



## Budget 2016 - Out with the old - In with the new

### Introduction

On March 22, 2016, Finance Minister Bill Morneau tabled his first Federal Budget. After 10 years of Conservative Budgets, this one feels different. It may be a matter of style and tone but there are also substantive changes.

Many measures previously proposed by the Conservatives were not proceeded with. Of note here is the Budget 2015 proposal and related July 31, 2015 draft legislation providing an exemption from capital gains on the disposition of private company shares or real estate when cash proceeds of sale are gifted to charity. ([AAMOT Sept 2015](#) )

Other measures enacted by the Conservatives were eliminated or will be phased out over time. See the discussion below regarding several personal tax credits.

Of the measures that were introduced, some were known issues on the Department of Finance's list – it was a question of *when* not *if* the loopholes would be plugged. Transfers of life insurance into a corporation and capital dividend account maximization where a different corporation is named as a beneficiary under the policy are examples here. Some were a surprise – the elimination of the tax deferral on fund switches within a mutual fund corporation.

Some items are yet to come. Hinted at in the Liberal Party Platform and directly commented on in the Budget documents was the intention to do a “review of the tax system to be completed in the coming year” to address “the ability of high-net-worth individuals to use private corporations to inappropriately reduce or defer tax.”

The biggest tax change proposed by the new government is already in effect. In December 2015, effective January 1, 2016, it was announced that the second federal income tax bracket was to be reduced from 22 percent to 20 percent and a new 33 percent tax bracket would apply for taxable income in excess of \$200,000. With this also came a tax increase of 4 percent on investment income of a corporation and adjustments to dividend refund and refundable dividend tax on hand calculations.

By far the biggest pre-Budget speculation did not come true – no change to the capital gains inclusion rate nor the stock options deduction.

The following represents a summary of measures of interest to investment and insurance advisors.

## Personal Measures

### Top Marginal Income Tax Rate – Consequential Amendments

On December 7, 2015, the Government announced the introduction of a 33 percent top marginal tax rate on taxable income in excess of \$200,000 for the 2016 and subsequent taxation years. Budget 2016 proposes further consequential amendments to reflect the new top marginal income tax rate. These amendments include:

- 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 for donations after the 2015 taxation year.
- For 2016 and later taxation years, the new 33 percent top rate will apply to excess employee profit sharing plan contributions.
- Increase the tax rate from 28 percent to 33 percent on personal service business income earned by corporations effective January 1, 2016, and;
- The recovery tax rule for qualified disability trusts will be amended to refer to the new 33 percent top rate after the 2015 taxation year.

### Taxation of Switch Fund Shares Issued by Mutual Fund Corporations

Canadian mutual funds can be in the legal form of a trust or corporation. Many of these mutual fund corporations are organized as “switch funds” which offer different types of asset exposure in different funds with each fund structured as a separate class of shares of 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 different funds. Currently, this type of exchange is deemed not to be a disposition for income tax purposes. This deferral benefit is not available to taxpayers investing in mutual fund trusts or directly in securities.

To ensure the recognition of capital gains, Budget 2016 proposes amendments to the *Income Tax Act* (ITA) so that an exchange of shares of a mutual fund corporation that results in the investor switching between funds will be considered a disposition at fair market value for tax purposes. The 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.

This is only the latest measure to reduce the attractiveness of mutual fund corporations. If you recall Budget 2013 introduced the elimination of the use of forward transactions for income recharacterization purposes (i.e. converting ordinary income to capital gains only 50 percent of which are included in income). Now with the proposed elimination of the tax deferral advantage of fund switches, the future of mutual fund corporations is questionable.

### Sales of Linked Notes

A linked note is a debt obligation, the return on which is linked to the performance of reference assets or indexes such as a basket of stocks, a stock index, a commodity, a currency or units of a fund. While the ITA contains rules that deem interest to accrue annually, investors often take the position that the accrued return is not determinable and therefore not taxable until maturity. Furthermore, investors who hold their linked notes as capital property often sell them prior to the determination date to, in effect, convert the return on the linked notes from fully taxable income to a capital gain taxed at 50 percent.

Budget 2016 proposes that the return on a linked note will retain the same character whether earned at maturity or upon a sale before maturity. Specifically, a deeming rule will apply to treat the gain realized on the sale of a linked note as interest that accrued on the debt obligation at the time of the disposition. However, any gain or loss on the linked note due to foreign exchange fluctuations is excluded in determining the amount of accrued interest. Also, if a portion of the return on a linked note is based on a fixed rate of interest, any part of the of the gain that is related to market interest rate fluctuations will also be excluded from the accrued interest and treated as a capital gain.

This measure will apply to sales of linked notes that occur after September 2016.

### **Canada Child Benefit**

Effective July 1, 2016, the new Canada Child Benefit (CCB) program will replace the Universal Child Care Benefit (UCCB) and the Canada Child Tax Benefit (CCTB).

The Canada Child Benefit will provide a maximum benefit of \$6,400 per child under the age of 6 and \$5,400 per child aged 6 through 17. Budget 2016 proposes to continue to provide an additional amount of up to \$2,730 per child eligible for the disability tax credit. The CCB declines based on adjusted family income and the number of children per family.

The non-taxable benefits will be paid monthly to eligible families beginning in July 2016 for the July 2016 to June 2017 benefit year and will be based on adjusted family net income for the 2015 taxation year.

### **Income Splitting Credit**

Budget 2016 proposes to eliminate the income splitting tax credit (also known as the Family Tax Cut) for couples with at least one child under the age of 18 for the 2016 and subsequent taxation years.

