

Canadian tax alert

2016-2017 federal budget highlights



The Minister of Finance, Bill Morneau, presented the 2016-2017 budget in the House of Commons this afternoon. In its first budget, the new government has expressed a commitment to growing the economy, creating jobs and strengthening the middle class.

As previously announced, the government has decreased the second marginal tax rate from 22% to 20.5% and introduced a new top marginal tax rate of 33% for income above \$200 thousand. In addition, the government proposes to restore the age of eligibility for the Old Age Security and Guaranteed Income Supplement to 65 from 67.

The budget proposes \$120 billion of investment in infrastructure and job creation over the next ten years, including significant investments in public transit, clean technology, and First Nations, Inuit Peoples and the Metis Nation.

A summary of the economic and tax highlights contained in the budget is provided below.

Economic outlook

Mr. Morneau indicated that the deficit for 2015-2016 will be \$5.4 billion while a deficit of \$29.4 billion is predicted for 2016-2017. The deficit is projected to decline gradually reaching \$14.3 billion by 2020-2021.

The federal debt-to-GDP ratio is estimated to be approximately 32.5% for 2016-2017. This ratio is projected to decline, reaching 30.9% in 2020-2021.

The GDP is expected to grow by 1.4% in 2016 and by 2.2% in future years.

The inflation rate for 2016 is estimated at 1.6%, reflecting falling gas prices, and is expected to be 2% in subsequent years.

The unemployment rate is currently 7.1% and is expected to decrease to 6.3% by 2020.

Tax measures concerning business

- The eligible capital property (ECP) regime is proposed to be repealed and replaced with a new capital cost allowance (CCA) class (Class 14.1) for businesses with a 100% inclusion rate and a 5% annual depreciation rate. The budget proposes to calculate and transfer cumulative eligible capital (CEC) pool balances to the new CCA class as of January 1, 2017. For the first ten years, the depreciation rate for the new CCA class will be 7% for expenditures incurred before January 1, 2017. Further transition rules are provided, including special transition rules for small businesses.
- This budget proposes to keep the small business tax rate at 10.5 percent after 2016 rather than reducing this rate to 9% by 2019 as announced in the previous budget. As a result, the budget also proposes to maintain the current gross-up (17%) and dividend tax credit (21/29 of the gross-up rate) rates applicable to non-eligible dividends.
- Where the exception to the deemed association corporation rules applies (i.e., an election not to be associated is made or the third corporation is not a CCPC), the budget proposes to make investment income derived from an associated corporation's active business ineligible for the small business deduction and taxable at the general corporate tax rate. Furthermore, where the exception applies, the third corporation will continue to be associated with each of the other corporations in applying the \$15 million taxable capital limit. These changes will apply to taxation years that begin on or after March 22, 2016.
- In order to address the multiplication of the small business deduction, the budget proposes the following changes, applicable on or after March 22, 2016:
 - Extend the specified partnership income rules to partnership structures where a CCPC provides services or property to a partnership during a taxation year of the CCPC where, at any time during the year, 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.
 - Address planning with corporate structures by deeming a CCPC's active business income from providing services or property in its taxation year to a private corporation to be ineligible for the small business deduction where, at any time during the year, 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. This change will not apply to a CCPC if all or substantially all of its active business income for the taxation year is earned from providing services or property to arm's length persons other than the private corporation.
- Based on the consultation on active versus investment business rules completed in August 2015, the government is not proposing any changes to these rules at this time.
- The budget confirms the government's intention to move forward with measures relating to the conversion of capital gains into tax-deductible intercorporate dividends.
- To ensure that the capital dividend account rules for private corporations, and the adjusted cost base rules for partnership interests apply as intended, the insurance benefit limit is proposed to apply regardless of whether the corporation or partnership that receives the policy benefit is a policyholder of the policy. In addition, the budget introduces information-reporting requirements

for a corporation or partnership that is not a policy holder but is entitled to receive a policy benefit. These changes are applicable to policy benefits received as a result of death on or after March 22, 2016.

