March 22, 2017

Canadian Budget 2017

On March 22, 2017 ("**Budget Day**"), the Honourable William Francis Morneau, Canada's Minister of Finance, tabled Canada's annual federal budget ("**Budget 2017**"). Importantly, Budget 2017 does not increase the capital gains inclusion rate nor does it introduce any rules targeted at the use of private corporations to reduce or defer tax. Instead, Budget 2017 proposes to build on the current Government's previous actions, and to introduce targeted investments aimed at fostering economic growth and benefitting the middle class.

Specifically, Budget 2017 proposes to close tax loopholes and strengthen the integrity of the tax system by implementing the following initiatives:

- preventing the avoidance of deferral of income tax through the use of offsetting derivative positions in straddle transactions;
- extending anti-avoidance rules applicable to RRSPs and TFSAs to RESPs and RDSPs;
- clarifying the meaning of *de facto* or factual control for purposes of determining who has control of a corporation; and
- preventing the avoidance of tax on income from the insurance of Canadian risks by extending the foreign-affiliate base erosion rules to foreign branches of Canadian life insurers.

Budget 2017 also pledges to invest an additional $523.9 million over five years to prevent tax evasion and improve tax compliance.

Finally, Budget 2017 signals the Government's commitment to implementing strong standards for corporate and beneficial ownership transparency and improving the availability of beneficial ownership information for legal persons and legal arrangements, including trusts. However, Budget 2017 does not indicate what substantive changes will be implemented, only that the Government will work with Provinces and Territories to establish a national strategy.

STUDY ON THE USE OF PRIVATE CORPORATIONS IN TAX PLANNING

Budget 2017 indicates that there are tax planning strategies using private corporations, which can benefit high-income individuals, and refers to the following three strategies as examples:

(i) using private corporations to sprinkle income (via dividends and capital gains) among family members (who may be subject to tax at lower rates);

(ii) holding a passive investment portfolio inside a private corporation so as to benefit from lower corporate income tax rates (although not stated, presumably in a manner so as to avoid the application of the additional refundable tax on aggregate investment income); and

(iii) converting regular income into capital gains.

The use of these planning strategies is under review, as is whether there are features of the current system that have an adverse impact on genuine business transactions involving family members. Budget 2017 indicates that the federal government will release a paper in the coming months setting out the nature of these issues and its proposed policy responses. No further information is provided.

BUSINESS INCOME TAX MEASURES

Investment Fund Mergers

Conversion of Mutual Fund Switch Corporation into Multiple Mutual Fund Trusts

Budget 2017 proposes to extend the mutual fund merger rules (which currently permit two mutual fund trusts to be merged on a tax-deferred basis or a mutual fund corporation to be merged into a mutual fund trust) to facilitate the reorganization of a mutual fund corporation that is structured as a “switch” fund (typically such corporations have multiple classes of shares, each tracking a distinct investment fund) into multiple mutual fund trusts on a tax-deferred basis. Qualification for the deferral will require that all or substantially all of the assets allocable to a particular class of shares be transferred to a particular mutual fund trust and that the shareholders of the class become unitholders of that mutual fund trust.

This measure will apply to qualifying reorganizations that occur on or after Budget Day.

Segregated Fund Mergers

Budget 2017 proposes to allow insurers to effect tax-deferred mergers of segregated funds on a basis that is consistent with the mutual fund merger rules. In addition, it is proposed that segregated funds be able to carry over non-capital losses that arise in taxation years beginning after 2017 to other taxation years that begin after 2017, subject to the usual restrictions and limitations for carrying non-capital losses forward and back.

This measure will apply to mergers carried out after 2017 and to losses arising in taxation years that begin after 2017.

Timing of Gains and Losses on Derivative Transactions

Elective Use of the Mark-to-Market Method

Responding to the Federal Court of Appeal’s (“**FCA**”) decision in *Kruger Inc. v. R.*, 2016 FCA 186 and the uncertainty surrounding the use of the mark-to-market rules by ordinary taxpayers in respect of certain property held on income account, Budget 2017 proposes to introduce an elective mark-to-market regime for taxpayers in respect of derivatives held on income account.

