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Federal Budget Report

On March 22, 2017, the Honourable Bill Morneau presented his second budget as Minister of Finance entitled "Building a Stronger Middle Class". Similar to last year's budget, this budget focused on providing fairness to the middle class through spending and tax changes.

The deficit reported for the 2016-17 fiscal year is $23 billion, which is lower than the deficit predicted in last year's budget of $29.4 billion. However, the government is predicting a deficit of $28.5 billion for 2017-18 and $27.4 billion for 2018-19. No reference is made to balancing the budget in the projections released and a deficit of $18.8 billion has been predicted for the 2021-22 fiscal year which is the final year for which detailed projections were presented.

In this budget, the government highlighted that it is making investments in six economic sectors: digital, clean technology, agri-food, advanced manufacturing, bio-sciences and clean resources.

Housing was another priority area addressed today. As the largest single commitment in this budget, the government announced that it will be investing over $11 billion in support of a National Housing Strategy. The government has also committed $7 billion over the next decade to increase the number of high-quality child care spaces available across the country.

On innovation, the government will create Innovation Canada and provide funding of $950 million over five years to spur innovation through superclusters. On the infrastructure front, the government announced that it would soon propose legislation establishing the Canada Infrastructure Bank in addition to appointing the bank's CEO, chair and board of directors. The goal is to have the bank up and running late this year.

In terms of tax changes, several credits and deductions have been eliminated. One significant change will affect professionals such as accountants, dentists, lawyers, doctors, veterinarians and chiropractors. The ability of these professionals to recognize their income on an "as billed" basis will be eliminated over a two year phase-in period.

The government also announced that it will release a discussion paper in the coming months that will deal with tax planning using private corporations. This paper will address income splitting using private companies, building portfolio investments in a private corporation and withdrawing funds from a private corporation as a capital gain as opposed to salaries or dividends.

The following is a summary of the more important items of interest to our clients.

HIGHLIGHTS

- Deficit of $23 billion forecast for 2016-17
- Deficit of $28.5 billion forecast for 2017-18
- No timetable set for balancing the federal budget
- Ability of professionals to defer taxation of work in progress to be repealed
- Government to release paper on private company tax planning
- Several income tax deductions and credits eliminated

Key Economic Statistics

Deficit in billions $	*2016-2017 Revised*	*2017-2018 Projected*	*2018-2019 Projected*
Budgetary Revenue	292.1	304.7	315.6
Program Expenses and Risk Adjustment	290.8	308.5	316.7
	1.3	(3.8)	(1.1)
Public Debt Charges	24.3	24.7	26.3
Budgetary Balance	(23.0)	(28.5)	(27.4)
Federal Debt	637.1	665.5	692.9

PERSONAL TAX MEASURES

Medical Expense Tax Credit Eligible Expenditures

Various costs related to reproductive technology use are eligible for the medical expense tax credit (METC), generally where the eligible expenses are incurred due to a medical infertility condition. The budget clarifies that such costs incurred by an individual who requires medical intervention to conceive a child, even where treatment is not on account of medical infertility, will be eligible for the METC. This measure will apply to 2017 and subsequent tax years, and a taxpayer will be allowed to elect in a year to apply this measure for any of the immediately preceding ten taxation years in their return of income in respect of the year.

Consolidation of Caregiver Credits

Under the current tax system, three non-refundable tax credits provide tax relief for caregivers. These include the infirm dependant credit, the caregiver credit and the family caregiver tax credit. In order to simplify the tax system, as well as better target those who need support, it is proposed that these credits be replaced with a new Canada Caregiver Credit, beginning with the 2017 taxation year.

The new credit will provide tax relief on an amount of:

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

The amounts of the new credit are consistent with the amounts that could have been claimed in respect of dependants under the current system of credits. The Canada Caregiver Credit will be reduced dollar-for-dollar by the dependant’s net income above $16,163 (in 2017). The credit amounts and income phase-out threshold will be indexed annually after 2017. For purposes of claiming this new credit, there will be no requirement for the dependant to live with the caregiver. However, the credit will no longer be available in respect of non-infirm seniors who live with their adult children.