- The budget proposes changes to the policy transfer rule to prevent an inappropriate receipt of tax-free amounts by a policyholder as a result of a disposition of an interest in a life insurance policy. In applying the policy transfer rule, the budget proposes to include the fair market value of any consideration given for an interest in a life insurance policy in the policyholder's proceeds of disposition and the acquiring person's cost. The increase in paid-up capital and the adjusted cost base of the shares or of an interest in a partnership, will also be limited to the proceeds of disposition where the disposition occurs on the contribution of capital to a corporation or partnership. These proposed changes will apply to dispositions that occur on or after March 22, 2016.
- In addition, the budget proposes to amend the capital dividend account rules for private corporations and the adjusted cost base rules for partnership interests where an interest in a life insurance policy was disposed of before March 22, 2016 under the policy transfer rules. These amendments apply to policies where policy benefits are received as a result of deaths occurring on or after March 22, 2016.
- When a foreign currency debt becomes a parked obligation, the budget introduces rules so that any accrued foreign exchange gains on this debt will be realized. However, special rules are provided for foreign currency debt arising in certain bona fide commercial transactions and for financially distressed debtors. These rules will apply to a foreign currency debt that meets the conditions to become a parked obligation on or after March 22, 2016. There is an exception if these conditions are met before 2017 and results from a written agreement entered into before March 22, 2016.
- The budget proposes to exclude derivatives from the application of the lower of cost and market method of valuation but still maintain the status of such property as inventory. This will apply to derivatives entered into on or after March 22, 2016.
- The budget proposes to expand Classes 43.1 and 43.2 to include certain electric vehicle charging stations, a broad range of short-and long-term storage equipment that is ancillary to eligible generation equipment and to include stand-alone electrical energy storage property in Class 43.1 if the round trip efficiency of the equipment is greater than 50% for property acquired for use on or after March 22, 2016 that has not been used or acquired for use before this date.
- To clarify the tax treatment of emissions allowances and to eliminate the double taxation of certain free allowances, the budget proposes to introduce specific rules that allow emissions allowance to be treated as inventory for all taxpayers. However, the "lower of cost and market" method for the valuation of inventory will not be available for these allowances. The changes will be applicable to emissions allowances acquired in taxation years beginning after 2016. On an elective basis, it will also apply to emissions allowances acquired in taxation years after 2012.
- As expected, Budget 2016 contains proposals regarding certain recommendations of the Organisation for Economic Co-operation and Development (OECD) as set out in its final reports on its base erosion and profit shifting (BEPS) initiative, released in October 2015. Specifically:
 - The budget proposes the adoption of the country-by-country (CBC) reporting standard for transfer pricing documentation for years beginning after 2015. The requirement applies to multinational enterprises with consolidated group revenues of at least EUR750 million, and whose ultimate parent entity is resident in Canada. Canadian resident subsidiaries may also be required to file CBC reports in circumstances where the corporate group is required to appoint a subsidiary as a surrogate to fulfil the filing obligation and the Canadian subsidiary is appointed for this purpose. CBC reports will be due within one year of the end of the fiscal

year to which the report relates. Draft legislation will be circulated for comment in the coming months, and the first exchange of CBC reports is expected by June 2018.

