2017 Federal Budget Review

On March 22, Finance Minister Bill Morneau unveiled the Liberal government's second Federal Budget entitled "Building a Strong Middle Class" which continues with many of the themes outlined in the Liberal election platform and last year's Federal Budget. The Budget anticipates a deficit of $23 billion for fiscal 2016-17 and forecasts a deficit of $28.5 billion for 2017-18.

Notable themes of the budget include innovation, gender analysis – by assessing the impact of proposed budget measures to ensure a fair and consistent treatment of both genders – and 'tax fairness' for the middle class. With regards to the latter, the Budget outlined the government's continued focus on closing perceived tax loopholes, cracking down on tax evasion, improving tax relief for the middle class, and eliminating existing tax measures that are considered ineffective and inefficient.

From a personal and small business tax perspective, which is the focus of this review, the Budget did not propose any increases to the capital gains inclusion rate (or income tax rates in general), nor did it introduce any significant small business tax changes affecting private corporations and their shareholders. However, with regards to private corporations, consistent with its election platform the government indicated in the Budget that it continues to review the use of tax strategies involving private corporations that inappropriately reduce personal taxes of high-income earners, and the government intends to release a paper in the coming months outlining proposed policy responses. The personal tax measures proposed in the Budget were somewhat minor, consisting primarily of tweaks to specific tax credits – such as the elimination of the public transit tax credit. This is in line with the government's review of the current tax system to eliminate tax measures viewed as poorly targeted and inefficient, as announced in last year's Federal Budget.

The most significant income tax measures affecting individuals and Canadian private companies are summarized below. Note that the measures introduced are only proposals at this stage and may not ultimately be enacted into law. Readers are cautioned to consult with their tax advisors for specific advice on how they may be affected by these proposals.

Summary of Personal Income Tax Proposals

In its ongoing review of tax measures viewed as ineffective and inefficient, the government proposes changes to the following tax credits:

Canada Caregiver Credit

Effective for the 2017 and subsequent taxation years, the Budget proposes to simplify the existing system of tax measures for caregivers by replacing the existing caregiver credit, infirm dependant credit and family caregiver tax credit with a new Canada Caregiver Credit. This new credit is intended to better target support to those most in need and extend tax relief to some caregivers who may not currently qualify due to the income level of their dependant. The new tax credit is intended to provide tax assistance to caregivers for dependants who have an infirmity and are dependent on the caregiver for support by reason of that infirmity.

Specifically, the Budget proposes that the new Canada Caregiver Credit amount will be:

- $6,883 (in 2017) in respect of expenses for care of dependent relatives with infirmities (including persons with disabilities) – parents, brothers and sisters, adult children, and other specific relatives.
- $2,150 (in 2017) in respect of expenses for care of a dependent spouse/common-law partner or minor child with an infirmity (including those with a disability).

It is intended that the Canada Caregiver Credit will extend tax relief to more caregivers by increasing the income threshold for the dependant at which the credit begins to phase out, i.e. the credit will start to be reduced (dollar-for-dollar) when the dependant's net income is above

$16,163 (in 2017). The credit amounts that may be claimed and the income thresholds above which the credit will begin to be phased out will be indexed to inflation for taxation years after 2017.

Disability Tax Credit Certification

The Budget proposes to add nurse practitioners to the list of medical practitioners that can certify eligibility for the disability tax credit. It is intended that a nurse practitioner will be permitted to certify eligibility for all types of impairments that are within the scope of their practice. This measure will apply to disability tax credit certifications made on or after Budget Day.

Tuition Tax Credit

The Budget proposes to extend the eligibility criteria for the tuition tax credit to fees for an individual's tuition paid to a university, college or other post-secondary institution in Canada for occupational skills courses that are not at the post-secondary level. The tuition tax credit would be available in these circumstances only if the course is taken for the purpose of providing the individual with skills (or improving the individual's skills) in an occupation and the individual has attained the age of 16 before the end of the year. This measure will apply in respect of eligible tuition fees for courses taken after 2016.

Medical Expense Tax Credit – Fertility-Related Expenses

In some cases, such as single individuals and same-sex couples, the use of reproductive technologies may not be directly related to a medical infertility condition. Even where such treatment is not medically indicated, the Budget proposes to clarify the application of the medical expense tax credit so that individuals who require medical intervention in order to conceive a child are eligible to claim the same expenses that would generally be eligible for individuals on account of medical infertility. This measure will apply to the 2017 and subsequent taxation years.

