April 21, 2015

Canadian Budget 2015

Seeking the Comfort and Support of "New Balance"

The Department of Finance (Canada) tabled its annual budget on April 21, 2015 (the "**Budget 2015**"). Normally released in February or early March, the Department of Finance (Canada) deferred its release until spring to give it an opportunity to take stock of the immediate and long-term impact of declining oil prices on the Canadian economy (e.g. federal revenues). Some might suggest the deferral was necessary to give the Government an opportunity to revise its course given a promise to produce in 2015 its first balanced budget in eight years (it was not clear whether Finance Minister Oliver was ferried to Parliament in a General Motors vehicle or whether it, too, was sold). As is the tradition, the Minister of Finance tabled the budget sporting newly acquired shoes; in this case a pair of "New Balance" running shoes.

Below is a summary of some of the key personal, business and international income tax measures proposed or discussed in Budget 2015.

BUSINESS MEASURES

Accelerated Capital Cost Allowance for Manufacturing and Processing

Budget 2015 proposes an accelerated capital cost allowance rate of 50 per cent for eligible assets (generally machinery and equipment) acquired by a taxpayer after 2015 and before 2026 primarily for use in Canada for the manufacturing and processing of goods for sale or lease. The deduction is available on a declining balance basis and the normal "half-year" rule will apply.

Decrease to the Small Business Tax Rate and Corresponding Adjustment to Gross-Up and Dividend Tax Credit Rates

Budget 2015 proposes a 2 percentage point decrease in the small business tax rate from 11 per cent in 2015 to 9 per cent in 2019. The reduction will be implemented as follows:

- 10.5 per cent effective January 1, 2016
- 10 per cent effective January 1, 2017
- 9.5 per cent effective January 1, 2018
- 9 per cent effective January 1, 2019

In conjunction with such reductions, Budget 2015 also proposes to adjust the gross-up factor and dividend tax credit rate applicable to non-eligible dividends (basically, dividends sourced from corporate income that is taxed at the small business rate). The gross-up percentage will be decreased from 18 per cent in 2015 to 17 per cent in 2016 and 2017, 16 per cent in 2018 and 15 per cent in 2019 and thereafter. The corresponding dividend tax credit rate will be changed from 13/18 of the gross-up amount to 21/29 effective January 1, 2016, 20/29 effective January 1, 2017 and 9/13 of such amount effective January 1, 2019. The budget indicates that such adjustments are necessary in order to maintain (or at least attempt to achieve) the integration of the corporate and personal tax systems. However, there will not be appropriate integration for non-eligible dividends paid after 2015 from retained earnings that arose in previous taxation years.

Denial of Inter-Corporate Dividend Deduction in respect of "Synthetic Equity Arrangements"

Subject to certain exceptions, inter-corporate dividends are generally received by a Canadian corporate shareholder from a taxable Canadian corporation tax-free (technically, the corporate shareholder may claim a deduction in computing taxable income equal to the full amount of the dividend so received). One exception to the inter-corporate dividend deduction is in respect of a dividend that is received as part of a "dividend rental arrangement".

In very general terms, a "dividend rental arrangement" is an arrangement entered into by a person whose main reason for entering into the arrangement was to receive a dividend on a share with respect to which another person bears the risk of loss or enjoys the opportunity for gain in any material respect.

Under a typical dividend rental arrangement, a corporation would purchase dividend-yielding stock from a counterparty. Following the payment of a dividend on such shares, the taxpayer would resell the shares to the original owner at a price based on the shares' market value as at the time of the original sale. Accordingly, no gain or loss would accrue to the taxpayer in respect of the shares and, in the absence of this exception, the taxpayer would receive the dividend on the shares tax-free.

Budget 2015 highlights a concern that some taxpayers (typically financial institutions) are entering into derivative transactions ("**synthetic equity arrangements**") whereby the taxpayer retains the legal ownership of an underlying Canadian share, but in which all or substantially all of the risk of loss and opportunity for gain in respect of the share is transferred to a counterparty. Under such an arrangement, the taxpayer is required to transfer the economic benefit of any dividends on the shares by making "dividend-equivalent payments" to the counterparty. By taking the position that the above-noted dividend rental arrangement rule does not apply, the taxpayer realizes a loss on the arrangement by claiming the inter-corporate dividend deduction to offset the dividend included in income while also deducting the amount of the dividend-equivalent payment made to the counterparty in computing its income. Budget 2015 notes that these arrangements have the potential to significantly erode the Canadian tax base in circumstances where the counterparty to the arrangement does not pay any Canadian income tax on the dividend-equivalent payments received (i.e. tax-exempt Canadian entities and non-resident persons, referred to as "**tax-indifferent investors**").

Budget 2015 proposes to modify the dividend rental arrangement rules to deny the inter-corporate dividend deduction for dividends received by a taxpayer on a Canadian share in respect of which the taxpayer (or a non-arm's length person) has entered into one or more agreements that have the effect of transferring all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share to another person (a "synthetic equity arrangement"). The definition will not include agreements that are traded on a recognized derivatives exchange unless it can reasonably be considered that the taxpayer knows, or ought to know, the identity of the counterparty to the agreement.

Recognizing that erosion to the Canadian tax base will only likely occur where the counterparty is a tax-indifferent investor, Budget 2015 proposes an exception to the denial of the inter-corporate dividend deduction where the taxpayer can establish that the counterparty is not a tax-indifferent investor. A taxpayer will be presumed to qualify for this exception where it obtains representations from its counterparty that it is not a tax-indifferent investor *and* either: (i) does not reasonably expect to eliminate all or substantially all of its risk of loss and opportunity for gain on the share, or (ii) has transferred such risk or opportunity to its own counterparty and has obtained such representations from that counterparty.

