2016 Federal Budget Review

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.

On March 22, Finance Minister Bill Morneau unveiled the new Liberal government's first Federal Budget entitled "Growing the Middle Class" which continues with many of the themes outlined in the Liberal election platform and the income tax measures introduced last December. The Budget anticipates a deficit of $5.4 billion for fiscal 2015-16 and forecasts a deficit of $29.4 billion for 2016-17.

The stated priorities of the Budget include help for the middle class, growth for the middle class – including investments in infrastructure and innovation – a better future for Indigenous peoples, a clean growth economy and an inclusive and fair Canada. Many of the Budget's tax initiatives are aimed at enhancing the integrity of the tax system, both domestically – by eliminating what the government describes as poorly targeted tax breaks and closing perceived loopholes – and internationally, through strengthening transfer-pricing documentation and addressing abusive use of tax treaties.

From a personal tax perspective, which is the focus of this review, as expected the government has formally introduced the new tax-free Canada Child Benefit, retained Old Age Security at age 65, and phases out several tax credits. Notably, the Budget does not change the capital gains inclusion rate or impact the taxation of stock options (which was suggested in the Liberal election tax platform), however, significant changes to the taxation of mutual fund corporation 'switch funds' and 'linked notes' are proposed.

From a charitable perspective, no income tax changes were proposed although the government indicated that it does not intend to proceed with the exemption from capital gains tax for donations involving the proceeds on disposition of private company shares and real estate which was proposed for 2017 in the previous Conservative government's budget last year. Notable proposals affecting Canadian small businesses include the conversion of the eligible capital property system into a new class of depreciable property (first announced in the 2014 Federal Budget), as well as legislative amendments to prevent the access and/or multiplication of the $500,000 small business deduction using certain complex partnership or corporate structures and closing perceived 'loopholes' which allowed private companies using life insurance policies to access certain unintended tax-free distributions.

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

Old Age Security (OAS)

As noted in the Liberal election platform and announced by the Prime Minister last week, the Budget formally outlines the government's intention to restore the eligibility of the Old Age Security program to age 65. The previous Conservative government had proposed to increase the age of eligibility for Old Age Security and Guaranteed Income Supplement benefits from 65 to 67 and Allowance benefits from 60 to 62 over the 2023 to 2029 period.

Canada Child Benefit (CCB)

To simplify and consolidate existing child benefits, the Budget proposes to replace the Canada Child Tax Benefit (CCTB) and Universal Child Care Benefit (UCCB) with a new Canada Child Benefit (CCB). The CCB will be a consolidated tax-free payment every month which will be targeted to low and middle-income families, whereas higher income families (generally over $150,000) will receive lower benefits than under the current system. Specifically, the CCB will provide a maximum annual benefit of $6,400 per child under the age of 6 and $5,400 per child aged 6 through 17. On the portion of adjusted family net income above $30,000 the benefit will be phased out with any remaining benefits further phased out where adjusted family net income exceeds $65,000. The UCCB and CCTB will be eliminated for months after June 2016 with the new CCB payments beginning thereafter.

Family Tax Cut

A non-refundable income splitting tax credit (aka the "Family Tax Cut") was introduced by the former Conservative government in 2014 for couples with at least one child under the age of 18. The credit allows a higher-income spouse or common-law partner to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner for the purpose of reducing the couple's total income tax liability to a maximum of $2,000. As expected, the Federal Budget introduces legislative amendments to formally repeal this tax credit for the 2016 and subsequent taxation years.

Education and Textbook Tax Credits

Currently, the education tax credit provides a 15 percent non-refundable tax credit of $400 per month of full-time enrolment in a qualifying educational program (and $120 per month of part-time enrolment) at a designated educational institution. In addition, the textbook tax credit provides a 15 percent non-refundable tax credit of $65 per month of full-time enrolment in a qualifying educational program (and $20 per month of part-time enrolment) at a designated educational institution.

The Federal Budget proposes to eliminate both of these credits effective January 1, 2017. Unused education and textbook credit amounts carried forward from years prior to 2017 will remain eligible to be claimed for 2017 and subsequent years.

Notably, these proposed measures do not eliminate the tuition tax credit which provides a 15 percent non-refundable tax credit on eligible fees for tuition and eligible examination fees paid to certain educational institutions.

