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2016 Federal Budget: Tax Highlights

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The new Liberal government's first budget (Budget 2016) has been the subject of anticipation and speculation, much of it apprehensive. Unusually, Budget 2016 is noteworthy for what it does not contain. Budget 2016 does not introduce changes to increase the tax rate on employee stock option benefits, which formed part of the Liberal government's election platform as discussed in our earlier notes on this topic (*Finance Minister Provides Guidance on Stock Option Grandfathering*, Nov. 20, 2015, and *Will Tax Treatment for Canadian Stock Options Change?* Oct. 29, 2015). Budget 2016 also does not contain any proposal to increase taxes on capital gains realized on the disposition of property, which had been the subject of some speculation.

The principal tax changes announced in Budget 2016 of interest to the business community are summarized below.

Repeal of Eligible Capital Property Regime

Budget 2016 proposes to repeal the regime for eligible capital property (ECP), which includes goodwill and other intangibles not included in a class of depreciable property, and replace it with a new capital cost allowance (CCA) pool. In the February 11, 2014 federal budget (Budget 2014), the Department of Finance sought input on whether the ECP regime should be repealed; in the April 21, 2015 federal budget (Budget 2015), the Department of Finance stated that it would release for comment detailed draft legislative proposals providing for the repeal of the ECP regime.

Currently, 75% of eligible capital expenditures are included in a cumulative eligible capital property (CEC) pool. A deduction can be claimed at the rate of 7% per year on a declining balance basis.

Under the proposed rules, 100% of expenditures incurred on or after January 1, 2017 that would have previously been included in the CEC pool will be included in a new class of depreciable property (class 14.1). The rate of depreciation for expenditures incurred on or after January 1, 2017 will be 5% on a declining balance basis.

CEC balances will be transferred to the new class 14.1 pool as of January 1, 2017. The CCA depreciation rate for property included in the class 14.1 pool related to expenditures incurred before January 1, 2017 will be 7% until 2027.

Perhaps the most significant consequence of the proposals is that a gain on the sale of ECP (including goodwill) will now be taxed as a capital gain and subject to the additional refundable tax applicable to investment income when realized by a Canadian-controlled private corporation (CCPC). Currently, 50% of such gain is included in business income and subject to the lower business tax rate. Therefore, the proposals will eliminate a tax-deferral opportunity that is currently available because of the treatment of gains on the sale of ECP as business income.

Small Business Deduction and Other Changes to Small Business Rules

Budget 2016 proposes to maintain the small business tax rate at 10.5% after 2016. The current gross-up factor and dividend tax credit rate applicable to non-eligible dividends will also be maintained.

Budget 2016 contains a number of proposals designed to preclude multiplying access to the small business deduction. A CCPC that is a member of a partnership can generally claim a small business deduction that is limited to the lesser of the active business income that it receives as a member of the partnership and its pro rata share of a notional $500,000 business limit determined at the partnership level (its "specified partnership income limit"). Structures have been implemented to circumvent the application of these rules – for example, a shareholder of a CCPC may be a member of a partnership, and the partnership may retain the CCPC as an independent contractor. To address this planning, Budget 2016 proposes to extend the provisions to partnership structures in which a CCPC provides services or property to the partnership where the CCPC or a shareholder of the CCPC is a member of the partnership or does not deal at arm's length with a member of the partnership. In this case, the CCPC will be deemed to be a member of the partnership and its income will be deemed to be partnership income. This rule will not apply where all or substantially all of the CCPC's active business income for the year is from providing services or property to arm's length persons other than the partnership.

A similar rule will apply where a CCPC earns active business income from providing services or property to a private corporation where 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. In this case, the income earned will be ineligible for the small business deduction, unless the CCPC earns all or substantially all of its active business income from providing services or property to arm's length persons other than the private corporation.

Under deemed association rules in the *Income Tax Act* (Canada) (the Act), two corporations are deemed to be associated if each corporation is associated with a third corporation. An exception applies if an election not to be associated is made or if the third corporation is not a CCPC. Budget 2016 proposes to make investment income derived from an associated corporation's active business income ineligible for the small business deduction where the exception applies; in addition, the third corporation will be considered to be associated for purposes of the $15-million taxable capital limit.