In *Kruger*, the FCA permitted a non-financial institution taxpayer to use mark-to-market accounting in computing its income from its dealings in foreign exchange options on the basis of the accurate picture of profit framework set out by the Supreme Court of Canada in *Canderel Ltd. v. R.*, 98 D.T.C. 6100 (SCC).

Budget 2017 proposes to allow taxpayers to elect to mark-to-market all of their “eligible derivatives” by filing an election in prescribed form. Once the election is made, it will apply to all eligible derivatives of the taxpayer and will remain in effect for all subsequent years unless it is revoked with Ministerial consent. If the election is made and the taxpayer is a financial institution within the meaning of subsection 142.2(1) of the *Income Tax Act* (Canada) (the “**Tax Act**”), the mark-to-market rules in section 142.2 will apply to the taxpayer’s eligible derivatives. If the taxpayer is not a financial institution, the taxpayer will be deemed to have disposed of its eligible derivatives for an amount equal to the fair market value thereof at the end of each taxation year and to have reacquired them at the same amount. Recognition of any accrued gain or loss on an eligible derivative as at the beginning of the first election year is deferred or suspended until the particular derivative is disposed.

An eligible derivative is generally defined to mean a swap agreement, forward purchase or sale agreement, forward rate agreement, futures agreement, option agreement or similar agreement if:

(i) it is not a capital property, a Canadian resource property, foreign resource property or an obligation on account of capital;

(ii) either the taxpayer has produced audited financial statements in accordance with GAAP or the agreement has a readily ascertainable fair market value; and

(iii) it is not a tracking property (other than certain excluded property) that is held by a financial institution as those terms are defined in subsection 142.2(1) of the Tax Act.

If the election is not made by a taxpayer (other than a financial institution), the measure clarifies that the taxpayer may not use a method similar to a mark-to-market method to compute its profits from, in general terms, an eligible derivative.

This election will be available for taxation years that begin on or after Budget Day.

Straddle Transactions

Budget 2017 proposes to introduce a specific anti-avoidance rule that targets straddle transactions. A new stop-loss rule will defer the realization of any loss on the disposition of a “position” to the extent of any unrealized gain on an “offsetting position.”

A straddle transaction might be entered as follows: A taxpayer might enter into two or more positions in respect of an investment (often derivatives) that are expected to generate equal and offsetting gains and losses. The taxpayer would close out its position with the accrued loss shortly before the end of a taxation year and close out the position with the accrued gain shortly after the beginning of the next taxation year. The loss would be applied to any current year income while recognition of the gain would be deferred to the following year. Successive straddle transactions might then be entered into in order to defer recognition of the gain indefinitely.

A "position" is defined as one or more properties, obligations or liabilities that is a share, partnership interest, trust interest, commodity, foreign currency, derivative (swap, forward, future, option and similar), foreign denominated debt, most convertible debt, certain prescribed debt obligations, certain lending arrangements and interests in substantially all of the foregoing where it is reasonable to conclude that, if there is more than one property, each of them is held in connection with each other.

An "offsetting position" is generally defined to mean one or more positions held by the taxpayer, a non-arm's length or affiliated person or any combination thereof (a "connected person"), that would have the effect of eliminating all of the holder's risk of loss and opportunity for gain or profit in respect of the particular position and, where held by a connected person and not by the taxpayer, can reasonably be considered to have been held for such intended purpose.

The stop-loss rule will not apply to a position:

(i) held by a financial institution (as defined in the mark-to-market property rules), mutual fund trust or mutual fund corporation;

(ii) that is a capital property of the taxpayer;

(iii) that is part of certain types of hedging transactions entered into in the ordinary course of the taxpayer's business (including debt incurred in the course of an operating business or commodities that the holder of the position manufacturers, produces, draws, extracts or processes);

(iv) that is part of a transaction or series of transactions, none of the main purposes of which is to defer or avoid tax; or

(v) where the offsetting position continues to be held throughout the 30-day period beginning on the date of disposition of the position and, at no time during that period, is the taxpayer's risk of loss or opportunity for gain or profit with respect to the position materially changed by another position that is entered into or disposed of, or would be if the other position were entered into or disposed of.

