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2017 FEDERAL BUDGET COMMENTARY

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The Federal Government's 2017–18 Budget gives Canadians a taste of what they might expect over the next couple of years: attempted efficiencies, closed tax loopholes, steady deficits, and a touch of caution. Budget 2017-18 outlines only $200 million in net new spending, but also an increase to the deficit of more than $5 billion for 2017–18, partly due to commitments from the previous budget, reduced revenues and increased general expenses.

The projected deficit for 2017–18 is $28.5 billion, declining to $18.8 billion by 2021–22 (including an annual $3 billion contingency fund). However, if the government's strong growth scenario plays out, we could see a much smaller deficit between $5 and $8 billion by 2021. Instead of planning to eliminate the deficit as previously proposed, the government says it will maintain a balanced net debt-to-GDP ratio of around 31 per cent over the next five years.

In order to advance the twin goals of reducing tax evasion and improving compliance, the government plans to give the Canada Revenue Agency an additional $523.9 million over the next five years. The government anticipates a five-fold return on its investment, hoping the CRA will recover an incremental $2.5 billion for its efforts. We can expect to see more substantial proposals for change as the year progresses. The government has clearly signaled that it will be looking for additional ways to prevent tax avoidance.

BUSINESS INCOME TAX MEASURES

The Budget makes no changes to corporate income tax rates. In addition, no changes were made to the eligibility for the small business tax rate.

Tax Planning Using Private Corporations

The government's review of federal tax expenditures highlighted issues in respect of tax planning strategies available to owners of private corporations. The government feels that these strategies can result in high-income individuals gaining unfair tax advantages which are not available to other Canadians. As the Budget papers indicate, measures have been put in place over the years to limit the scope of certain of these arrangements. The government, however, is of the opinion that such measures have not always been as effective as desired. Accordingly, the government is further reviewing the use of private corporation tax planning strategies that may reduce the personal taxation of high-income earners in a manner considered inappropriate.

In particular, the government has identified the following strategies for review:

- Income splitting — causing income that would be taxable to an individual at a high rate to be realized by, and therefore taxed in the hands of, a family member

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subject to a lower marginal tax rate, commonly achieved through dividends or capital gains.

- Holding of portfolio investments — corporate tax rates on ordinary business income are generally much lower than personal rates; retaining income in a private corporation can therefore facilitate accumulation of a larger pool of funds for investment.
- Conversion of regular income into capital gains — causing income that would normally be paid to the shareholder as salary or dividend to be converted to capital gains, taxed at a significantly lower tax rate.

As part of its review of this area, the government will also examine current legislation that may have inappropriate tax consequences in connection with genuine business transactions between family members, including inter-generational transfers of family businesses. In the coming months, a paper will be released which will review these issues in detail and provide proposed policy responses.

Billed-Basis Accounting

Members of designated professions (accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of their work in progress (WIP) in computing their income. Where this election is made, a tax deferral is achieved as the costs associated with the WIP are deducted as incurred, whereas the revenue is recognized only when the WIP is actually billed to clients.

The Budget proposes to eliminate the WIP exclusion over a two-year period, effective for taxation years beginning after March 21, 2017. For the first affected taxation year, WIP will be valued at 50 per cent of the lesser of its cost and fair market value. For subsequent years, WIP will be valued at the lesser of its cost and fair market value.

Meaning of Factual Control

There are two main definitions of control for tax purposes — de jure or legal control and de facto or factual control. Some provisions rely on de jure control, whereas others rely on de facto control.

De facto control is broader than legal control and takes into account influence, which if exercised, would result in control in fact of a corporation. It is particularly relevant for purposes of determining whether or not corporations are associated, and therefore, are required to share the annual $500,000 small business deduction limit.

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Recent jurisprudence essentially restricted control in fact to circumstances where the potential controller has an enforceable right to influence the board of directors, or where the controller can exercise influence over shareholders who have the right and ability to make changes to the board.

The Budget proposes to effectively overturn the effect of the recent jurisprudence. For taxation years beginning after March 21, 2017, all factors relevant in the particular situation, not just those which meet the criteria set out in the recent jurisprudence, shall be considered in assessing whether or not de facto control is present.

Distribution of T4 Information Slips

Effective for 2017, employers will not be required to obtain express consent from employees to electronically distribute T4s (Statement of Remuneration Paid). Privacy policy safeguards specified by the Minister of National Revenue will be required to be in place before an employer can electronically distribute T4s without employee consent.

Timing of Recognition of Gains and Losses on Derivatives

Derivatives are sophisticated financial instruments whose value is derived from the value of an underlying interest. The Budget proposes two measures that clarify the timing of the recognition of gains and losses from derivatives held on income account.