In addition, the Budget will introduce the ability for individuals to elect for this measure to apply for any of the immediately preceding ten taxation years.

Public Transit Tax Credit

The Budget proposes to eliminate the existing public transit tax credit, which provides a 15-per-cent non-refundable tax credit in respect of the cost of eligible public transit passes (including annual and monthly passes, as well as weekly passes and electronic fare cards used on an ongoing basis), effective as of July 1, 2017. Specifically, the cost of public transit passes and electronic fare cards attributable to public transit use that occurs after June 2017 will no longer be eligible for the credit.

Other personal tax measures identified as providing greater consistency or enhancing the integrity of the tax system include the following:

Home Relocation Loans – Deduction

Where a person receives a loan because of their employment, and the interest rate on the loan is below a prescribed rate, the employee is deemed to have received a taxable benefit. However, a portion of this benefit may be deductible from taxable income. The Budget proposes to amend the current tax law to eliminate the deduction in respect of eligible home relocation loans, effective for benefits arising in the 2018 and subsequent taxation years.

Anti-Avoidance Rules – Registered Education Savings Plans (RESPs) and Registered Disability Savings Plans (RDSPs)

A number of anti-avoidance rules currently exist for registered plans (i.e., Tax-Free Savings Accounts, Registered Retirement Savings Plans and Registered Retirement Income Funds) to help ensure that the plans do not provide excessive tax advantages unrelated to their respective basic objectives. These include:

- the advantage rules, which help prevent the exploitation of the tax attributes of a registered plan (e.g., by shifting returns from a taxable investment to a registered plan);
- the prohibited investment rules, which generally ensure that investments held by a registered plan are arm's length "portfolio" investments; and
- the non-qualified investment rules, which restrict the classes of investments that may be held by a registered plan.

To improve the consistency of the tax rules that apply to investments held by registered plans, the Budget proposes to extend the anti-avoidance rules described above to RESPs and RDSPs. Subject to certain exceptions and transitional measures, these proposals will apply to transactions occurring, and investments acquired, after Budget Day.

Canadian Private Business Tax Measures

Consistent with its stated review of the tax system to eliminate tax measures seen as poorly targeted and inefficient, the government is also reviewing the increasingly complex tax rules governing small businesses and corporations. The following are some income tax measures affecting small businesses addressed in the Budget as part of this broad review.

Billed-Basis Accounting

Taxpayers are generally required to include the value of work-in-progress (WIP) in computing their income for tax purposes. However, taxpayers in certain designated professions (for example, accountants, dentists, lawyers, medical doctors) may elect to exclude the value of their WIP in computing their income. This election effectively allows income to be recognized when the work is billed (billed-basis accounting). Billed-basis accounting enables taxpayers to defer tax by permitting the costs associated with WIP to be deducted in advance without the matching inclusion of the associated revenues.

The Budget proposes to eliminate the ability for designated professionals to elect to use billed-basis accounting. This measure will apply to taxation years that begin on or after Budget Day, however a transitional period is proposed to mitigate the impact to affected taxpayers.

Meaning of Factual Control

The income tax law recognizes two forms of control of a corporation: *de jure* (legal) control and *de facto* (factual) control. Legal control of a corporation generally entails the right to elect the majority of the board of directors of the corporation. Factual control of a corporation exists where a person has other factors of influence that, if exercised, would result in control in fact of the corporation. A person may have factual control of a corporation even though the person does not have legal control of the corporation. In every situation, consideration of all the relevant factors is required in determining whether there is factual control of a corporation.

The concept of factual control is broader than legal control and these factual control tests are generally used to ensure that certain corporate tax preferences are not accessed inappropriately. One of these such preferential tax measures commonly accessed by small business corporations is the small business deduction – an annual benefit of reduced federal corporate income tax on the first $500,000 of qualifying active business income. The $500,000 income threshold is an amount that is to be shared amongst 'associated' corporations and the factual control tests are used in determining what entities are associated corporations. The 2016 federal budget introduced a number of measures to ensure that inappropriately accessing or multiplying the benefit of the small business deduction is not achieved.

A recent court decision has restricted the scope of application of factors to consider in making a determination of factual control of a corporation. Consistent with measures introduced in the 2016 federal budget, and to prevent taxpayers from inappropriately accessing certain tax benefits, the Budget proposes that the tax legislation be amended to clarify that the factors considered in determining factual control are not limited to the narrower requirements of this decision.