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 not offered at the post-secondary level, for courses taken after 2016. The credit will be available in these circumstances if the course is taken for the purpose of providing the individual with skills (or improving skills) in an occupation and where the individual has attained the age of 16 before the end of the year. Effective for 2017 and subsequent years, eligibility as a “qualifying student” will be extended to individuals in these circumstances who would otherwise meet the conditions to be a “qualifying student”, allowing the full amount of bursaries received for such courses to qualify for the scholarship exemption (where conditions are met).

Anti-Avoidance Rules for Registered Plans

Tax-Free Savings Accounts, Registered Retirement Savings Plans and Registered Retirement Income Funds are subject to a number of anti-avoidance rules. The budget proposes to extend these rules to Registered Education Savings Plans and Registered Disability Savings Plans. This measure will generally apply to transactions occurring and investments acquired after March 22, 2017. Note that investment income generated after March 22, 2017 on previously acquired investments will be considered a transaction occurring after March 22, 2017. There will be certain exceptions to the effective date of this rule. In particular, the advantage rules will not apply to swap transactions undertaken before July 2017, although there will be a transition rule in place to permit certain swap transactions until the end of 2021. As well, under certain conditions, a plan holder may elect by April 1, 2018 to pay Part 1 tax (in lieu of the advantage tax) on distributions of investment income from an investment held on March 22, 2017 that becomes a prohibited investment under this measure.

Other Changes

Disability Tax Credit (DTC) Eligibility Certification - The budget proposes to add nurse practitioners to the list of eligible medical practitioners effective for DTC certifications made on or after March 22, 2017. A nurse practitioner will be permitted to certify for all types of impairments that are within the scope of their practice.

Mineral Exploration Tax Credit for Flow-Through Share Investors – As announced on March 5, 2017, the budget confirms the extension of eligibility for the credit for one year, to flow-through share agreements entered into on or before March 31, 2018.

Electronic Distribution of T4 Information Slips – Effective for 2017 and subsequent taxation years, it is proposed that employers will be allowed to distribute T4 (Statement of Remuneration Paid) information slips electronically to current active employees, without being required to obtain express consent from those employees. An employer will need to have sufficient privacy safeguards in place as specified by the Minister of National Revenue. However, employers will be required to issue paper copies to employees who request them.

Public Transit Tax Credit – This budget proposes to eliminate the public transit tax credit, effective July 1, 2017.

Home Relocation Loans Deduction – The deduction available from the taxable benefit that arises on certain home relocation loans will be eliminated in respect of benefits arising in 2018 and subsequent taxation years.

Allowance for Members of Legislative Assemblies and Certain Municipal Officers – Certain officials can exclude non-accountable allowances received for work expenses from their taxable income, within a specific salary and remuneration limit. Effective for 2019 and subsequent taxation years, the budget proposes to require non-accountable allowances paid to such officials to be taxable. The reimbursement of employment expenses will remain a non-taxable benefit to the recipient.

Ecological Gifts Program - Special tax assistance is available for certain donations of ecologically sensitive land or easements, covenants and servitudes on such land (ecogifts). This budget proposes several measures to better protect gifts of ecologically sensitive land, which will apply in respect of transactions or events that occur on or after March 22, 2017.

BUSINESS TAX MEASURES

Billed-Basis Accounting for Professionals

Taxpayers are generally required to include the value of work in progress in computing their income for tax purposes. However, certain professionals (including accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of work in progress in computing their income. This election effectively allows income to be recognized when the work is billed ("billed-basis accounting").

This budget proposes to eliminate the ability for designated professionals to elect to use billed-basis accounting. This change will have a significant short-term impact on affected taxpayers. This measure will apply to taxation years that begin on or after March 22, 2017, and to mitigate the effect on taxpayers, a transitional period will be provided to phase in the inclusion of work in progress into income.

For the first taxation year that begins on or after March 22, 2017, 50% of the lesser of the cost and the fair market value of work in progress will be taken into account for the purposes of determining the value of inventory held by the business under the Income Tax Act (ITA). For the second, and each successive taxation year that begins on or after March 22, 2017, the full amount of the lesser of the cost and the fair market value of work in progress will be taken into account for the purposes of valuing inventory.