In the past, there was uncertainty as to whether taxpayers could mark to market their derivatives held on income account under the general principles of profit computation. A recent Federal Court of Appeal decision allowed the use of the mark-to-market method for a taxpayer which was not a financial institution, on the basis that it provided an accurate picture of the taxpayer's income.

To provide certainty regarding the choice of using the mark-to-market method, the Budget proposes an elective mark-to-market regime for derivatives held on income account, so that taxpayers will be allowed to mark to market all of their eligible derivatives for taxation years beginning after March 21, 2017. Once made, the election will remain effective for all subsequent years, unless revoked with the consent of the Minister of National Revenue.

A straddle transaction is one in which a taxpayer concurrently enters into two or more positions, often derivative positions, that are expected to generate equal and offsetting gains and losses on account of income. In order to obtain a tax deferral, the position with the accrued loss would be disposed of in an earlier taxation year than the position with the accrued gain. In addition, the taxpayer could attempt to indefinitely defer the recognition of the gain by entering into successive straddle transactions.

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The Budget proposes to introduce a specific anti-avoidance "stop-loss" rule, which will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain inherent in an offsetting position. This proposal will apply to any loss realized on a position entered into after March 21, 2017.

Mutual Fund Mergers

Mutual funds can be structured as either corporations or trusts. The Income Tax Act (ITA) currently contains provisions that facilitate the merger of mutual funds on a tax-deferred basis. Two mutual fund trusts can be merged into one, or a mutual fund corporation can be merged into a mutual fund trust. The current rules, however, do not provide for the reorganization of a mutual fund corporation, particularly one with multiple classes of shares, into multiple mutual fund trusts.

The Budget proposes to allow the tax-deferred restructuring of a mutual fund corporation into multiple mutual fund trusts. This measure will be applicable to qualifying reorganizations occurring on or after March 22, 2017.

Clean Energy Generation Equipment

Capital cost allowance (CCA) classes 43.1 and 43.2 provide for accelerated CCA on clean energy generation equipment. The Budget expands the assets qualifying for these classes to include geothermal energy equipment used primarily for the purpose of generating heat or a combination of heat and electricity and certain equipment in district energy systems that use geothermal heating as an energy source.

Canadian renewable and conservation expenses may be deducted in the year incurred, carried forward indefinitely for use in future years or transferred to investors through a flow-through share mechanism. The Budget proposes to include in this category, expenses incurred to determine the quality and extent of geothermal resources and the cost of geothermal drilling for electricity and heating projects.

The measures are applicable for new property acquired for use and expenses incurred after March 21, 2017.

Resource Measures

Expenditures in respect of drilling or completing a discovery well, including building access roads to or preparing the site for such wells, are currently classified as Canadian exploration expense (CEE), which is fully deductible in the year incurred. The Budget proposes to classify these expenditures as Canadian development expense (CDE), which is deductible on a 30 per cent declining-balance basis.

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This measure will apply to expenses incurred after 2018, including those incurred in 2019 that could have been deemed incurred in 2018 under the "look-back" rule. Expenses incurred before 2021, pursuant to a written commitment to incur the expenses entered into before March 22, 2017, will still qualify as CEE.

Eligible small oil and gas corporations will no longer be able to treat their first $1 million of CDE as CEE. This measure will apply to expenses incurred after 2018, including those incurred in 2019 that could have been deemed incurred in 2018 under the "look-back" rule. Expenses incurred after 2018 and before April 2019 that are renounced to investors under a flow-through share agreement entered into after 2016 and before March 22, 2017, will be exempt from the new rules.

Child Care Space Investment Tax Credit

The Budget eliminates the investment tax credit for child care space expenditures incurred after March 21, 2017. Expenditures incurred before 2020 pursuant to written agreements entered into before March 22, 2017 will still be eligible for the investment tax credit.

PERSONAL INCOME TAX MEASURES

Personal income tax rates will not change under the Budget.

The Budget did not propose changes that were the subject of heavy speculation. In particular, the capital gains inclusion rate will not increase, and therefore, remains at 50 per cent. Furthermore, a dollar limit is not imposed on the employee stock option deduction, and therefore it will continue to be calculated as half the stock option benefit amount.

Tuition Tax Credit

The Tuition Tax Credit can currently be claimed with respect to occupational skills courses taken at a non-post-secondary institution, but it cannot be claimed for similar non-post-secondary level courses taken at a college or university.

Effective January 1, 2017, the Budget proposes to allow the Tuition Tax Credit to be claimed in the latter instance, and further, to allow the scholarship exemption for bursaries related to such courses, provided that all other conditions for the exemption are met.