This measure would apply to any loss realized on a position on or after Budget Day.

Meaning of Factual Control

Budget 2017 proposes an expanded definition of *de facto* control of a corporation (i.e. where a corporation is controlled, directly or indirectly, in any manner whatever) in the form of proposed subsection 256(5.11) of the Tax Act. This proposal is in response to and a rejection of the FCA's recent decision in *McGillivray Restaurant Ltd. v. R.*, 2016 FCA 99. In *McGillivray*, the FCA concluded that a factor that does not 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, ought not to be considered as having the potential to establish *de facto* control.

Budget 2017 proposes that when determining whether a taxpayer has any direct or indirect influence which could, if exercised, result in *de facto* control of a corporation, it is necessary to take into consideration "all factors that are relevant in the circumstances." Moreover, the new proposed rule provides that this influence is not limited to, and that the relevant factors to be considered in determining its existence need not include, a legally enforceable right or ability held by the taxpayer to effect a change in the corporation's board of directors or the board's powers or any ability to exercise influence over the shareholder or shareholders who have such right or ability.

Consequently, the absence of any legally enforceable right or ability held by a taxpayer or significant influence exercisable by a taxpayer over a corporation's shareholders will not, in and of itself, preclude the finding of *de facto* control held by that taxpayer. Among other things, the interplay of this legislatively broadened scope of *de facto* control with the relatively recently enacted rules in respect of "specified corporate income" in subsection 125(7) of the Tax Act should be considered. Corporate structures which were implemented in part to avoid association through common *de facto* control should also be re-examined.

Billed-Basis Accounting (WIP) for Certain Professionals

Budget 2017 contains measures to eliminate the ability of taxpayers who earn business income from certain professional practices (i.e. accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) to recognize income inclusions for work-in-progress ("**WIP**") when the work is billed. Currently, paragraph 34(a) of the Tax Act allows taxpayers who earn income from these designated professional practices to opt-out of accrual basis accounting for WIP. Subsections 10(4) and (5) of the Tax Act provide that taxpayers who have WIP in respect of which no election has been made under paragraph 34(a) must include the value of that WIP into their income for the taxation year in which the WIP is created.

Budget 2017 proposes to amend paragraph 34(a) of the Tax Act to limit its application to taxation years which begin before Budget day. The proposed amendments also provide for a transitional rule in proposed subsection 10(14.1) of the Tax Act so that taxpayers who no longer qualify for the deferred income inclusion are given one taxation year in which only half of the value of unbilled WIP is included in the taxpayer's income. Accordingly, designated professionals carrying on business through a professional corporation should be careful not to undertake any transaction(s) that could bring about a deemed year-end in respect of the transitional year.

Miscellaneous Business Tax Measures

- <u>Class 43.1 and 43.2 – Geothermal Equipment</u>. Applicable in respect of property acquired for use on or after Budget Day (or not used or acquired for use prior), Budget 2017 proposes the expansion of Class 43.1 and 43.2 clean energy depreciable property to include geothermal equipment used primarily for the purposes of generating heat or the cogeneration of heat and electricity, label geothermal heating as an eligible thermal energy source for use in a district energy system, and ensure expenses incurred for the purposes of determining the extent and quality of a geothermal resource and drilling costs qualify as a Canadian renewable and conservation expense.

- Reclassification of Oil & Gas Discovery Well Costs. Applicable to expenses incurred after 2018, but not expenses actually incurred before 2021 if the taxpayer entered into a written commitment before Budget Day to incur those expenses, Budget 2017 proposes that expenditures related to drilling or completing a discovery well generally be classified as a Canadian development expense (which may be deducted at a rate of 30% on a declining balance basis) instead of a Canadian exploration expense (which may be fully deducted in the year incurred).