Children's Fitness and Arts Tax Credits

The children's fitness tax credit provides a 15 percent refundable tax credit on up to $1,000 of eligible fitness expenses for children under 16 years of age at the beginning of the taxation year. Similarly, the children's arts tax credit provides a 15 percent non-refundable tax credit on up to $500 in eligible fees for programs of artistic, cultural, recreational and developmental activity for children under 16 years of age. For both credits, supplemental amounts are available and the age limit is extended to 18 for children eligible for the disability tax credit.

The Federal Budget proposes to phase out the children's fitness and arts tax credits by reducing the 2016 maximum eligible amounts to $500 from $1,000 for the children's fitness tax credit (which will remain refundable for 2016) and to $250 from $500 for the children's arts tax credit. The supplemental amounts for children eligible for the disability tax credit will remain at $500 for 2016. It is intended that both credits will be eliminated for the 2017 and subsequent taxation years.

School Supply Tax Credit

To recognize that many teachers and early childhood educators often incur (at their own expense) the cost of supplies for the purpose of teaching or otherwise enhancing students' learning in the classroom or learning environment, the Federal Budget proposes to introduce a teacher and early childhood educator school supply tax credit. This proposed tax credit will allow an employee who is an eligible educator to claim a 15 percent refundable income tax credit based on an amount of up to $1,000 in expenditures made by the employee in a taxation year for eligible supplies (such as games, puzzles, art supplies and various stationery items) acquired on or after January 1, 2016.

Mutual Fund 'Switches'

Canadian mutual funds can be set up either in the form of a trust or as a corporation. While most mutual funds are structured as trusts, some of those structured as mutual fund corporations are organized as "switch funds" where each fund is structured as a separate class of shares within the mutual fund corporation. Investors are able to exchange shares of one class of the mutual fund corporation for shares of another class in order to switch their economic exposure between the mutual fund corporation's different funds. By virtue of a general provision in the current tax legislation that applies to convertible corporate securities, this exchange is deemed not to be a taxable disposition. However, this deferral benefit that is available to taxable investors in switch funds is not available to taxpayers investing in mutual fund trusts or investing on their own account directly in securities.

Therefore, as a means of ensuring the appropriate recognition of capital gains, the Budget proposes to amend the tax legislation so that an exchange of shares of a mutual fund corporation that results in the investor switching between funds will be considered for tax purposes to be a disposition at fair market value. However, this proposed measure will not apply to switches where the shares received in exchange differ only in respect of management fees (or expenses to be borne by investors) and otherwise derive their value from the same portfolio or fund within the mutual fund corporation (e.g., the switch is between different series of shares within the same class). This measure will apply to dispositions of shares that occur after September 2016.

Sales of 'Linked Notes'

A "linked note" is a debt obligation the return on which is linked in some manner to the performance of one or more reference assets or indexes over the term of the obligation. Common examples include principal-protected notes and principal at-risk notes. Under

a principal-protected note, the amount payable to the investor at maturity is equal to the principal amount invested plus a return, if any, wholly or partially linked to the performance of the reference asset or index. Under a principal-at-risk note, there is a risk, depending on the performance of the reference asset or index, that the amount payable to the investor at maturity may be less than the principal amount invested.

The Income Tax Act contains rules that deem interest to accrue on a prescribed debt obligation (including a typical linked note), which requires an investor to accrue the maximum amount of interest that could be payable on the note for a given taxation year. Investors generally take the position that there is no deemed accrual of interest on a linked note prior to the maximum amount of interest becoming determinable. Instead, the full amount of the return on the note is typically included in the investor's income in the taxation year when it becomes determinable, which is generally shortly before maturity. However, some investors, who hold their linked notes as capital property, sell them on a secondary market prior to the determination date as a means of converting the return on the notes from ordinary income to capital gains, only 50 percent of which is included in their income.

The 2016 Federal Budget proposes to amend the Income Tax Act so that the return on a linked note retains the same character whether it is earned at maturity or reflected in a secondary market sale. Specifically, a deeming rule will apply for the purposes of the rule relating to accrued interest on sales of debt obligations. This deeming rule will treat any gain realized on the sale of a linked note as interest that accrued on the debt obligation for a period commencing before the time of the sale and ending at that time. An exception will also be provided where a portion of the return on a linked note is based on a fixed rate of interest. In that case, any portion of the gain that is reasonably attributable to market interest rate fluctuations will be excluded. This measure will apply to sales of linked notes that occur after September 2016.

