The 2017 federal budget: what's changed, what hasn't

Kim G C Moody FCPA, FCA, TEP, Elan Harper MBA and Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP
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On March 22, 2017, the federal Liberal government released their 2nd budget. For those of you who are not inclined to read the detail and commentary below, an executive summary follows.

EXECUTIVE SUMMARY

1. Capital gains inclusion rates – The status quo of 50% of capital gains inclusion remains… no change.
2. Stock option deduction – No changes.
3. Tax rates – No changes to personal or corporate tax rates.
4. Consultation study/paper on private corporations to be released by the government – This study will eventually comment on common "planning" for private corporations and their shareholders with the intent of shutting down such plans.
5. Work-in-progress election under section 34 to be eliminated – This is huge for professionals. Currently, WIP can be excluded from the calculation of taxable income. For taxation years that begin on or after March 22, 2017, affected professionals will not be able to utilize this accounting method, and will have to include WIP in their taxable income. Limited transitional rules will be available to help mitigate the impact of this change.
6. Commodity straddle transactions – These transactions will now be ineffective in deferring income.
7. Changes to the factual control rule for purposes of the association rules – In order to overcome the effect of a recent court case that restricted the application of the *de facto* control rule, the Budget proposes to introduce new subsection 256(5.11) which will override the court's decision, and force taxpayers to consider all facts that are relevant in the circumstances.
8. Canadian Exploration Expense: oil and gas discovery wells and renunciation – The Budget proposes to classify drilling and completion expenses for successful discovery wells incurred after 2018 as Canadian Development Expenses (CDE), rather than Canadian Exploration Expense (CEE). Additionally, the reclassification of the first $1 million of expenses renounced to flow-through share investors as CEE rather than CDE will no longer be allowed.
9. Disability tax credit changes – The Budget proposes to add nurse practitioners to the list of medical practitioners that can certify eligibility for the disability tax credit in respect of certifications made on or after March 22, 2017.
10. Consolidation of the infirm dependent, caregiver and family caregiver personal credits into the Canada Caregiver Credit – The intent of this new caregiver credit appears to consolidate all such credits into one. The combined credit, however, will no longer be available in respect of non-infirm seniors who reside with their adult children, where previously a reduced credit was available under the caregiver credit. These changes apply to 2017 and subsequent taxation years.
11. Tuition tax credit changes – 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 that are not at the post-secondary level,

effective for 2017 and subsequent taxation years.

12. Public transit personal tax credit – The Budget proposes to allow for a partial claim in respect of eligible expenditures prior to July 1, 2017. The credit will be fully eliminated for public transit costs incurred after June 2017.
13. RESP and RDSP anti-avoidance changes – The anti-avoidance rules that currently apply to RRSPs, RRIFs, and TFSAs (the “advantage” rules, the “prohibited investment” rules, and the “non-qualified investment” rules) will be extended to RESPs and RDSPs.
14. Corporate and beneficial ownership transparency – The federal government will collaborate with the provinces to “strengthen the transparency of legal persons and legal arrangements and improve the availability of beneficial ownership information”. In addition, the government is exploring ways to enhance the tax reporting requirements for trusts in order to improve the collection of beneficial ownership information.
15. Cash purchase tickets for farmers – The government announced a consultation study on whether or not the existing income tax deferral available in respect of deliveries of listed grains is appropriate. Stakeholders should submit their comments by May 24, 2017.
16. Increased funding to the Canada Revenue Agency (CRA) – The Budget announced another half a billion dollars in funding to the CRA over five years in an effort to prevent tax evasion and improve tax compliance.

ANALYSIS AND COMMENTARY

1. Capital gains inclusion rates, tax rates, and stock option deduction

After much speculation – including some from our firm – capital gains inclusion rates remain unchanged. Whew! In our opinion, increasing capital gains inclusion rates would have had a significant negative effect on taxpayer investments and the Canadian economy as a whole. This also means that the effective tax rate for capital gains continues to be more favourable than eligible or non-eligible dividends in most cases (but the government is currently reviewing planning transactions that take advantage of this – see discussion below).

