain an inter-corporate dividend that exceeds "safe income" if a purpose (or in some cases the effect) is the reduction of a gain that would otherwise be realized on a disposition of a share. The rules are expanded to apply to dividends that have as a purpose the reduction of the fair market value of shares or the increase in the total tax cost of the dividend recipient's assets. This change recognizes that, for example, a dividend could be used to increase a loss on a share that is being disposed of, and that loss could be used to offset a capital gain on another asset. Practically, given that the offending outcome need only be one of the purposes of the dividend, not its main purpose, it seems very difficult to know when these rules will apply. The Canada Revenue Agency (CRA) played a vital role in the interpretation of subsection 55(2) in its early history. Only time will tell if it will provide useful guidance again.

The text of the subsection 55(2) rules is significantly expanded to address the use of stock dividends to shift value, including where the stated capital, and therefore the tax cost, of the shares issued on the stock dividend is less than the fair value of those shares. As part of the stock dividend changes, the rules determining the cost of shares acquired on a stock dividend are also amended.

Historically, dividends that exceed "safe income" have been excused from the application of subsection 55(2) when they occur as part of a "butterfly" reorganization or when they occur as part of a series where, very generally, any tax-benefited transaction in the series (such as tax exempt dividends) occur within a related group and non-related persons do not increase their ownership interest in members of the related group as part of the series of transactions.

This second, related group exception will now be curtailed and will apply only to dividends deemed to arise on share redemptions. Presumably, the logic for this is that such transactions cannot result in duplicated tax cost in the same way that other dividends can. Preliminarily, one would expect that most transactions that rely on the related group exception will still qualify. But care will be required. For many years, the CRA has insisted that internal reorganizations intended to rely on exceptions to subsection 55(2) had to comply with the butterfly rules (which prevent basis duplication), even in cases in which the related group exception would apply and could allow basis duplication. The proposed changes will bring the law more into line with that position.

The drafters have pulled subsection 55(2) apart in order to make these changes. While the general principles of the rules are preserved in their restructured form, it remains to be seen whether technical issues will be created by this reconfiguration.

These changes will apply to dividends received after April 20, 2015.

- **BEPS and Tax Avoidance.** While not introducing any specific measures, Budget 2015 refers to the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) and confirms that the government will proceed in this area by balancing tax integrity and fairness with the competitiveness of Canada's tax system. Budget 2015 affirms that the government is "committed to maintaining Canada's advantage as an attractive destination for business investment".

- **Exchange of Information.** As a connected point, Budget 2015 confirms that Canada proposes to implement automatic exchange of tax information with foreign tax authorities under a common reporting standard developed by the OECD, commencing July 1, 2017. The process will require financial institutions to collect and report information on accounts held by non-residents, which will have at least some similarities with the FATCA reporting requirements that these institutions have been grappling with in recent years.

- **Repeal of Eligible Capital Property.** In Budget 2014, the Department of Finance sought input on whether a new class of depreciable property should be created to replace the existing regime for eligible capital property, which includes goodwill and other intangibles not included in a class of depreciable property. It appears that the Department of Finance has concluded that the new class of depreciable property should be created and it will release detailed draft legislative proposals for comment before their inclusion in a bill.

- **Small Business Deduction.** The first $500,000 per year of qualifying active business income of a Canadian-controlled private corporation is generally subject to federal corporate income tax at a rate of 11%. Budget 2015 proposes a 2% decrease in the 11% small business tax rate to 9%, which will be phased in over four years with a 0.5% decrease occurring on January 1 of each 2016, 2017, 2018 and 2019.

  In response to comments from taxpayers, Budget 2015 states that the Department of Finance is reviewing the circumstances in which income from a business whose principal purpose is to earn income from property should qualify as active business income. Interested parties are encouraged to submit comments by August 31, 2015.

- **TFSAs.** The TFSA annual contribution limit is increased to $10,000, from $5,500, effective for the 2015 and subsequent calendar years. It will no longer be indexed annually to inflation.

- **RRIFs.** The current mandatory withdrawal amounts from registered retirement income funds (RRIFs) will be reduced on the basis of revised assumptions as to nominal rate of return and indexing for individuals aged 71 to 94, effective for the 2015 and subsequent taxation years. Under a transitional rule, RRIF holders who withdraw more than the reduced minimum amount in 2015 will be permitted to recontribute the excess on a tax-deductible basis until February 29, 2016.

- **Alternative Arguments by the CRA.** To address a recent court decision, Budget 2015 proposes to amend the tax rules to "clarify" that the CRA may, at any time, increase or adjust any amount included in an assessment to which a taxpayer has objected or that is under appeal, provided the total tax liability is not increased. This proposal could further impede the ability of large corporations to challenge tax assessments.

*If you have any questions regarding the foregoing, please contact Ian Crosbie (416.367.6958), Elie Roth (416.863.5587), Raj Juneja (416.863.5508) or Christopher Anderson (416.367.7448) in our Toronto office or Brian Bloom (514.841.6505), Nathan Boidman (514.841.6409), Fred Purkey (514.841.6458) or Michael Kandev (514.841.6556) in our Montréal office.*

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