Other investment-related tax proposals

The Federal Budget will:

- extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2017. This credit provides an additional income tax benefit equal to 15 percent of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.
- support provinces that use a labour-sponsored venture capital corporation (LSVCC) – which facilitates access to venture capital for small and medium-sized businesses – by restoring the federal LSVCC tax credit to 15 percent for share purchases of provincially registered LSVCCs prescribed under the Income Tax Act for the 2016 and subsequent taxation years.

Finally, in addition to previously announced changes, the Federal Budget proposes further consequential amendments to reflect the new top 2016 federal marginal income tax rate for individuals including:

- legislative changes that will provide a 33 percent charitable donation tax credit (on donations above $200) to trusts that are subject to the 33 percent rate on all of their taxable income, and
- a 5 percent increase to 33 percent to the tax rate on personal services business income earned by corporations.

Canadian Private Business Tax Measures

Small Business Tax Rate

Small businesses benefit from a reduced federal corporate income tax rate of 10.5 percent – a preference relative to the general federal corporate income tax rate of 15 percent. Specifically, the small business deduction reduces to 10.5 percent the federal corporate income tax rate applying to the first $500,000 per year of qualifying active business income of a Canadian-controlled private corporation (CCPC). In last year's Federal Budget, the former Conservative government implemented changes to gradually reduce the small business tax rate from 11 percent in 2015 to 9 percent by 2019.

The 2016 Federal Budget proposes to eliminate the phased-in reduction of the small business tax rate such that the rate remains at 10.5 percent for 2016 and subsequent years.

The $500,000 small business deduction limit is shared among associated companies and is clawed back when the associated group of companies has taxable capital in excess of $10 million and completely eliminated with taxable capital in excess of $15 million. It should be noted that each province sets its own small business income tax rates and threshold limits.

The dividend tax credit (DTC) within the personal income tax system is a mechanism used in order to maintain appropriate integration in our tax system, i.e., to ensure that income earned by a corporation and paid out to an individual as a dividend will be subject to the same amount of tax as income earned directly by the individual. As a consequential result of maintaining the small business tax rate at 10.5 percent, the Budget also proposes to maintain the current gross-up factor and DTC rate applicable to non-eligible dividends (generally, dividends distributed from corporate income taxed at the small business tax rate).

Continued

Multiplication of the Small Business Deduction

The small business deduction (SBD), as defined above, includes rules that are intended to preclude the inappropriate multiplication of access to the deduction. The 2016 Federal Budget proposes changes to expand these rules to address concerns about certain partnership and corporate structures that multiply access to the small business deduction.

Currently, income tax rules provide that the small business deduction for a CCPC that is a member of a partnership can claim in respect of its income from the partnership 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 (commonly known as its specified partnership income limit, or "SPI limit"). Note this SPI limit is not applicable to individuals who are members of a partnership. These "specified partnership income" rules effectively eliminate the multiplication of the SBD where a CCPC is a member of a partnership.

Some taxpayers have implemented structures to circumvent the application of these rules through the use of alternative corporate and partnership structures. In a typical structure, a shareholder of a CCPC is a member of a partnership (i.e., the CCPC itself is not a member of the partnership) and the partnership pays the CCPC as an independent contractor under a contract for services. As a result, the CCPC claims a full small business deduction in respect of its active business income earned from the partnership (without regard to a SPI limit) because, although the shareholder of the CCPC is a member of the partnership, the CCPC is not itself a member. These partnership and CCPC structures are commonly found in the legal and accountancy professions where the practitioner is a direct member of a partnership (with other arm's length practitioners) and is a shareholder of his/her own professional corporation which provides contract services to the partnership. In such structures, because each practitioner's professional corporation is not a direct member of the partnership each practitioner's corporation has access to its own $500,000 small business limit without regard to the determination of its specified partnership income.

To address the government's concerns with this tax planning, the 2016 Federal Budget proposes to extend the specified partnership income rules to a CCPC which is not a member of the partnership. Specifically, the proposed rules will deem a CCPC to be a member of a partnership, at any time during the year where:

1. it is not otherwise a member of the partnership;
2. it provides services or property to the partnership at any time in the year taxation year;
3. a member of the partnership does not deal at arm's length with the CCPC, or a shareholder of the CCPC, in the tax year (for example the shareholder of the CCPC is a member of the partnership); and
4. it is not the case that all or substantially all of the CCPC's active business income for the tax year is from providing services or property to arm's length persons other than the partnership.