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Simplifying the Caregiver Tax Credit System

The existing Caregiver Credit, Infirm Dependent Credit and Family Caregiver Tax Credit each have different eligibility rules. The Budget proposes to simplify these existing credits by replacing them with a single new, non-refundable tax credit for 2017 and subsequent taxation years, namely the Canada Caregiver Credit.

The new credit is available for each person who, at any time in the year, is dependent on the taxpayer because of mental or physical infirmity, *and* either is a spouse or a common-law partner of the taxpayer, or has reached the age of 18 and is a dependent of the taxpayer. The persons who qualify as a dependent will not change from the current regime.

The dependent will not be required to live with the taxpayer in order for the taxpayer to be eligible for the new credit. The new credit, however, will not be available in respect of non-infirm seniors who reside with their adult children.

Subject to indexing, the maximum amount of the credit is $6,883 (reduced dollar-for-dollar by the amount by which the dependent's income exceeds $16,163). This amount is stated to be generally consistent with the amounts that could have been claimed under the current regime. In addition, the proposals may extend the credit to some caregivers who may not have been eligible under the current regime, because of the income level of dependent.

Disability Tax Credit — Certification by Nurse Practitioners

The Budget proposes to allow nurse practitioners to certify impairments for purposes of the Disability Tax Credit. This measure will be effective for certifications made after March 21, 2017.

Medical Expense Tax Credit — Fertility-Related Expenses

For the 2017 taxation year and beyond, the Budget proposes to clarify the types of fertility-related expenses that are eligible for the Medical Expense Tax Credit. In particular, persons who require medical intervention to conceive, even if not infertile, will explicitly be allowed to claim the credit for expenses that would generally be eligible for someone who has an infertility condition.

Mineral Exploration Tax Credit for Flow-Through Share Investors

Eligibility for the Mineral Exploration Tax Credit is proposed to be extended for one year under the Budget. The credit will apply to flow-through share agreements entered into on or before March 31, 2018.

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Elimination of the Public Transit Tax Credit and the Employee Home Relocation Loan Deduction

The public transit tax credit is proposed to be eliminated under the Budget for transit use after June 30, 2017. The employee home relocation loan deduction will be eliminated for taxable benefits realized by an employee on January 1, 2018 and beyond.

Anti-avoidance Rules for Registered Plans

The anti-avoidance rules that currently exist for RRSPs and TFSAs are proposed to be extended to RESPs and RDSPs under the Budget. These changes will apply to transactions occurring after March 22, 2017, with certain exceptions.

Allowances for Members of Legislative Assemblies and Certain Municipal Officers

The Budget proposes to include non-accountable allowances paid to certain officials in their income, beginning in the 2019 taxation year.

CHARITIES AND NON-PROFIT ORGANIZATIONS

Ecological Gifts Program

The Budget proposes the following measures to protect gifts of ecologically sensitive property made after March 21, 2017:

- The 50 per cent tax which applies where the use of ecologically sensitive land is changed, or the property is disposed of, without the consent of Environment and Climate Change Canada (ECCC), will be extended to situations where the land is transferred between organizations for consideration and the transferee changes the use of the property or disposes of it without the consent of ECCC.
- The requirement for ECCC to approve recipients of ecological gifts will be extended, on a gift-by-gift basis, to municipalities and municipal and public bodies performing a function of government.
- Private foundations are no longer permitted to receive ecological gifts.
- The donation of personal servitudes will qualify as ecological gifts, provided certain conditions are met (e.g., the servitude must run for at least 100 years).

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Gifts of Medicine

The additional corporate deduction for gifts of medicine from their inventory is eliminated for such gifts made after March 21, 2017.

First-Time Donor's Super Credit

The Budget confirms the expiration of the First-Time Donor's Super Credit after 2017.

SALES TAX, EXCISE TAX AND OTHER MEASURES

Taxi and Ride-Sharing Services

To ensure that the GST/HST applies consistently to taxi services and ride-sharing services, effective July 1, 2017, the definition of a taxi business will be amended to require providers of ride-sharing services to register for the GST/HST and charge sales tax on their fares, in the same manner as taxi operators.

Elimination of Non-Resident GST/HST Rebate for Tour Package Accommodations

The GST/HST rebate available to non-resident individuals and tour operators in respect of the accommodation portion of eligible tour packages will be repealed effective March 23, 2017, subject to a transitional exemption in respect of eligible tour packages supplied and paid for prior to January 1, 2018.

Tobacco and Alcohol Taxation

Effective March 23, 2017:

- Excise duties on alcohol products increase by 2%, with annual indexing of rates thereafter.
- Excise duties on cigarettes and other tobacco products increases.
- The 10.5% surtax on profits arising from the manufacture of tobacco or tobacco products is repealed.

We encourage you to discuss the contents of this Budget and how it impacts your tax situation with your Zeifmans advisor.