Budget 2015 announced a review of the circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income eligible for the small business deduction. This review has been completed and no changes to these rules are proposed.

Life Insurance Proceeds and Transfer of Policies

In general, life insurance proceeds received are added to the capital dividend account (CDA) of a private corporation or to the adjusted cost base (ACB) of a partner's interest in a partnership, and may be distributed tax-free to the shareholder or partner. This treatment is limited to the policy benefit received in excess of the policyholder's ACB of the policy. Budget 2016 proposes to address tax planning that avoids this limitation by restricting the increase to CDA or ACB regardless of whether the recipient of the policy benefit is a policyholder. To support this proposal, information-reporting requirements will be introduced to apply where a corporation or partnership that is not a policyholder is entitled to receive a policy benefit.

Where a policyholder disposes of an interest in a life insurance policy to a non-arm's length person, the policyholder's proceeds of disposition are deemed to be equal to the amount that the policyholder would be entitled to receive if the policy were surrendered. Budget 2016 proposes to include the fair market value of any consideration received for an interest in a life insurance policy in the policyholder's proceeds of disposition. Where the disposition arises on a contribution of capital to a corporation or partnership, the increase in the paid-up capital (PUC) and ACB of the shares or partnership interest will be limited to these proceeds of the disposition.

Where an interest in a life insurance policy was disposed of prior to March 22, 2016 for consideration that exceeded the surrender value, the amount of the policy benefit otherwise permitted to be added to the corporation's CDA, or the ACB of an interest in a partnership, is proposed to be reduced by the amount of the excess. In the case of a capital contribution, the increase in the PUC and ACB of the shares or partnership interest will similarly be limited. This measure will apply in respect of policies under which policy benefits are received as a result of deaths that occur on or after the budget date.

Emissions Trading Regimes

An emissions trading regime imposes an obligation on emitters of greenhouse gases or other regulated substances to deliver emissions allowances to a government. These allowances may be provided by the government or acquired in the market or at auction. The Act does not currently address the tax treatment of emissions trading regimes, and Budget 2016 announces the introduction of a new set of rules to address this omission.

Under the proposed rules, emissions allowances will be treated as inventory, though the "lower of cost and market" method for valuation will not be available due to the potential volatility in the value of emissions allowances. There will be no income inclusion where a taxpayer receives an emissions allowance from a government for no consideration, and on the disposition of an emissions allowance (otherwise than in satisfaction of an emissions obligation), a taxpayer will be required to include in its income any proceeds of disposition in excess of its cost of the allowance. In addition, special rules will govern a taxpayer's ability to claim a deduction in respect of an emissions obligation, including rules limiting such deductions to the extent that the obligation exceeds the cost of any emissions allowances acquired by the taxpayer that can be used to settle the obligation.

Matters Affecting Financial Instruments

Budget 2016 contains several initiatives affecting the taxation of financial instruments.

Switch Fund Shares. So-called switch fund mutual fund corporations have made use of rules in the Act that allow a shareholder to convert shares from one class to another without having a taxable disposition, allowing investors to switch between different investment categories within the same mutual fund on a tax-deferred basis. Under the Budget 2016 changes, a switch between classes of mutual fund corporation shares that results in a change of the underlying investment fund will be a taxable disposition. Where the only effect of the switch is a change with respect to management fees or expenses, it will not be treated as a taxable event. The new rules will apply to switches after September 2016.

Linked Notes. A variety of notes are regularly issued into the market that have a return linked to the performance of a stock index or other reference assets. Generally, the position taken is that the return on these notes does not have to be accrued under the interest accrual rules in the Act because the amount payable to the investor is not sufficiently certain. Holders of the notes who sell them prior to maturity may take the position that the proceeds of sale are a capital gain. Under the Budget 2016 changes, on a sale of a note, any gain will be treated as interest that accrued to the date of sale and will be taxed as income. This change will not apply to gains relating to foreign currency fluctuation or gains relating to general movements in interest rates affecting any fixed interest component of the return on the note. The new rules will apply to dispositions after September 2016.