- Budget 2016 confirms the government's commitment to address treaty shopping through the incorporation of either a principal purpose test or a limitation on benefits rule into Canada's existing treaties, in accordance with the BEPS minimum standard. The implementation of such treaty amendments will be achieved through bilateral negotiations, the development of the multilateral instrument in 2016, or a combination of both approaches. The budget contains no reference to the government's intentions concerning the domestic anti-treaty shopping proposals previously released in Budget 2014.
- The budget indicates the government's position that the OECD's recently revised Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations reflect current audit and assessing practices of the Canada Revenue Agency (CRA), with the exception of revisions pertaining to two areas where follow-up work by BEPS project participants continues namely, the development of a threshold for the proposed simplified approach to low value-adding services, and the definition of risk-free and risk-adjusted returns for minimally functional entities. The CRA will determine its approach after such work is completed.
- The budget proposes the implementation of the BEPS minimum standard concerning the spontaneous exchange of certain tax rulings with other jurisdictions, with exchanges commencing in 2016 through existing mechanisms, and subject to existing safeguards concerning confidentiality of taxpayer information.
- Effective March 22, 2016, the budget proposes to amend the cross-border anti-surplus stripping rule contained in section 212.1 of the Income Tax Act to clarify its application in situations where non-resident taxpayers seek to repatriate funds from a Canadian-resident subsidiary free of Canadian withholding tax through an increase of paid-up capital achieved on certain reorganizations of Canadian and non-resident subsidiaries. The budget indicates that such amendments are intended to provide greater certainty concerning existing policy intentions.
- Budget 2016 proposes the expansion of the existing back-to-back loan rules concerning the imposition of non-resident withholding tax in the following ways:
 - Expanding their application to rents and royalties paid after 2016.
 - Ensuring their application to character substitution arrangements, whereby the transaction between the Canadian payer and the intermediary is legally different from, but economically similar to, the transaction between the intermediary and the ultimate recipient. For example, the currently enacted rules do not apply when a Canadian taxpayer pays interest to an intermediary, and that intermediary then pays the same amount in the form of a royalty to a third party, even if the two arrangements would otherwise be considered to be connected for purposes of these rules. This proposal will apply to payments made after 2016.
 - Adding similar rules in the context of the shareholder loan rules. Such rules will deem a debt owed by an intermediary to a Canadian-resident corporation to instead be owed by the non-resident shareholder. Such amendments are proposed to take effect as of March 22, 2016, with deemed indebtedness resulting from existing arrangements being considered to have become owing on that date.
 - Clarifying the application of the rules in situations where multiple intermediaries exist. In such situations, incremental withholding tax will be imposed based on the rate that would be applicable on a payment made by the Canadian resident to the ultimate recipient in a chain of connected arrangements. These rules will be effective for payments made after 2016, and to shareholder debts as of January 1, 2017.

Tax measures concerning individuals

- As indicated during the election campaign, for 2016 and subsequent years, the government has proposed the elimination of the income splitting tax credit for couples with at least one child under the age of 18.
- The budget proposes the complete elimination of the children's fitness and arts tax credit as well as the education and textbook tax credit effective as of January 1, 2017. The maximum Children's Fitness and Arts tax credit will be halved for 2016, and the ability to carry forward unused amounts in respect of the textbook and education tax credits will remain unaffected.
- The rate at which the labour-sponsored venture capital corporations (LSVCC) tax credit for share purchases of provincially registered LSVCCs prescribed under the Income Tax Act is proposed to be restored to 15% for the 2016 and subsequent taxation years. No change to the previously announced phase-out of the credit for federally registered LSVCCs is contemplated.
- Exchanges of shares of a mutual fund corporation (or an investment corporation) that occur after September 2016, and that result in the investor switching between classes in order to switch economic exposure to different underlying assets, are proposed to result in a deemed disposition at fair market value for tax purposes. These new "switch fund" rules will not apply to mere switches between series of shares within a class.
- Effective for transactions after September 2016, gains realized on the disposition of a linked note will be deemed to be accrued interest for tax purposes. Foreign currency fluctuations will be ignored for this purpose, and an exception will be provided to the extent that a portion of the gain is attributable to fluctuations in market rates of interest and a portion of the underlying return on the note is based on a fixed rate of interest.
- Eligibility for the 15% mineral exploration tax credit is proposed to be extended for one year for flow-through share agreements entered into on or before March 31, 2017.
- A number of consequential amendments resulting from the December 7, 2015 announcement of a new 33% top marginal personal tax rate have been proposed, applicable to 2016 and subsequent taxation years, including, among others:
 - A tax rate increase from 28% to 33% on personal service business income earned by corporations.
 - A reduction in the "relevant tax factor" (which applies for purposes of the foreign affiliate rules) from 2.2 to 1.9.
 - The application of the 33% rate to excess employee profit sharing plan contributions.
 - The availability of a 33% charitable donation tax credit on donations over \$200 made after the 2015 taxation year by trusts that are subject to the 33% rate on all of their taxable income.
- A new refundable teacher and early childhood educator school supply tax credit is proposed for eligible supplies acquired on or after January 1, 2016, applied at a rate of 15% on up to \$1,000 of eligible purchases.
- As previously announced, a new Canada child benefit (CCB) is proposed to be introduced to replace the current Canada child tax benefit and universal child care benefit. CCB payments will begin in July 2016. The CCB will provide an annual benefit of up to \$6,400 per child under six years of age and up to \$5,400 per child aged six through 17 years old. The benefit will be phased out as adjusted family net income increases. An additional amount of \$2,730 per child eligible for the disability tax credit will continue to be provided. These amounts will be paid monthly to eligible families, will not be taxable and will not reduce the amount eligible for the goods and services tax (GST) credit, the guaranteed income supplement, the Canada education savings grant, the Canada learning bond and the Canada disability savings grant.
 - The children's special allowance will be increased to the same level as is proposed for the CCB, effective July 1, 2016.
- An increase to the northern residents deductions is proposed as of the 2016 taxation year. The northern zone residency deduction will increase from \$8.25 to \$11 per day (or from \$16.50 to \$22 per household). The deduction for residents in the intermediate zone will be one half of the northern zone amount.