Tax Planning Using Private Corporations

The government review of federal tax expenditures highlighted a number of issues regarding tax planning strategies using private corporations, which can result in high-income individuals gaining tax advantages. A variety of tax reduction strategies are available to these individuals that are not available to other Canadians. These strategies include:

- Income splitting by way of dividends paid to lower-income family members.
- Building a passive investment portfolio inside a private corporation by taking advantage of generally lower corporate tax rates.
- Receiving distributions from private companies as capital gains as opposed to salaries or dividends that are taxed at a higher rate.

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.

Insurers of Farming and Fishing Property

Insurers of farming and fishing property benefit from a tax exemption based upon the proportion of their gross premium income, and that of their affiliated insurers, that is earned from the insurance of property used in farming or fishing (including residences of farmers or fishers). Prescribed insurers are provided preferential access to this exemption.

This budget proposes to eliminate the tax exemption for insurers of farming and fishing property. This measure will apply to taxation years that begin after 2018.

Meaning of Factual Control

Our tax rules recognize two forms of control of a corporation: *de jure* (legal) control and *de facto* (factual) control. The concept of factual control is broader than legal control. The factual control test is used for the purpose of determining whether two or more Canadian-controlled private corporations are "associated corporations". Associated corporations must be considered together in determining whether certain thresholds are met, such as the $500,000 small business deduction limit and the limit on qualifying expenditures relating to the refundable 35% scientific research and experimental development tax credit.

While a significant body of case law has developed concerning which factors may be useful in determining whether factual control exists, a recent court decision limited the scope of such factors.

This budget proposes that the ITA be amended to clarify that, in determining whether factual control of a corporation exists, all factors that are relevant to the determination be taken into consideration. However, the determination need not include consideration of whether a taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, or the board's powers, or to exercise influence over the shareholders who have that right or ability. This measure is to apply in respect of taxation years that begin on or after March 22, 2017.

Clean Energy Generation Equipment: Geothermal Energy

This budget proposes to expand the availability of faster tax write-offs to investments in geothermal technologies and equipment. Specifically, it is proposed that eligible geothermal energy equipment under Class 43.1 and 43.2 be expanded to include geothermal equipment that is used primarily for the purpose of generating heat or a combination of heat and electricity. As well, amendments have been proposed to ensure that geothermal heating will be made an eligible thermal energy source for use in a district energy system. And finally, expenses incurred for the purpose of determining the extent and quality of a geothermal resource and the cost of all geothermal drilling, for both electricity and heating projects, will qualify as Canadian renewable and conservation expenses.

These proposals will generally apply in respect of property acquired for use on or after March 22, 2017.

Canadian Exploration Expense: Oil and Gas Discovery Wells

This budget proposes that expenditures related to drilling or completing a discovery well (or in building a temporary access road to, or in preparing a site in respect of, any such well) generally be classified as Canadian development expenses (CDE) instead of Canadian exploration expenses (CEE).

This proposed change will apply to expenses incurred after 2018 (including expenses incurred in 2019 that could have been deemed to have been incurred in 2018 because of the "look-back" rule). The proposed change will not apply to expenses actually incurred before 2021 where the taxpayer has, before March 22, 2017, entered into a written commitment (including a commitment to a government under the terms of a license or permit) to incur those expenses.

Reclassification of Expenses Renounced to Flow-Through Shares

This budget proposes to no longer permit eligible small oil and gas corporations to treat the first $1 million of CDE as CEE. This measure will apply in respect of expenses incurred after 2018 (including expenses incurred in 2019 that could have been deemed to be incurred in 2018 because of the look-back rule), with the exception of expenses incurred after 2018 and before April 2019 that are renounced under a flow-through share agreement entered into after 2016 and before March 22, 2017.

Investment Fund Mergers

The ITA contains specific rules to facilitate the reorganization of certain investment funds on a tax-deferred basis. However, these rules apply in a limited number of circumstances.