In addition, no specific tax rate increases –personal or corporate – were announced. Again, this is positive news given the fact that Canada remains in the top 10 of the highest tax rate jurisdictions amongst its OECD peers. With the Budget announcing significant estimated deficits – over $100 billion for the next five years – the possibility for tax rate reductions in the near term appears to be slim.

There had been some speculation that the government was revisiting the notion of repealing the stock option deduction, which was something the Liberals had promised to do during the 2015 Election but backed away shortly after being elected. The 2017 Budget contains no material on either an elimination or commitment to the stock option deduction. In our opinion, eliminating the stock option deduction without a corresponding replacement to enhance innovation and encourage start-up entrepreneurship would be a mistake. We’re glad to see the stock option deduction remains.

2. Consultation study/paper on private corporations to be released by the government

The Budget documents contain an ominous announcement for private corporations and their shareholders. It appears the government is committed to “shutting down” common remuneration planning for private corporations and its shareholders. The announcement of a consultation on how private corporations income split or reduce their tax loads is reproduced below from the budget documents:

The 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 unfair tax advantages. A variety of tax reduction strategies are available to these individuals that are not available to other Canadians. These strategies include:

- *Sprinkling income using private corporations, which can reduce income taxes by causing income that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates (or who may not be taxable at all).*
- *Holding a passive investment portfolio inside a private corporation, which may be financially advantageous for owners of private corporations compared to otherwise similar investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate accumulation of earnings that can be invested in a passive portfolio.*
- *Converting a private corporation's regular income into capital gains, which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains.*

A number of measures have been put in place over the years to limit the scope of some of these planning arrangements, but such measures have not always been fully effective. The Government is therefore further reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes of high-income earners. In doing so, the Government will also consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members. 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. In addressing these issues, the Government will ensure that corporations that contribute to job creation and economic growth by actively investing in their business continue to benefit from a highly competitive tax regime.

For the first bullet above, this type of income splitting is very common. Dividends are often paid to non-active family members who are direct or indirect shareholders, and this practice was "approved" by the 1998 Supreme Court of Canada's decision in *Neuman*. The announcement of this aspect of the study appears to be an attempt to prevent such income splitting with adult family members who are direct or indirect shareholders (minor family members are already prevented from receiving private company dividends due to the "kiddie tax" provisions under section 120.4 of the *Income Tax Act* (*the Act*). Time will tell what the consultation paper will propose but it smells to us that an "efforts" test may be proposed in order to overcome the *Neuman* decision. Perhaps there will be some other tests?

For the second and third bullets above, such "plans" are very narrow but are often used by clever tax practitioners to reduce or defer tax. Although they may not be widely utilized, the government is obviously concerned.

Private corporations and their shareholders, be warned. Significant changes to remuneration planning are coming.

3. <u>Work-in-progress election under section 34 to be eliminated</u>

Professionals… this is a big change for you. Currently, professionals are required – like all businesses (except cash based farmers) – to record their revenue on an accrual basis. This requires professionals to keep track of their work-in-progress (WIP). WIP is effectively the aggregate of unbilled amounts that are expected to be invoiced to a client in the future. For example, if John the Accountant incurs $1,000 of time on Sally the Client, the $1,000 of WIP is included in his revenues. However, *the Act* currently enables John to deduct his WIP at his taxation year end (and include the amount of WIP in income that he deducted in the previous year) pursuant to section 34 of *the Act*. In real life, the conversion of WIP to an invoice, and then to cash, can be length – especially if John is a notoriously slow biller and collector. Accordingly, the ability to deduct the year-end WIP of a professional is very helpful. Well, those days are over. The Budget proposes to eliminate the ability for designated professionals to elect to use "billed-basis" accounting. The Budget documents announced this as follows:

Taxpayers are generally required to include the value of work in progress in computing their income for tax purposes. However, taxpayers in certain designated professions (i.e., 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). Billed-basis accounting enables taxpayers to defer tax by permitting the costs associated with work in progress to be expensed without the matching inclusion of the associated revenues. Budget 2017 proposes to eliminate the ability for designated professionals to elect to use billed-basis accounting.