- In order to ensure that income-tested benefits are not affected by assistance provided by the Ontario government to low income households to pay for electricity costs under the Ontario electricity support program, the budget proposes that such amounts will not be taxable under the Income Tax Act. This measure is applicable to the 2016 and subsequent taxation years.

Sales and other tax measures

- The government has indicated that it will not proceed with Budget 2015 measures that would grant an exemption from capital gains taxation for certain dispositions of real estate or private corporation shares where cash proceeds from the disposition are donated to a registered charity or other qualified donee within 30 days.
- The budget proposes to expand the list of medical devices which are zero-rated for GST/HST purposes for sales of these devices after March 22, 2016.
- Budget 2016 adds clarification that the GST/HST will generally apply to purely cosmetic procedures provided by all suppliers including registered charities after March 22, 2016. Cosmetic procedures required for medical or reconstructive purposes will continue to be exempt for GST/HST.
- The zero-rating rules for GST/HST on exported call centre services are proposed to be modified by the budget so that these services will only continue to be zero-rated if the service is supplied to a non-resident person who is not registered for GST/HST purposes, and it can reasonably be expected that the services are to be rendered primarily to individuals who are outside of Canada. This modification will apply to supplies made after March 22, 2016.
- The budget proposes to simplify the reporting for homebuilders of grandparented housing sales and provide builders with an opportunity to correct past misreporting by filing an election between May 1, 2016 and December 31, 2016.
- Budget 2016 proposes a change where a charity supplies property or services in exchange for a donation and when an income tax receipt may be issued for a portion of the donation such that only the value of the goods or services provided will be subject to GST/HST. This proposed change will apply to supplies made after March 22, 2016 with some additional relief provided retroactively.
- The budget proposes to ease the requirements relating to the characterization as a financial institution for GST/HST purposes so that a person engaging in basic deposit-making activities will be excluded from this definition.
- Certain financial institutions are required to self-assess GST/HST on particular expenses incurred outside of Canada that relate to their Canadian activities. The budget proposes to clarify that certain components of imported reinsurance services and other services are not to be included in the calculation of amounts subject to self-assessment effective for year ends after November 16, 2005.
- The budget proposes to require that, for the purpose of the closely related test for GST/HST purposes, a corporation or partnership is required to hold and control 90% or more of the votes in respect of every corporate matter of the subsidiary corporation in order to qualify as closely related. The proposed measure will apply after March 22, 2017; however, it will apply after March 22, 2016 for elections under section 150 and 156 of the Excise Tax Act that are filed after March 22, 2016 and that are to be effective as of March 23, 2016.
- Budget 2016 proposes to clarify situations where relief from excise tax is granted relating to diesel fuel used as heating oil or to generate electricity.
 - First, relief from excise tax will be limited only to heating oil that is consumed exclusively for providing heat to a home, building or similar structure for fuel delivered after June 2016 or to fuel delivery prior to July 2016 that is intended to be used after June 2016.

- Second, relief relating to the generation of electricity used in or by a vehicle for fuel delivered after June 2016 or delivered before 2016 but intended to be used after June 2016 will be removed.
- The budget proposes to require security for payment of assessed amounts in excess of \$10 million. If the security is not provided, the Minister is given with the authority to collect such amount. This measure applies to amounts assessed and penalties determined under the Excise Act after the date of Royal Assent.

For further details, we refer you to the [Ministry of Finance website](#).



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