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2017 Federal Budget: Tax Highlights

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The Liberal government's second budget (Budget 2017) comes during a period of exceptional global political and economic uncertainty. Of particular importance from a Canadian economic and tax policy perspective is the uncertainty about how the Trump administration's agenda will unfold in the coming months. Will its foreign and trade policies have a material impact on Canada, and will the United States pursue a tax reform agenda that will impose practical constraints on Canadian policy alternatives?

As the government attempts to advance its stated priorities of innovation, job creation and infrastructure investment, there has been much speculation in the weeks leading up to Budget Day (March 22, 2017) regarding the extent to which Mr. Trump's promises of extensive U.S. corporate tax reform will influence the Liberal government's approach to anticipated Canadian tax reforms. For instance, the federal government's recent extension of its federal tax credit review, which was originally expected to culminate in a tax reform plan that would be released on Budget Day, will allow the government to first observe how the promised U.S. tax reform unfolds. In recent months, the most prominently rumoured Canadian tax change has been a suspected increase in the capital gains inclusion rate. For the second consecutive year, this rumour has not come to fruition, as Budget 2017 leaves the taxation of capital gains unchanged.

The principal tax changes announced in Budget 2017 of interest to the business community are summarized below.

Income Tax Measures

Elimination of Billed-Basis Tax Reporting

Accountants, dentists, lawyers, doctors, veterinarians and chiropractors have been able to compute their income for tax purposes by including in income amounts that have been billed during the year and excluding work in progress that remains unbilled at the end of the year. The costs incurred in the year are deducted against the billed income. In an unexpected move, Budget 2017 proposes to eliminate this rule. Such professionals will no longer be able to report income on the billed basis. A transitional rule provides that in the first taxation year that begins after Budget Day, both the cost and the fair market value of the taxpayer's work in progress is one half of the amount otherwise determined. This change accelerates income that would otherwise have been taxable in the next year into an earlier year; it does not affect the total amount of income over time. The Budget Supplementary Information indicates that this change is expected to generate $425 million in revenue over the next three years.

The cash-basis reporting available to farming and fishing business is not affected by this change, although Budget 2017 announces a consultation on the treatment of deferred cash purchase tickets that could lead to the elimination of the deferral opportunity they provide in respect of "listed grain" sales.

Timing of Recognition of Gains and Losses on Derivatives

As part of Budget 2017, the government proposes two measures addressing the timing of recognition of gains and losses on derivatives. The first one addresses the outcome of the Federal Court of Appeal decision in *Kruger Inc. v. Canada* (for our previous release see The Federal Court of Appeal Permits Use of Mark-To-Market Tax Accounting). This case held that the taxpayer was entitled to use the mark-to-market method in computing its income for federal income tax purposes and, as a result, it was entitled to recognize an accrued year-end loss on its book of foreign exchange option contracts. To provide a clear framework for exercising the choice of using the mark-to-market method and to ensure that this choice does not lead to avoidance opportunities, Budget 2017 proposes to introduce an elective mark-to-market regime for derivatives held on income account. Specifically, an election will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election will remain effective for all subsequent years unless revoked with the consent of the government. This election will be available for taxation years that begin on or after Budget Day.

A second measure deals with so-called straddle transactions. Typically, a straddle is a transaction in which a taxpayer concurrently enters into derivative positions that are expected to generate equal and offsetting gains and losses. Shortly before its taxation year-end, the taxpayer disposes of the position with the accrued loss, while shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain. There are several variations to this type of transaction, including combining it with an exit strategy that shifts the offsetting gain to a tax-indifferent investor. The government has been challenging these transactions using various rules and principles, including the general anti-avoidance rule. Now Budget 2017 proposes to introduce a stop-loss rule that will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. The stop-loss rule will be subject to several exceptions, including for financial institutions and hedging transactions. A carve-out would also apply if none of the main purposes of the transactions is to defer or avoid tax. This measure will apply to any loss realized on a position entered into on or after Budget Day.

Treaty Shopping

Budget 2016 confirmed the government's commitment to address treaty abuse in accordance with the proposals coming out of the OECD's base erosion and profit shifting (BEPS) project. On November 24, 2016, members of an ad hoc group consisting of more than 100 jurisdictions (including Canada) under the aegis of the OECD concluded negotiations of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). The MLI is intended to be an instrument that can be used to uniformly and efficiently implement recommendations regarding tax treaty policy and practice across thousands of bilateral tax treaties between participating jurisdictions.