Debt Parking and Foreign Exchange. Currently, where a party connected with a debtor acquires the debt from an arm's length creditor at less than 80% of its issue price, the discounted amount is treated as being forgiven. Otherwise, this sort of parking can avoid the application of debt forgiveness rules where the debt effectively has been eliminated for less than its full amount. Where a debt has a significant foreign exchange gain associated with it, there may also be an incentive to have the debt purchased by a related party rather than repaid, in order to avoid realizing the gain. Under the Budget 2016 changes, where a debt is "parked" in this fashion, foreign exchange gains will be realized. In general, the framework for determining whether the debt is parked will be based on the existing debt forgiveness rules. The rule will not apply in certain circumstances, such as a transaction that involves the acquisition of a substantial interest in the debtor where the main purposes of the transaction do not include avoiding the foreign exchange gain. Similarly, a change in the status of the holder relative to the issuer will not trigger the rules where the main purposes of the change do not include avoiding the recognition of the foreign exchange gain. The rules will apply to debt parking that occurs after March 22, 2016, with grandfathering where the transaction is pursuant to a pre-existing written agreement.

Valuation of Derivatives. Derivatives that are held as inventory and are not mark-to-market property under the Act will no longer qualify for the lower of cost and market treatment normally accorded to inventory under the Act. Instead, they will be carried at cost. This change will apply to derivatives entered into on or after March 22, 2016.

Treaty Shopping and Implementation of OECD Anti-BEPS Proposals

On October 5, 2015, the OECD released the package of final reports from the base erosion and profit shifting (BEPS) project, responding to a series of issues that had been identified in the July 2013 BEPS Action Plan, which was endorsed by the G20 (including Canada) at the November 2015 Leaders' Summit. However, Budget 2016 proceeds with a cautious and very limited implementation of these BEPS proposals.

First, Budget 2016 confirms the government's commitment to address treaty abuse in accordance with the BEPS proposals and states that, going forward, Canada will consider either the limitation on benefits article or the principal purpose test approach to addressing treaty shopping, depending on the particular circumstances. Budget 2016 notes that amendments to Canada's tax treaties to include a treaty anti-abuse rule could be achieved through bilateral negotiations, the multilateral instrument that will be developed in 2016, or a combination of the two. In line with the BEPS proposals, Canada seems to have abandoned its initiative presented in Budget 2014 to adopt a general domestic anti-treaty-shopping rule.

Second, Canada is predictably moving ahead with the OECD new minimum standards in the area of reporting and information exchange by adopting country-by-country reporting for large MNEs for years beginning after 2015 and committing to spontaneous exchange with other tax administrations of tax rulings starting in 2016.

Finally, Budget 2016 states that the Canada Revenue Agency (CRA) is now applying the revised OECD guidance on transfer pricing, which purportedly "provides an improved interpretation of the arm's length principle". These comments by the government seem to ignore the 2012 Supreme Court decision in the *Glaxo* transfer pricing case that held that the OECD transfer pricing guidelines do not make law, per se, in Canada. Significantly, the CRA will not be adjusting its administrative practices at this time in the two most controversial areas of the OECD's BEPS-related transfer pricing work: the proposed simplified approach to low-value-adding services and the treatment of so-called cash boxes. Canada will decide on a course of action with regard to these measures after follow-up work by the OECD is complete.

Extension of the Back-to-Back Rules

Budget 2014 introduced rules to limit the use of back-to-back arrangements in the context of Canada's thin capitalization rules and withholding tax regime. In the latter context, these anti-avoidance rules ensure that the amount of withholding tax in respect of a cross-border interest payment cannot be reduced through the use of a back-to-back arrangement. Significantly, these rules have a policy overlap with the BEPS initiative discussed above.