This measure will apply in respect of taxation years that begin on or after Budget Day.

Other notable measures

Flow-Through Share Investments

Currently certain eligible small oil and gas corporations can reclassify up to $1 million of Canadian development expenses (CDE) as Canadian exploration expenses (CEE) when renounced to flow-through share investors under a flow-through share agreement. CDE is deductible at a rate of 30 per-cent on a declining basis whereas CEE is fully deductible in the year it is incurred. The Budget proposes to remove this tax preference and no longer permit eligible small oil and gas corporations to reclassify the first $1 million of CDE as immediately deductible CEE. This is intended to help ensure that these development expenses, which create an asset of enduring value, are deducted gradually over time.

Furthermore, additional tax incentives may also be available to investors of flow-through entities. In particular, the mineral exploration tax credit provides an additional income tax benefit for individuals who invest in mining flow-through shares. This credit is equal to 15-per-cent of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors. The government proposes to extend eligibility for the mineral exploration tax credit for an additional year, to flow-through share agreements entered into on or before March 31, 2018.

Derivatives – Timing of Recognition of Gains and Losses

Derivatives are sophisticated financial instruments whose value is derived from the value of an underlying interest. The budget proposes two measures to clarify the timing of recognition of income gains and losses on derivatives, including an elective 'mark-to-market'

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method and the introduction of a "stop-loss" anti-avoidance rule for "straddle" transactions which will effectively defer the realization of an accrued loss on the disposition of a position to the extent of any unrealized gain on an offsetting position.

Charitable Giving

There were limited measures in the Budget impacting charitable giving, the most notable of which involves the ecological gifts program as outlined below.

Ecological Gifts

The Budget proposes several measures intended to better protect gifts of ecologically sensitive land, which are eligible for significant tax incentives such as a tax exemption for capital gains realized on the donation of qualifying property. Most notably, in light of the potential conflicts of interest that can arise involving a donation of ecologically sensitive land to a private foundation, the Budget proposes that private foundations no longer be permitted to receive these ecogifts, effective for transactions occurring on or after Budget Day.

Future Tax Measures

Tax Planning Using Private Companies

As noted previously, the government is undertaking a review of federal tax expenditures to close perceived tax loopholes and improve the integrity and administration of the tax system. Many of the above proposals from the Budget are consistent with the government's intention to improve the efficiency, certainty and fairness of the tax system.

In addition, this review of federal tax expenditures highlighted a number of issues regarding tax planning strategies involving private corporations, which can result in high income individuals gaining perceived tax advantages through a variety of tax reduction strategies available to these individuals that are not available to other Canadians. Strategies involving private corporations specifically identified by the government include:

- *Sprinkling income,* which can reduce income taxes by causing income (such as dividends and capital gains) that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates (or who may not be taxable at all).
- *Holding passive investment portfolios,* which may be financially advantageous for owners of private corporations compared to otherwise similar investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate accumulation of earnings that can be invested in a passive portfolio.
- *Converting regular income into capital gains*, which can reduce income taxes by taking advantage of the lower tax rates on capital gains relative to regular income.

A number of measures have been put in place over the years to limit the scope of some of these planning arrangements, but such measures have not always been considered fully effective. The government is therefore further reviewing the use of tax planning strategies involving private corporations that are seen as inappropriately reducing personal taxes of high-income earners. The government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.

In addition to the review of tax planning involving private companies, the government also reaffirmed its commitment to move forward as required with technical amendments with a view to improving the certainty of the tax system.

Tax Integrity Measures

The Budget also indicated that the government will continue to increase support to the Canada Revenue Agency in its efforts to crack down on tax evasion and combat tax avoidance domestically and internationally, by:

- Increasing verification activities;
- Hiring additional auditors and specialists with a focus on the underground economy;
- Developing robust business intelligence infrastructure and risk assessment systems to target high-risk international tax and abusive tax avoidance cases; and
- Improving the quality of investigative work that targets criminal tax evaders.

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The **2017 Federal Budget Review** was developed by our in-house experts in the Enterprise Wealth Planning Group at BMO Wealth Management: **John Waters**, Vice-President, Director of Tax Consulting Services and **Dante Rossi**, Director, Tax Planning. For more insights, visit bmo.com/wealthexchange

If you have any questions regarding these budget proposals, please consult with your tax advisor for further details.

This document is a summary of the Federal Budget and does not represent BMO Financial Group's view on the tax policies expressed in the Federal Budget.

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