As noted, if all above criteria are met, the CCPC which is not a member of the partnership, will be deemed to be a member of the partnership and as a result will be subject to the same restrictions as if it were a member, which will effectively restrict the ability to multiply access to the SBD.

The Budget also introduces comparable restrictions on similar structures using corporations (vs. partnerships) to multiply access to the SBD.

These measures will apply to taxation years that begin on or after the budget date, March 22, 2016.

Avoidance of the Business Limit and the Taxable Capital Limit

As previously noted, the small business deduction limit ($500,000) is shared among associated companies and is clawed back when the associated group of companies has taxable capital in excess of $10 million and completely eliminated with taxable capital in excess of $15 million. There are a number of technical rules that apply for the purpose of determining if two or more corporations are associated with each other. However, a corporation that is wholly owned by an individual is generally not associated with a corporation that is wholly owned by the individual's spouse or another related individual.

There is a special rule, under which two corporations that would not otherwise be associated will be treated as associated if each of the corporations is associated with the same third corporation. Since the $15 million taxable capital limit is based on the capital of associated corporations, none of the corporations is eligible to claim the small business deduction if the total taxable capital of the three corporations exceeds $15 million.

There is an exception to this special rule: two corporations that are associated because they are associated with the same third corporation will not be treated as being associated with each other if the third corporation is not a CCPC or, if it is a CCPC, it elects not to be associated with the other two corporations for the purpose of determining entitlement to the SBD. The effect of this exception is that the third corporation cannot itself claim a SBD (if it is a CCPC),

but the other two corporations may each claim a $500,000 small business deduction subject to their own taxable capital limit. In addition, where such an exception exists to disassociate the two corporations which otherwise wouldn't be associated if not for the third corporation; where the other two corporations earn active business income, their SBD limits are determined without regard to the taxable capital of the third corporation to which they are each associated. As such, where this exception applies, the Budget proposes to ensure that the third corporation will continue to be associated with each of the other two corporations for the purposes of applying the $15 million taxable capital limit.

It is important to note that this special exception discussed above does not currently affect associated corporation status for the purpose of another rule that treats a CCPC's investment income (e.g., interest and rental income) as active business eligible for the SBD if that income is derived from the active business of an associated corporation. Accordingly, two corporations may not be associated for the purpose of claiming the maximum small business deduction while retaining the ability to treat investment income that one receives from the other as active business income. However, the Budget proposes to amend the income tax rules to ensure that investment income derived from an associated corporation's active business will be ineligible for the SBD and be taxed at the general corporate income tax rate where the above exception to the deemed associated corporation rules applies (i.e., an election not to be associated is made where two CCPCs would otherwise be associated because of a third corporation).

These measures will apply to taxation years that begin on or after the budget date, March 22, 2016.

Treatment of Life Insurance Policies

Where a policyholder disposes of an interest in a life insurance policy to an arm's length person, the fair market value (FMV) of any consideration is included in computing the proceeds of the disposition. In contrast, where a policyholder disposes of such an interest to a non-arm's length person, a special rule (the "policy transfer rule") deems the policyholder's proceeds of the disposition, and the acquiring person's cost, of the interest to be the amount that the policyholder would be entitled to receive if the policy were surrendered (the "interest's surrender value") at that time.

Where the policy transfer rule applies, the amount by which any consideration given for the interest, typically an amount equal to the FMV, exceeds the interest's surrender value is not taxed as income under the rules that apply to dispositions of interests in life insurance policies. As such, in situations where a personal life insurance policy of the shareholder of a private corporation is transferred to that private corporation, the excess amount can be extracted from the corporation tax-free. In addition, this excess will ultimately be reflected in the policy benefit under that policy. Where the policy benefit is received by a private corporation (typically the death benefit), the FMV of the policy less the policy's adjusted cost base (ACB) is credited to the private corporations capital dividend account (CDA). The CDA balance can be paid tax-free to that corporation's shareholders. Where this is the case and consideration to acquire the interest was not recognized under the policy transfer rule, the amount of the excess is effectively extracted from the private corporation a second time as a tax-free, rather than as a taxable, amount.

