The TaxLetter®

Vol. 34, No. 4 | Your Guide to Tax-Saving Strategies | April 2016

TAXSTRATEGY

The 2016 federal budget

Taxpayer Beware

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The Liberal government's Federal Budget was released on March 22, 2016, with the theme of "growing the middle class". The budget project significant deficits over the next several years. The forecast reflects a deficit of $5.4 billion for 2015–16, and projects additional deficits of $29.4 billion, $29 billion, $22.8 billion, $17.7 billion and $14.3 billion for 2016–17, 2017–18, 2018–19, 2019–2020 and 2020–2021, respectively. Happily though, the government is starting from a relatively strong fiscal position in 2016.

So what does this all mean for your final tax bill? Read on for a summary of some of the personal & business tax measures that might be of interest to you.

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Personal Tax Measures

Canada Child Benefit

The budget has introduced the non-taxable Canada Child Benefit (CCB), which will replace the Canada Child Tax Benefit (CCTB) and Universal Child Care Benefit (UCCB) assistance programs effective July 1, 2016.

The new CCB will provide financial assistance in the form of monthly payments to families with children under the age of 18. A maximum benefit of $6,400 will be provided for each child under the age of 6 and $5,400 for children aged 6 to 17. These maximums begin to phase out where the adjusted family net income is between $30,000 and $65,000. The phase-out rates in this threshold range from 7% for a one-child family up to 23% for a family with 4 or more children. Once adjusted family net income exceeds $65,000, any remaining benefit is phased out at slower rates ranging from 3.2% to 9.5%.

Changes to Credits:

- *Family Tax Cut Credit*: The budget proposes to eliminate this credit, which currently allows a higher-income earning spouse (or common-law partner) to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner in order to reduce the couple's combined tax liability to a maximum of $2,000.
- *Children's Fitness and Arts Tax Credits*: The government proposes to cut in half the maximum eligible expenditures on which this 15% refundable credit can be claimed for 2016 (i.e., from $1,000 to $500 for fitness, and from $500 to $250 for arts). For 2017, this credit will be eliminated.
- *Education and Textbook Tax Credit*: Effective January 1, 2017, the budget proposes to eliminate this 15% non-refundable credit; however, unused education and text book credits carried forward from prior to 2017, will remain available to be claimed in 2017 and subsequent years.
- *Teacher and Early Childhood Educator School Supply Tax Credit*: The budget introduced this credit to provide for a 15% refundable credit based on the amount of expenditures, up to a maximum of

$1,000, made for eligible supplies purchased on or after January 1, 2016. The credit is available to eligible educators who are teachers or early childhood educators that hold a valid certificate recognized by the province or territory in which they are employed. The credit cannot be applied to expenditures claimed under any other provision of the Income Tax Act.

Personal Tax Rates

On December 7, 2015, the Liberal government announced that it will reduce the personal income tax rate in the second bracket from 22 per cent to 20.5 per cent for 2016 and onwards, as well as create a new top tax bracket of 33 per cent on taxable income over $200,000. As a result of these changes, the 2016 budget introduced certain consequential amendments, including:

- Charitable donation tax credit rate on gifts above $200 is increased to 33% for trusts that are subject to the 33% tax rate on all of their taxable income.
- The new 33% top marginal personal tax rate will apply to excess employee profit-sharing plan contributions.
- Effective January 1, 2016, the tax rate on personal services business income earned by a corporation will be increased from 28% to 33%. The rate increase will be prorated for taxation years that straddle January 1, 2016.
- Effective for 2016 and subsequent years, the “relevant tax factor” for purposes of computing the grossed-up deduction of foreign accrual tax is reduced from 2.2 to 1.9.
- The formulas used to calculate the refundable tax under the capital gains refund mechanism for mutual fund trusts will be amended to reflect the new 33% top marginal rate. In addition, the Part XII.2 tax rate on the distributed income of certain trusts will be increased from 36% to 40%, and the recovery tax rule for qualified disability trusts will be amended to reflect the new 33% top marginal rate.