This measure will apply to taxation years that begin on or after Budget Day.

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 Budget Day, 50 per cent 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. For the second, and each successive, taxation year that begins on or after Budget Day, 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.

Ouch! This hurts. Many professionals were stung hard by the 2016 Budget with the significant changes to the small business deduction (which curtailed many professionals' ability to maximize the use of that deduction). This amendment continues the attack on professionals. While not relevant, it is interesting to note that United States professionals are generally not taxed on their WIP. Accordingly, the proposed Canadian change puts Canadian professionals at a comparative disadvantage.

The amendments to effectuate this change are being made to section 10 (the inventory section of *the Act*) and section 34 (as previously described). The exact effect of this change with the proposed amendment is not entirely clear given current commercial practices of professional firms. Standby… this is a big change and will require firms to take a very close look at their accounting practices and systems.

4. <u>Commodity straddle transactions</u>

The Budget documents provide a good description of the proposed changes that will apply for transactions on or after March 22, 2017, and is replicated below:

In its simplest form, a straddle is a transaction 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. Shortly before its taxation yearend, the taxpayer disposes of the position with the accrued loss *(the losing leg) and realizes the loss. Shortly after the beginning of the following taxation year, the taxpayer disposes of the offsetting position with the accrued gain (the winning leg) and realizes the gain. The taxpayer claims a deduction in respect of the realized loss against other income in the initial taxation year and defers the recognition of the offsetting gain until the following taxation year. The taxpayer claims the benefit of the deferral although economically the two positions are offsetting. Moreover, the taxpayer could attempt to indefinitely defer the recognition of the gain on the winning leg by entering into successive straddle transactions.*

There are several variations to this basic straddle transaction, including combining it with an exit strategy that shifts the offsetting gain to a tax-indifferent investor.

Straddle transactions raise significant tax base and fairness concerns. Although these transactions are being challenged using certain judicial principles and existing provisions of the Income Tax Act, including the general anti-avoidance rule, these challenges can be time-consuming and costly. Accordingly, specific legislation is proposed to clarify that these transactions contravene the scheme of the Income Tax Act. Budget 2017 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. In particular, it will generally not apply to a position if:

- *it is held by a financial institution, as defined for the purposes of the mark-to-market property rules, or by a mutual fund trust or mutual fund corporation;*
- *it is part of certain types of hedging transactions entered into in the ordinary course of the taxpayer's business;*
- *the taxpayer continues to hold the offsetting position throughout a specified period that begins on the date of disposition of the position; or*
- *it is part of a transaction or a series of transactions none of the main purposes of which is to defer or avoid tax. This measure will apply to any loss realized on a position entered into on or after Budget Day.*

There are many taxpayers who have employed straddle transactions in their "planning" resulting in a deferral of their taxable income. Such plans are now effectively dead. These proposed rules may also affect the tax reporting of taxpayers who use hedges or derivatives as part of their businesses, even where tax deferral or tax reduction was not an objective.

5. <u>Changes to the factual control rule for purposes of the association rules</u>

The association rules in section 256 of *the Act* are designed to restrict "associated" corporations from claiming multiple small business deductions to reduce tax. These rules are complex and rely on legal control (who legally controls the corporation) and factual control (who, in fact, controls the corporation). Both legal and factual control may cause corporations to become associated, thereby causing restricted access to the small business deduction.

The Budget announced changes to the factual control rule in section 256. The government's reason for the change was as follows:

A person may have factual control of a corporation even though the person does not have legal control of the corporation. Legal control of a corporation generally entails the right to elect the majority of the board of directors of the corporation. Factual control of a corporation exists where a person has "directly or indirectly in any manner whatever" influence that, if exercised, would result in control in fact of the corporation. In each situation, consideration of all the relevant factors is required in determining whether there is factual control of a corporation. A significant body of case law has developed concerning which factors may be useful in determining whether factual control exists.