Merger of switch corporations into mutual fund trusts

The ITA contains special rules to facilitate the merger of mutual funds on a tax-deferred basis, under which two mutual fund trusts can be merged or a mutual fund corporation can be merged into a mutual fund trust. However, these rules do not provide for the reorganization of a mutual fund corporation into multiple mutual fund trusts. This budget proposes to extend the mutual fund merger rules to facilitate the reorganization of a mutual fund corporation that is structured as a switch corporation into multiple mutual fund trusts on a tax-deferred basis. To qualify for this tax deferral, in respect of each class of shares of the mutual fund corporation that is or is part of an investment fund, all or substantially all of the assets allocable to that class must be transferred to a mutual fund trust and the shareholders of that class must become unitholders of that mutual fund trust.

This measure will apply to qualifying reorganizations that occur on or after March 22, 2017.

Segregated fund mergers

To provide consistent treatment between mutual fund trusts and segregated funds, this budget proposes to allow insurers to effect tax-deferred mergers of segregated funds. It is proposed that these rules generally parallel the mutual fund merger rules. In addition, it is proposed that, for non-capital losses that arise in taxation years that begin after 2017, a segregated fund be able to carry over those losses and apply them in computing its taxable income for taxation years that begin after 2017. The use of these losses will be subject to the normal limitations for the carrying forward and back of non-capital losses. As is the case with the mutual fund merger rules, the use of these losses will be restricted following a segregated fund merger.

In order to ensure that the life insurance industry has an opportunity to provide comments on these proposed rules, this measure will apply to mergers of segregated funds carried out after 2017 and to losses arising in taxation years that begin after 2017.

Timing of Recognition of Gains and Losses on Derivatives

While derivatives are sophisticated financial instruments, there are no specific rules in the ITA that govern the timing of the recognition of gains and losses on derivatives held on income account. This budget has two proposals that clarify the scheme of the ITA in this regard.

Elective use of the mark-to-market method

Although in the past there has been 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 a taxpayer that was not a financial institution to use the mark-to-market method on the basis that it provided an accurate picture of the taxpayer’s income. This budget proposes to introduce an elective mark-to-market regime for derivatives held on income account by introducing an election that will allow taxpayers to mark to market all of their eligible derivatives. Once made, the election will remain effective for all subsequent years unless revoked with the consent of the Minister of National Revenue.

Once an election is made by a taxpayer, the taxpayer will be required to annually include in computing their income the increase or decrease in value of its eligible derivatives. Furthermore, the recognition of any accrued gain or loss on an eligible derivative (that was previously subject to tax on a realization basis) at the beginning of the first election year will be deferred until the derivative is disposed of. This election will be available for taxation years that begin on or after March 22, 2017.

Straddle transactions

The budget proposes to introduce a specific anti-avoidance rule that targets straddle transactions. In particular, a stop-loss rule will effectively defer the realization of any loss on the disposition of a position to the extent of any unrealized gain on an offsetting position. A gain in respect of an offsetting position would generally be unrealized where the offsetting position has not been disposed of and is not subject to mark-to-market taxation.

For the purposes of the stop-loss rule, a position will generally be defined as including any interest in actively traded personal properties (e.g., commodities), as well as derivatives and certain debt obligations. An offsetting position with respect to a position held by a taxpayer will generally be a position that has the effect of eliminating all or substantially all of the taxpayer’s risk of loss and opportunity for gain or profit in respect of the position. The stop-loss rule will be subject to a number of exceptions. This measure will apply to any loss realized on a position entered into on or after March 22, 2017.

Additional Deduction for Gifts of Medicine

Corporations that donate medicine from their inventory to an eligible charity can claim an additional deduction equal to the lesser of the cost of the donated medicine and 50% of the amount by which the fair market value of the donated medicine exceeds its cost. The budget proposes to eliminate this deduction for gifts of medicine. This measure does not affect the general income tax treatment of donations made by corporations to registered charities, including donations of medicine. This measure will apply to gifts of medicine made on or after March 22, 2017.