Budget 2016 proposes to build on the existing back-to-back loan rules in the context of Canada's withholding tax regime by (1) extending their application to rents and royalties; (2) adding character substitution rules that prevent the avoidance of the back-to-back rules through the substitution of economically similar arrangements between the intermediary and another non-resident person; and (3) clarifying the application of the back-to-back loan rules to multiple intermediary structures. These changes will apply to payments of interest or royalties made after 2016. Similar changes will be introduced to the existing shareholder loan rules.

The so-called character substitution rules may adversely affect some inbound investment structures because one of their stated targets is situations in which interest or royalties are paid by a Canadian-resident person to an intermediary, and a non-resident person holds shares of the intermediary that include certain obligations to pay dividends or that satisfy certain other conditions (e.g., they are redeemable or cancellable).

Cross-Border Surplus Stripping

A corporation resident in Canada can generally distribute PUC to its non-resident shareholders without withholding tax. Other distributions or deemed distributions made by a Canadian corporation to a non-resident shareholder are generally subject to a 25% withholding tax, subject to reduction under an applicable tax treaty.

Section 212.1 of the Act applies to certain transfers by a non-resident shareholder of shares of a Canadian-resident corporation (subject corporation) to a second non-arm's length Canadian-resident corporation (purchaser corporation). Where it applies, the fair market value of any non-share consideration (boot) received by the non-resident shareholder in excess of the paid-up capital of the subject corporation shares is deemed to be a dividend paid to the non-resident by the purchaser corporation, and the paid-up capital of any shares of the purchaser corporation issued to the non-resident cannot exceed the paid-up capital of the subject corporation shares, less the fair market value of any boot. Section 212.1 is intended to ensure that profits of the subject corporation in excess of its paid-up capital cannot be indirectly distributed to the non-resident shareholder in a manner that avoids withholding tax.

An exception to section 212.1 in subsection 212.1(4) ensures that the rule does not apply to a disposition of subject corporation shares by a non-resident corporation to a purchaser corporation that controlled the non-resident. This exception is intended to allow Canadian corporations to unwind "sandwich structures", where a non-resident subsidiary of a Canadian corporation owns shares of a second Canadian corporation. Budget 2016 states that non-resident parent corporations were reorganizing their Canadian subsidiaries to intentionally create sandwich structures to avoid the application of section 212.1. Budget 2016 revises the subsection 212.1(4) exception so that it is not available on an acquisition of shares of a subject corporation by a purchaser corporation where, at the time of the disposition or at any time during the series of transactions that includes the disposition, a non-resident that does not deal at arm's length with the purchaser corporation owns, directly or indirectly, any shares of the purchaser corporation.

The revisions to subsection 212.1(4) potentially give rise to unintended consequences. Revised subsection 212.1(4) does not appear to be available if the purchaser corporation had a non-arm's- length non-resident shareholder at any time in the series of transactions that includes the disposition, even if the purchaser corporation is no longer controlled by a non-resident shareholder at the time of the disposition of the subject corporation shares. In addition, if the exception in subsection 212.1(4) is unavailable, it is the non-resident subsidiary of the purchaser corporation that will receive the deemed dividend, and this deemed dividend will often be subject to a higher withholding tax rate than a dividend paid to a non-resident parent of the purchaser corporation.

Section 212.1 is also amended so that if no consideration is received by a non-resident for shares of a subject corporation (*e.g.*, on the wind-up of a sandwich structure), the non-resident is deemed to have received boot having a fair market value equal to the fair market value of the shares of the subject corporation.

Other Previously Announced Measures

Capital Gain Stripping: Subsection 55(2). Budget 2016 confirms the government's intention to proceed with measures contained in Budget 2015 and related draft legislation released on July 31, 2015 that proposed major changes to the form and substance of the anti-gain stripping rules in subsection 55(2) of the Act, which recharacterize tax-exempt intercorporate dividends as capital gains in certain cases when they exceed the "safe income" of the dividend payer.

Donation of Private Company Shares and Real Estate. Surprisingly, Budget 2016 confirms that the government does not intend to proceed with proposals contained in Budget 2015 providing for a tax exemption for capital gains realized on certain dispositions of private corporation shares and real estate if the cash proceeds of sale are donated to a registered charity or other qualified donee within 30 days of the disposition.

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