A recent court decision held that, in order for a factor to be considered in determining whether factual control exists, it must include "a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability". This requirement limits the scope of factors that may be taken into consideration in determining whether factual control of a corporation exists. It is not intended from a policy perspective that the factual control test be dependent on the existence of such a legally enforceable right, or that factors that do not include such a right ought to be disregarded. To ensure taxpayers do not inappropriately access certain tax preferences, Budget 2017 proposes that the Income Tax Act be amended to clarify that, in determining whether factual control of a corporation exists, factors may be considered that are not limited to the requirement set out above. This measure will apply in respect of taxation years that begin on or after Budget Day.

The court case that the government has an issue with was the 2016 Federal Court of Appeal decision in *McGillivray Restaurant Ltd*. To address the concern, the Budget proposes to modify subsection 256(5.1) by adding a clarifying provision in new subsection 256(5.11). Proposed subsection 256(5.11) will require the taxpayer to consider all factors that are relevant in the circumstances, and such factors will not be limited to whether the taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, etc. This proposed amendment will apply to taxation years that begin on or after March 22, 2017.

Accordingly, for any taxpayers who have been resting comfortably that their corporations are not associated because of the reasoning in *McGillivray*, such positions will need to be revisited. Arguably, proposed subsection 256(5.11) may cause the concept of *de facto* control to be even broader than it was pre-*McGillivray*.

6. <u>Canadian Exploration Expense: oil and gas discovery wells and change to renunciation</u>

Drilling and completion expenses in respect of successful discovery wells (or for building a temporary access road to, or preparing a site in respect of, any such well) are currently classified as CEE and eligible for 100% deduction in the year incurred. Under the Budget, such expenses incurred after 2018 will instead be treated as CDE eligible only for 30% deductibility on a declining-balance basis. Additionally, the reclassification of the first $1 million of expenses renounced to flow-through share investors as CEE rather than CDE will be no longer be allowed under the proposal.

This proposed change to the deductibility of drilling expenses comes at a particularly bad time for the oil and gas industry which has been plagued by prolonged low commodity prices, and any measure which reduces the incentive to drill is a hurtful blow to an already struggling industry. While flow-through share agreements, which allow corporations to renounce expenses to investors for use in reducing their own taxable income, may be less commonly used today than in the past, reducing the attractiveness of these investment vehicles adversely impacts the ability for junior oil and gas firms to find critical investment dollars.

Within the budget documents this measure is justified in part as one that:

..supports Canada's international commitments to phase out inefficient fossil fuel subsidies and indirectly supports the targets and actions in the Federal Sustainable Development Strategy, including those relating to reducing emissions of greenhouse gases.

While the direct impact of these proposed measures to the industry may not be terribly significant, it seems the underlying message to producers may be that the oil and gas industry in Canada is no longer open for business.

7. <u>Changes to tuition, disability, infirm dependent, caregiver, family caregiver and transit pass credits</u>

Beyond what was mentioned in the executive summary above, we have no material comments other than the consolidation of the various caregiver credits are welcome as is the elimination of the transit pass credit. We believe the elimination of many of the "boutique" personal tax credits assists with simplification of *the Act* and related administration. With respect to the expansion of the tuition credits to certain additional occupational courses, well, sure, why not.

8. <u>Corporate and beneficial ownership transparency</u>

Many jurisdictions around the world are in the midst of updating their laws to require more transparency regarding the ownership of corporations and trusts, in order to prevent inappropriate cash flows and behaviors. For example, a number of European countries have put forward proposals requiring "trust registers" whereby certain trusts must publicly disclose their beneficiaries. The United States has recently, in certain jurisdictions, required more disclosure on LLCs so as to ensure money laundering is not being facilitated through various real estate acquisitions. One could debate forever the pros vs. cons of such initiatives, and many practitioners and academics have in recent years. The Budget documents reveal the following:

The Government of Canada is committed to implementing strong standards for corporate and beneficial ownership transparency that provide safeguards against money laundering, terrorist financing, tax evasion and tax avoidance, while continuing to facilitate the ease of doing business in Canada. Understanding the ownership and control of corporations is vital for good corporate governance and to protect the integrity of the tax and financial systems.