Investment Tax Credit for Child Care Spaces

This budget proposes to eliminate the investment tax credit for child care spaces, which provides a 25% non-refundable tax credit on costs incurred to build or expand child care spaces in licensed child care facilities. This measure generally applies in respect of expenditures incurred on or after March 22, 2017, but also provides transitional relief.

Consultation on Cash Purchase Tickets

In circumstances where a farmer delivers a listed grain to the operator of a licensed elevator, the operator may issue a cash purchase ticket or other prescribed form of settlement to the farmer. If the cash purchase ticket (or other prescribed form of settlement) in respect of a delivery of a listed grain is payable in the year following the year in which the grain is delivered, the taxpayer includes the amount of the ticket in income in that following year. This allows for the tax deferral of deferred cash purchase tickets for deliveries of listed grains. However, due to deregulation in the industry, there may no longer be a clear policy rationale for maintaining this tax deferral. As a result, the budget launched a consultation on the income tax deferral available in respect of deferred cash purchase tickets for deliveries of listed grains. Stakeholders are invited to provide comments on the ongoing utility and potential elimination of the tax deferral, including any appropriate transitional period or rules by May 24, 2017.

INTERNATIONAL TAX MEASURES

Extending the Base Erosion Rules to Foreign Branches of Life Insurers

This budget proposes to amend the ITA to ensure that Canadian life insurers are taxable in Canada with respect to their income from the insurance of Canadian risks. This rule will be modelled on the existing anti-avoidance rule in the foreign accrual property income regime and will apply where 10% or more of the gross premium income (net of reinsurance ceded) earned by a foreign branch of a Canadian life insurer is premium income in respect of Canadian risks. Where the proposed rule applies, it will deem the insurance of Canadian risks by a foreign branch of a Canadian life insurer to be part of a business carried on by the life insurer in Canada and the related insurance policies to be life insurance policies in Canada.

It is additionally proposed that complementary anti-avoidance rules be introduced to ensure the integrity of the proposed rule. This measure will apply to taxation years of Canadian taxpayers that begin on or after March 22, 2017.

SALES TAX, EXCISE AND OTHER MEASURES

Opioid Overdose Treatment Drug - Naloxone

In order to restore the GST/HST-free treatment of naloxone, a drug used to treat opioid overdose, this budget proposes to add the drug (and its salts) to the list of GST/HST-free non-prescription drugs that are used to treat life-threatening conditions. This measure is generally retroactive to March 22, 2016, the date the drug became available without a prescription for emergency use.

Taxi and Ride-Sharing Services

This budget proposes to amend the definition of a taxi business to require providers of ride-sharing services to register for the GST/HST and charge tax on their fares in the same manner as taxi operators. As such, the GST/HST definition of a taxi business is proposed to be amended to include persons engaged in a business of transporting passengers for fares by motor vehicle within a municipality and its environs where the transportation is arranged for or coordinated through an electronic platform or system, such as a mobile application or website. These changes will not apply to a school transportation service for elementary or secondary students or a sightseeing service. The amendment will be effective as of July 1, 2017.

GST/HST Rebate to Non-Residents for Tour Package Accommodations

This budget proposes to repeal the GST/HST rebate available to non-residents for the GST/HST that is payable in respect of the accommodation portion of eligible tour packages. The repeal will generally apply in respect of supplies of tour packages or accommodations made after March 22, 2017 and is subject to transitional measures.

Tobacco Taxation

With respect to tobacco tax, this budget proposes to:

- eliminate the tobacco manufacturers' surtax;
- adjust tobacco excise duty rates on cigarettes and other tobacco products; and
- subject inventories of cigarettes held by manufacturers, importers, wholesalers and retailers to a tax of $.00265 per cigarette (subject to certain exemptions).

These measures will be effective as of March 23, 2017.

Alcohol Taxation

This budget proposes that excise duty rates on alcohol products be increased by 2% effective March 23, 2017 in respect of duty that becomes payable after that date.

Customs Tariff and Special Import Measures

This budget proposes changes to the rules of origin under Canada's tariff regime for least developed countries in order for more apparel products imported from the world's poorest countries to qualify for duty-free treatment when imported to Canada. This budget also proposes a number of amendments to the Special Import Measures Act and related trade remedy regulations.

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