Miscellaneous Personal Measures

- Ontario Electricity Support Program: This program, which took effect on January 1, 2016, provides relief to low-income households for the cost of electricity via a monthly credit on a taxpayer’s electricity bill. The budget proposes to exclude such credits from a taxpayer’s income so that other benefits subject to income threshold tests are not adversely impacted.
- Mineral Exploration Tax Credit: Eligibility for this credit is proposed to be extended for one year under the budget (i.e. the credit will apply to flow-through share agreements entered into on or before March 31, 2017).
- Labour-Sponsored Venture Capital Corporation (LSVCC) Tax Credit: This previously cut 15% credit is being reestablished for a purchase of shares of a <u>provincially</u> registered LSVCC for the 2016 taxation year and beyond. The budget, however, does not reestablish the tax credit for a <u>federally</u> registered LSVCC; the credit will remain at 5 per cent in 2016 and will be eliminated in 2017.

Business Tax Measures

Small Business Tax Rate

The previously announced reductions in the corporate income tax rate applicable to small-business income of a Canadian-controlled private corporation (CCPC) have been removed. Budget 2016 proposes that the federal small business tax rate remain at 10.5% after 2016.

The related dividend gross-up of 17% for other than eligible dividends and the dividend tax credit of 21/29 of the gross-up will remain for 2016 and subsequent taxation years. However, since the reduction of the small business deduction no longer exists, consequential changes to the dividend gross-up and dividend tax credit will also not be moving forward.

Multiplication of the Small Business Deduction

For corporate taxation years that begin after March 21, 2016, structures designed to increase the small business deduction claim on active business income earned through a partnership will no longer be effective. In addition, the small business deduction will be limited where a corporation provides services or property in related party structures. The taxable capital limit will now be shared among associated corporations, notwithstanding any elections made to disassociate them for other purposes (currently the rules allowed for a corporation to elect not to be a CCPC so as to avoid association between common corporations). This will also apply in respect of investment income earned by these corporations from the common corporation (i.e. the election is no longer available).

Tax on Personal Services Business Income

Effective January 1, 2016, the federal tax rate on personal services business income will be increased to 33% from 28% (this is meant to correspond with the increase to the top federal personal tax rate on income over $200,000). Note: the rate increase will be prorated for taxation years which straddle January 1, 2016.

Corporate Owned Insurance

Distributions Involving Life Insurance Proceeds

Corporate-owned life insurance has traditionally been a tax effective tool, as the portion of life insurance proceeds received by a corporation that exceeds the cost of the policy can be added to the corporation's capital dividend account (CDA) and withdrawn, tax-free, by the shareholders. The budget introduced measures that are aimed at preventing artificial increases in the amount added to the CDA. These rules will apply regardless of whether or not the corporation receiving the policy benefit is a policyholder. Similar rules will be adopted for policies held by partnerships, and reporting requirements will also be introduced. The changes will apply to policy benefits received as result of a death occurring after March 22, 2016.

Transfers of Life Insurance Policies

The budget also proposed changes to deem the proceeds of disposition received by a taxpayer on the transfer of a life insurance to a private corporation to be equal to the fair market of the consideration received, and not the cash surrender value of the policy as is currently the case. This rule will apply to transfers made on or after March 22, 2016. This can create a big hurdle for current practice, as generally the cash surrender value will be nominal in relation to the policy value.

Changes will also be made to reduce the capital dividend inclusion upon the ultimate death of the insured for private corporations where life insurance policies have been transferred for consideration in excess of their cash surrender value prior to March 22, 2016.

Eligible Capital Property

The Budget proposes to repeal the eligible capital property (ECP) regime and replace it with a new capital cost allowance (CCA) class effective January 1, 2017. The full cost of an eligible capital expenditure (rather than a percentage of the cost) will be added to the new class, which will have an annual depreciation rate of 5%. For simplicity, the existing CCA rules, including rules relating to recapture, capital gains and depreciation will apply. Additions to the new CCA class will be subject to the half-year rule.

The effect of this change will cause ECP to be taxed in essentially the same manner as ordinary, depreciable capital property. This change will potentially cause a larger tax bill for those taxpayers who are considering a sale of assets of a business, the bulk of whose value is tied up in goodwill. The proposed change will tax the income from the sale of ECP (such as goodwill) at capital gains rate (effective rate of 25%) rather than at 50% of the active business rate.

Transition rules will apply to existing, cumulative eligible capital pool balances beginning January 1, 2017. The existing pool balances will be transferred to the new CCA class, and for the first ten years will be depreciated at an annual rate of 7%.

The one main take away from this change is that if you or a client of yours is thinking of selling assets of their business where goodwill is involved, you might consider moving that sale up to occur before January 1, 2017 so as to take advantage of the current regime before the higher take rate kicks in for the sale of ECP. ❐