The Government will collaborate with provinces and territories to put in place a national strategy to strengthen the transparency of legal persons and legal arrangements and improve the availability of beneficial ownership information.

The Government is also examining ways to enhance the tax reporting requirements for trusts in order to improve the collection of beneficial ownership information. These actions will ensure that law enforcement and other authorities have timely access to the information needed to crack down on money laundering, terrorist financing and tax evasion and to combat tax avoidance.

Standby… these changes could be a material shift in the Canadian disclosure landscape for corporations and trusts, but until we see the results of such efforts and study by the government, there is not much to comment on.

9. Cash purchase tickets for farmers

The Budget documents aptly describe the proposed changes as follows:

When a farmer delivers a listed grain (i.e., wheat, oats, barley, rye, flaxseed, rapeseed or canola) to the operator of a licensed elevator, the operator may issue to the farmer a cash purchase ticket or other prescribed form of settlement. 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 (a "deferred cash purchase ticket"), the taxpayer includes the amount of the ticket in income in that following year. The treatment of deferred cash purchase tickets that are issued in respect of deliveries of listed grains is a departure from the general rule with respect to taxpayers (including other farmers) who are required to include the amount of a security or other evidence of indebtedness received as payment of a currently-payable debt in income in the year in which it is received.

The historical rationale for the tax deferral for cash purchase tickets in respect of listed grains relates to international grain shipment agreements and the Canadian Wheat Board's former position as the sole purchaser of listed grain in Manitoba, Saskatchewan, and Alberta. With the deregulation of the grain marketing regime and commercialization of the Canadian Wheat Board, the delivery of the listed grains is now the responsibility of private business rather than the federal government. As a result, there is arguably no longer a clear policy rationale for maintaining the tax deferral accorded to deferred cash purchase tickets received as payment for listed grains.

Budget 2017 launches 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 this tax deferral, including any appropriate transitional period or rules. The Government invites interested parties to submit comments by May 24, 2017. Please send your comments to consultation_tax_2017@canada.ca.

Farmers who may be affected by any proposed change may wish to contribute comments to the consultation.

10. Increased funding to the Canada Revenue Agency

The Budget documents announced the increased funding to the CRA as follows:

Budget 2017 will invest an additional $523.9 million over five years to prevent tax evasion and improve tax compliance. The investment will be used to fund new initiatives and extend existing programs that ensure our tax system is fair and equitable for all Canadians.

The measures in Budget 2017 will build on previous investments to support the CRA in its continued efforts to crack down on tax evasion and combat tax avoidance by:

- *Increasing verification activities.*
- *Hiring additional auditors and specialists with a focus on the underground economy.*
- *Developing robust business intelligence infrastructure and risk assessment systems to*

target high-risk international tax and abusive tax avoidance cases.

- *Improving the quality of investigative work that targets criminal tax evaders.*

The government has been expanding its investment in tax enforcement for the last couple years, and this is consistent with that trend. Taxpayers should expect to hear more from their friendly neighborhood CRA agent going forward.

While I've never been accused of promoting bigger government, conceivably a commensurate increase to the budget of the Tax Court of Canada and Department of Justice will also be necessary. Inevitably, the increased enforcement by the CRA will also drive activity for these already over-burdened institutions.

CONCLUDING COMMENTS

The 2017 federal budget can be characterized as a "light" tax budget without much meat on the bone for tax practitioners to chew on; however, the changes to the deductibility of drilling expenses is worrisome – particularly for us here in Alberta. The consultation paper that will be released in the coming months regarding private corporations is definitely of concern. The professional community will be very concerned about the change in the taxation of WIP… this will impact many professionals negatively in the short term. While we are happy that there were no changes in capital gains inclusion and tax rates, we believe "meatier" changes are likely to come as the government continues to review "tax expenditures" as a result of its recently released study. Stay tuned… the tax world is exciting!