In Budget 2017 the government stated that it is pursuing signature of the MLI and is undertaking the necessary domestic processes to do so.

Meaning of Factual Control

Two tests for control of a corporation are recognized in the *Income Tax Act* (Canada) (ITA): *de jure* (legal) control and *de facto* (factual) control. The factual control test is relevant in determining a corporation's status as a Canadian-controlled private corporation, as well as whether corporations are associated, which can affect their small business deduction limit and the limit on qualifying expenditures relating to the refundable 35% SR&ED tax credit. A recent judicial decision (*McGillivray Restaurant Ltd. v. The Queen*) held that for a factor to be considered in determining whether factual control exists, it must include "a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability," and rejected consideration of factors related to operational control in making this determination.

Budget 2017 notes that it was not intended from a policy perspective that the factual control test depend on the existence of a legally enforceable right of this nature, or that other factors be disregarded, and proposes to amend the ITA to clarify that the determination whether factual control exists is to be made by taking into consideration all factors that are relevant in the circumstances. This test may lead to considerably more uncertainty in its application than the approach applied in *McGillivray*. This amendment will apply in respect of taxation years beginning after March 21, 2017.

Anti-Avoidance Rules for Registered Plans

The ITA contains anti-avoidance rules applicable to holders of tax-free savings accounts (TFSAs), registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs). These rules are aimed at ensuring that investments held through registered plans are arm's-length portfolio investments and that no advantages are derived from transactions that would not have occurred on an open market. In these situations, penalty-type taxes apply to the holder of the registered plan. Budget 2017 proposes to extend the application of these anti-avoidance rules to registered education savings plans (RESPs) and registered disability savings plans (RDSPs). Subject to specific exceptions, the proposed rules apply to investments acquired after Budget Day and to investment income generated after Budget Day on previously acquired investments.

Merger of Switch Corporations into Mutual Fund Trusts

Canadian mutual funds can be in the legal form of a trust or a corporation. Switch corporations are mutual fund corporations with multiple classes of shares, where typically each class is a distinct investment fund.

For qualifying reorganizations occurring after March 21, 2017, the budget proposes to extend the current mutual fund merger rules to facilitate the reorganization of a switch corporation into multiple mutual fund trusts on a tax-deferred basis. The rules will apply to a class of shares if all or substantially all of the assets allocable to that class are transferred to a mutual fund trust and the shareholders of that class become unitholders of that mutual fund trust.

Switch fund mutual fund corporations historically allowed a shareholder to convert shares for one class to another class without having a taxable disposition. As a result of amendments announced in Budget 2016, any such conversion is now a taxable disposition to the shareholder except where the switch is a change with respect to management fees or expenses.

Consultation on Taxation of Private Corporations

Budget 2017 does not include any measures that affect the taxation of private corporations. The federal government has announced that it will issue a paper in the coming months discussing certain tax-planning strategies involving private corporations and its proposed responses to these strategies. The following strategies were highlighted in Budget 2017 as items that the government may address in this paper:

- Using a private corporation to "sprinkle" income via dividends and capital gains among family members who may be subject to a lower rate of tax on the income.
- Holding a passive investment portfolio inside a private corporation where the corporate tax on the income is lower than the personal rate of tax.
- Converting income that would be taxed in the hands of individual shareholders as a dividend or salary into a capital gain.

Budget 2017 notes that a number of existing measures limit the scope of certain of these strategies, but that these measures may not apply in all circumstances. The forthcoming paper will include the federal government's proposed policy measures on these issues, including possible legislative changes. The paper may also include relieving measures to existing rules that may provide disincentives to genuine business transactions. No timeline was given as to when this paper would be issued or the consultation period for business to provide its views on these items.

Excise Tax Measures

"Uber" Tax

Budget 2017 proposes to amend the *Excise Tax Act* (Canada) so that ride-sharing services, such as Uber, will be required to charge goods and services tax/ harmonized sales tax on its services in the same manner as taxis. This measure is intended to level the playing field between ride-sharing services and taxis.

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 Marie-Emmanuelle Vaillancourt (514.841.6543) or Michael Kandev (514.841.6556) in our Montréal office.