Budget 2016 proposes amendments to the Income Tax Act to ensure that amounts are not inappropriately received tax-free by a policyholder as a result of a disposition of an interest in a life insurance policy. The measure will, in applying the policy transfer rule, include the FMV of any consideration given for an interest in a life insurance policy in the policyholder's proceeds of the disposition and the acquiring person's cost.

This measure will apply to dispositions that occur on or after the budget date, March 22, 2016.

Furthermore, the Budget proposes to amend the CDA rules for previous transactions prior to the budget date involving life insurance transfers under the policy transfer rules. This amendment will apply where an interest in a life insurance policy was disposed of before the budget date for consideration in excess of the proceeds of the disposition determined under the policy transfer rule. In this case, the amount of the policy benefit otherwise permitted to be added to a corporation's CDA account will be reduced by the amount of the excess. The reduction to the CDA balance thereby effectively limits the amount that can be withdrawn tax-free from the corporation upon the death of the insured.

The government is similarly concerned with other scenarios where taxpayers have structured their affairs to artificially increase a corporation's CDA balance. Although they are challenging the structures under existing tax rules, the Budget proposes additional rules to ensure that the CDA rules apply as intended. In this regard, new measures will also introduce information-reporting requirements that will apply where a corporation is not a policyholder but is entitled to receive a policy benefit.

These rules will apply to policy benefits received as a result of a death that occurs on or after Budget date, March 22, 2016.

Continued

Eligible Capital Property

Eligible capital property (ECP) for income tax purposes includes intangible property such as goodwill and licences, franchises and quotas of indeterminate duration, as well as certain other rights.

As originally announced in the 2014 Federal Budget, the government has been considering the conversion of ECP into a new class of depreciable property to simplify the tax compliance burden for affected taxpayers. Following its review of the stakeholders' responses to the policy underlying the 2014 Budget proposal, the 2016 Federal Budget confirms the new government's intention to repeal the ECP regime, replace it with a new capital cost allowance (CCA) class available and provide rules to transfer taxpayers' existing cumulative eligible capital (CEC) pools to the new CCA class. As part of this change, the Budget also proposes to allow small balances of ECP carried over to the new CCA class to be deducted more quickly, and to allow up to $3,000 in incorporation costs to be deducted as a current expense.

This measure, including the transitional rules, will apply as of January 1, 2017.

Charitable Giving

Although no specific income tax measures were proposed in the Budget, the Liberal government took the opportunity to announce that it does not intend to proceed with the measure proposed in last year's Federal Budget that would have provided an exemption from capital gains tax for certain dispositions (after 2016) of private corporation shares or real estate where cash proceeds from the disposition are donated to a registered charity or other qualified donee within 30 days.

Future Tax Measures

Notwithstanding the above, the government also announced that it intends to proceed with a number of tax measures that were originally proposed in previous budgets, many of which would close tax loopholes and improve the integrity and administration of the tax system. In addition, the Budget affirms the government's commitment to improve the efficiency, certainty and fairness of the tax system. In particular, in the coming year the government expressed its intention to undertake a review of the tax system to determine whether it works well, with a view to eliminating poorly targeted and inefficient tax measures.

The **2016 Federal Budget Review** was developed by our in-house experts in the Enterprise Wealth Planning Group: **John Waters**, Vice-President, Head of Tax & Estate Planning and **Dante Rossi**, Senior Manager, Tax and Estate Planning. For more articles visit **bmowealthexchange.com**

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

We're here to help.™

BMO Wealth Management ("we") is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing wealth management products and services. This document has been prepared for use by the following BMO Wealth Management member companies: BMO Private Investment Counsel Inc., BMO Trust Co., *BMO Nesbitt Burns Inc., *BMO InvestorLine Inc., and BMO Investments Inc.

These comments are general in nature, provided for information purposes only, and do not constitute legal, investment, trust, estate, accounting or tax advice. Technical content in this report is provided for the general guidance, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. It is your responsibility to consult with the appropriate professionals in those areas regarding your specific circumstances.

Unless otherwise qualified, any opinions, estimates and projections in this report are those of the author(s) as of its publication date, are subject to change without notice, and may not reflect those of BMO Wealth Management. This report may not reflect all available information.

Neither BMO Wealth Management nor the author or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities.

™ / ® Trade-marks of Bank of Montreal, used under license.

*Members-Canadian Investor Protection Fund.