- Reclassification of Certain Oil and Gas Expenditures Renounced to Flow-Through Shareholders. Budget 2017 proposes to prohibit eligible small oil and gas corporations from treating the first $1 million of any Canadian development expense as a Canadian exploration expense, thereby impacting the classification and treatment of such expenses if renounced to flow-through shareholders. This measure will apply after 2018, 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 Budget Day.

- Elimination of additional deduction for gifts of medicine made on or after Budget Day.

- Elimination of investment tax credit for costs incurred on or after Budget Day to build or expand child care spaces in child care facilities.

- Elimination of tax exemption for insurers of farming and fishing property for taxation years beginning after 2018.

INTERNATIONAL TAX MEASURES

OECD BEPS Project and the Multilateral Instrument

Budget 2017’s update on the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project is sparse. Budget 2017 summarizes certain of the measures already implemented or underway (e.g. enactment of country-by-country reporting rules for large multinational enterprises, a commitment to improve the mutual agreement procedure in tax treaties, the spontaneous international exchange of tax rulings, and the exchange of information between tax authorities starting in 2018). In regard to the recently developed multilateral instrument to streamline the implementation of tax treaty-related BEPS recommendations, Budget 2017 simply notes that Canada participated in its development and that the Government is pursuing signature of the instrument and will undertake the necessary domestic action to do so. More detail in this regard would have been welcome given that the multilateral instrument contains tremendous optionality and approaches among numerous mandatory and permissive provisions which require a “match” between two jurisdictions before an existing treaty between those two jurisdictions would be altered. Budget 2017 does not signal whether the Government has any particular preference between one option or another or otherwise provide any timelines.

With respect to certain other BEPS recommendations, Budget 2017 notes that Canada already has a robust controlled foreign affiliate regime that prevents the shifting of income to foreign subsidiaries, has implemented disclosure requirements in respect of specific tax avoidance transactions, and is already applying revised international guidelines on transfer pricing.

Extension of Foreign Affiliate Base Erosion Rules to Foreign Branches of Life Insurers

Budget 2017 proposes to 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 where 10 per cent or more of the gross premium income (net of reinsurance ceded) earned by the foreign branch is premium income in respect of Canadian risks. In addition, the anti-avoidance rules under the foreign accrual property income (FAPI) regime in respect of "insurance swaps" or the ceding of Canadian risks will be extended to foreign branches of life insurers and new anti-avoidance rules will be introduced to target the insurance of foreign risk by a life insurer that is part of a transaction or series of transactions one of the purposes of which was to avoid the proposed rule by treating the life insurer as if it had insured Canadian risk.

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

PERSONAL INCOME TAX MEASURES

Anti-avoidance Rules for Registered Plans

Budget 2017 introduces a number of anti-avoidance rules for registered education savings plans (**"RESPs"**) and registered disability savings plans (**"RDSPs"**) which parallel the advantage, prohibited investment and non-qualified investment rules currently applicable to registered retirement savings plans ("**RRSPs**"), registered retirement income funds ("**RRIFs**") and tax-free savings accounts ("**TFSAs**").

The advantage rules are generally designed to prevent taxpayers from exploiting the tax attributes of a registered plan. A benefit or other amount treated as an advantage is taxed at 100%. The "controlling individual" (i.e. the holder, subscriber or annuitant) of a registered plan is generally liable to pay the tax. These rules will also now apply to RESPs and RDSPs.

The prohibited investment rules impose a tax on the controlling individual where an investment held in a registered plan is a "prohibited investment." "Prohibited investments" are generally comprised of non-arm's length (or nearly non-arm's length) securities (e.g. debt issued by the controlling individual, shares of a corporation in which the controlling individual has a significant interest, etc.). Where a prohibited investment is acquired by a registered plan, the controlling individual faces a punitive tax equal to 50% of the fair market value of the prohibited investment. Currently, this regime only applies to TFSAs, RRSPs and RRIFs. Budget 2017 proposes to extend the application of these rules to RESPs and RDSPs.