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 by up to \$2,000.

Pension income splitting will not be affected by this change.

### **Children's Fitness and Arts Tax Credits**

Budget 2016 proposes to phase out the children's fitness and arts tax credits by 2017.

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. For 2016, the budget reduces the 2016 maximum eligible amount for the refundable credit to \$500 (from \$1,000)

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 2016, the Budget reduces the 2016 maximum eligible amount for the non-refundable credit to \$250 (from \$500)

The supplemental amounts for children eligible for the disability tax credit and who are under 18 years of age will remain at \$500 for 2016.

### **Education and Textbook Tax Credits**

Budget 2016 proposes to eliminate the education and textbook tax credits effective January 1, 2017. Unused education and textbook credit amounts carried forward from years prior to 2017 will remain available to be claimed in 2017 and subsequent years. This measure does not eliminate the tuition tax credit.

The Budget notes that changes will be made to ensure that other income tax provisions (such as the tax exemption for scholarship, fellowship and bursary income) that currently rely on eligibility for the education tax credit or use terms defined for the purpose of the education tax credit will be unaffected by its elimination.

### **Enhancing the Canada Pension Plan**

In December 2015, the government began discussions on enhancing the Canada Pension Plan (CPP) with the provinces and territories. In the coming months, the government will expand this process, launching consultations to give Canadians an opportunity to share their views on enhancing the CPP.

### **Restoring Eligibility Ages of Old Age Security Program**

Budget 2016 proposes to restore the eligibility age for Old Age Security (OAS) and Guaranteed Income Supplement (GIS) benefits to 65 (from 67) and Allowance benefits to 60 (from 62).

## **Small Business Measures**

### **Capital Dividend Account – Ownership and beneficiary of a life insurance policy**

Budget 2016 proposes to address certain ownership structures that have resulted in artificial increases in a corporation's capital dividend account (CDA).

The ITA provides that the death benefit from a life insurance policy is generally received tax free. In order to preserve this treatment when a private corporation is the recipient of a life insurance death benefit, the ITA provides that the corporation receives a credit to its CDA equal to the excess of the death benefit received over the adjusted cost basis (ACB) of the policy to that corporation. Capital dividends can be paid out of a corporation to the extent of its CDA and are generally non-taxable to the shareholder. Some taxpayers were structuring their affairs so that the life insurance policy was owned by a different corporation than the corporation that was the beneficiary, so the reduction to the credit to the CDA did not apply. The budget proposes to amend the ITA so that after March 22, 2016 the credit to the CDA will be reduced by the ACB of the policy regardless of who owns the policy. A similar mechanism exists for partnerships to be able to distribute life insurance death benefits on a tax free basis, and a similar change is proposed to prevent this planning in the partnership context.

As an enforcement mechanism, the Budget introduces an information reporting requirement applicable to a corporation or partnership that is not a policyholder or owner but is entitled to receive a policy benefit.

### **Transfers of Life Insurance to a Corporation**

Of no surprise is that Budget 2016 proposes to amend the ITA relating to transfers of a life insurance policy from a person to a related private corporation. Transfers of a life insurance policy generally give rise to a taxable policy gain equal to the excess of the proceeds received over the ACB of the policy. There is a loophole in the current rules that allows a person to sell a life insurance policy to a related corporation for an amount greater than that used to determine their policy gain for tax purposes. This excess is not taxable to the transferor, so it essentially represents a way of extracting money from a corporation tax-free. The Budget includes proposals that will prevent this planning after March 22, 2016 by ensuring the proceeds from the sale (that is used to determine the taxable policy gain) is not less than the amount of the consideration received from the corporation. In addition, the Budget proposes that if a policy was transferred to a private corporation prior to March 22, 2016, the excess of the consideration received on the transfer over the proceeds used to determine the policy gain will reduce the CDA credit to the private corporation. So, transfers that have already occurred will be impacted. Similar changes are proposed to prevent this planning in the partnership context.

### **Small Business Tax Rate**

The federal small business tax rate applies to the first \$500,000 of active business income of a Canadian-controlled private corporation. Budget 2015 proposed to reduce the rate from 11 to 9 percent over the next 4 years.

Budget 2016 proposes that the small business tax rate remain at 10.5 percent after 2016. The Budget also proposes to maintain the current gross-up factor and dividend tax credit rate applicable to non-eligible dividends in order to preserve tax integration.

### **Multiplication of the Small Business Deduction**

Planning techniques exist that allow certain partnership and corporate structures access to multiple small business deductions. Budget 2016 proposes measures to limit structures that multiply access to the small business deduction.

## Active Versus Investment Income

Budget 2015 announced a consultation on the circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income. Budget 2016 maintains that such businesses must have more than five full time employees to claim the small business deduction.

## Eligible Capital Property (ECP)

Budget 2014 announced a consultation relating to the repeal of the ECP regime and replacement with a new capital cost allowance (CCA) class. Budget 2016 proposes to repeal the ECP regime with a new class of depreciable property for CCA purposes. In general, this measure will mean an increase in tax on the sale of goodwill, certain licenses, franchises and quotas. Under the proposal, cumulative eligible capital (CEC) pool balances will be calculated and transferred to the new CCA class as of January 1, 2017.

## Conclusion

In many respects, from a tax measures perspective, it's out with the old and in with the new. A new approach and a new philosophy - not necessarily better, just different.

The commentary in this publication is for general information only and should not be considered legal, tax or other professional advice to any party. Individuals should seek the advice of professionals to ensure that any action taken with respect to this information is appropriate to their specific situation.