RRSPs, TFSAs and RRIFs are taxable on the acquisition of and on income earned from non-qualified investments. Budget 2017 proposes to apply the non-qualified investment rules in a consistent manner to RESPs and RDSPs.

The newly-expanded rules will apply to investments acquired after Budget Day and transactions occurring on or after Budget Day (income generated on or after Budget Day from an investment acquired before Budget Day is considered to be a "transaction occurring" on or after Budget Day), subject to the following exceptions: (i) the advantage rules will not apply in respect of a swap transaction that has taken place before July 2017, (ii) a swap transaction which is undertaken to "purify" a RESP or RDSP of prohibited investments or advantages is permitted until the end of 2021, and (iii) where certain conditions are met, an election can be made by April 1, 2018 to pay Part I tax on distributions of investment income from an investment which became a prohibited investment on Budget Day, rather than be subject to the 100% advantage tax.

Miscellaneous Personal Tax Measures

Budget 2017 proposes the repeal, amendment and addition of numerous credits, personal programs and other measures:

- add "nurse practitioners" to the list of medical professionals who can certify an individual's eligibility for the disability tax credit;
- amend the medical expense tax credit to deem expenses incurred by individuals to conceive a child to be medical expenses incurred on account of a medical condition which renders the individual incapable of conceiving a child;
- consolidate the Infirm Dependant Credit, the Caregiver Credit and the Family Caregiver Credit into one new 15% non-refundable credit;
- reiterate the Government's commitment to extend eligibility for the mineral exploration tax credit to flow-through arrangements entered into on or before March 31, 2018;
- propose that employers be allowed to distribute T4 Information Slips solely by electronic means;
- extend the eligibility criteria for the tuition tax credit for non-post-secondary level occupational programs;
- delay the repeal of the National Child Benefit supplement reference in the Canada Child Benefit rules in the Act until July 1, 2018;
- render the transferee of an ecological gift who changes the use of the subject property or disposes of the subject property without the consent of Environment and Climate Change Canada liable to pay a 50% tax on the fair market value of the subject property;
- eliminate the public transit tax credit, effective as of July 1, 2017;
- eliminate the non-taxability of non-accountable allowances for certain public officials effective as of January 1, 2019; and
- eliminate the Home Relocation Loans Deduction for benefits arising in the 2018 and subsequent taxation years.

PREVIOUSLY ANNOUNCED MEASURES

Budget 2017 confirms the intention of the Government to proceed with the following tax measures, as modified since their initial release:

- amendments to the capital gains exemption in respect of the sale of a Principal Residence;
- new information-reporting requirements for dispositions of an interest in a life insurance policy; and
- other legislative and regulatory proposals relating to: (1) the September 16, 2016 income tax technical amendments; and (2) GST/HST, including the GST/HST Joint Venture Election.

SALES AND EXCISE TAX MEASURES

- Effective as of July 1, 2017, the definition of a taxi business is amended to require providers of ride-sharing services (e.g., Uber or Lyft drivers) to register for the GST/HST and charge tax on their fares. This measure ensures that ride-sharing services are treated in a similar manner to traditional taxi businesses for GST/HST purposes.
- Repeal the GST/HST rebate available to non-residents for GST/HST payable in respect of the accommodation portion of eligible tour packages.
- Effective as of March 22, 2016, to add Naloxone and its salts (which may be used to treat opioid overdoses) to the list of GST/HST-free non-prescription drugs. However, this amendment does not apply to a supply of Naloxone made before Budget Day, for which GST/HST was charged, collected, remitted or paid.
- Elimination of the 10.5% tobacco manufacturer's surtax coupled with an increase of the excise duty rate on cigarettes and other tobacco products.
- 2% increase on the excise duty rates on alcohol products with increases indexed to the Consumer Price Index on April 1 of each year starting in 2018.

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