A supporting anti-avoidance measure will be introduced to deem certain agreements that do not meet the definition of synthetic equity arrangement to be dividend rental arrangements if such agreements eliminate a taxpayer's risk of loss or opportunity for gain in respect of a share in circumstances where the purposes of a series of transactions that includes such agreement is to avoid this measure.

This measure will apply to dividends that are paid or become payable after October 2015.

Alternative Proposal

Budget 2015 notes that, from a policy perspective, a case can be made that a precondition for the inter-corporate dividend deduction should be that the shareholder bear the risk of loss or enjoy the opportunity for gain in respect of the share. Accordingly, the Government has invited stakeholders to comment on whether an alternative proposal could be supported that would deny the inter-corporate dividend deduction in respect of *all* synthetic equity arrangements, regardless of the status of the counterparty. This would seem to be inappropriate where a taxable Canadian counterparty is required to include the dividend-equivalent payment in income. Comments on this alternative proposal are due by August 31, 2015. The alternative proposal, if adopted, will not apply until the results of the consultation process are announced.

Revisions to Capital Gains Stripping Rules – Subsection 55(2)

Budget 2015 proposes the expansion of the existing anti-avoidance rule in subsection 55(2). Subsection 55(2) applies to convert what otherwise would be a tax-free inter-corporate dividend into a capital gain where one of the purposes of the dividend (or one of the results, in the case of a deemed dividend arising on a redemption of shares) is to effect a significant reduction in the capital gain that would otherwise be realized on the disposition of any share at its fair market value. A dividend is not subject to conversion under subsection 55(2) in certain circumstances including to the extent the dividend is attributable to the safe income on hand of the shares on which it is paid.

The Government considers the same tax policy concern to arise where dividends are paid on a share not to reduce a capital gain but instead to cause the fair market value of a share to be reduced below its cost or the total cost of properties held by the dividend recipient to be increased. In such circumstances, the unrealized loss created by the payment of the dividend could be applied to offset an unrealized capital gain on another property.

Budget 2015 proposes to amend subsection 55(2) so that it will apply where one of the purposes of the payment or receipt of the dividend is to cause: i) a significant reduction in the fair market value of a share, or ii) a significant increase in the total cost of properties held by the dividend recipient. The proposed measures will also ensure that stock dividends cannot be used in a manner which would circumvent the rules, as occurred in the case of *D&D Livestock v. The Queen,* (2013 TCC 318), where a stock dividend paid by a parent out of safe income partly derived from the safe income of a subsidiary company was determined not to have reduced the safe income on hand of the shares of the subsidiary.

In addition, the application of the exception in paragraph 55(3)(a) for certain dividends paid between related parties will be restricted and will only apply to deemed dividends arising on a redemption, acquisition or cancellation of shares.

This measure will apply to dividends received by a corporation on or after April 21, 2015.

Consultation re Specified Investment Business for Self Storage and Campgrounds

The small business deduction applies to active business income earned by a Canadian-controlled private corporation. For this purpose, an active business is defined to specifically exclude a "specified investment business", the principal purpose of which is to earn income from property unless the business has more than five full-time employees. Businesses such as self-storage facilities and campgrounds have argued that the application of these provisions is unfair. Budget 2015 announced a consultation as to the circumstances in which a business earning property income should be entitled to the benefit of the small business deduction.

Update on Consultation Regarding the Eligible Capital Property Regime

Budget 2014 announced a public consultation on the proposal to repeal the eligible capital property regime and replace it with a new capital cost allowance class. Budget 2015 announces the Government's intention to release detailed draft legislative proposals for stakeholder comments on these measures before their inclusion in a bill. No timeline has been provided.

INTERNATIONAL MEASURES

Update on "Treaty Shopping" and OECD BEPS Project

Budget 2014 introduced a proposed domestic rule designed to counteract planning undertaken to exploit the interaction between domestic and international tax rules to shift profits away from Canada on a tax-free or tax-reduced basis (e.g. treaty shopping, base erosion and profit shifting). The measure was introduced in the context of the Canada Revenue Agency's recent failures in the Courts to attack or otherwise deny the benefits of such planning and the work that had been done (and continues to be done) by the members of the Organization for Economic Co-operation and Development ("OECD") and the G-20 in issues identified in the OECD's

Action Plan on Base Erosion and Profit Shifting ("BEPS"). In August 2014, the Department of Finance (Canada) announced that it would no longer pursue the measures proposed in Budget 2014, but instead would wait to assess the outcome and conclusions reached as part of the BEPS project. Budget 2015 reiterates the Government's commitment to await the conclusion of the BEPS project and then proceed in the area "in a manner that balances tax integrity and fairness with the competitiveness of Canada's tax system". No timeline or suggestion of any other measures has been provided.

Relaxation of Withholding Obligations of Certain Non-Resident Employers

Budget 2015 proposes to relieve non-resident employers of the requirement to withhold income tax in respect of non-resident employees working in Canada in certain circumstances. Withholding will not be required by an employer resident in a country with which Canada has a tax treaty and which does not have a permanent establishment in Canada in respect of an employee who would be exempt from Canadian tax under a tax treaty and is not in Canada for more than 90 days in any 12 month period that includes the time of payment. The employer must receive certification by the Minister of National Revenue to benefit. The new rule will apply to payments made after 2015.

Simplification of Foreign Asset Reporting System

A simpler form of reporting will be implemented for taxpayers whose total cost of foreign assets is less than $250,000 throughout the year.

FAPI – Further Measures to Prevent the Shifting of Income from the Insurance of Canadian Risk (Captive Insurance)

Budget 2015 proposes to strengthen the anti-avoidance measures introduced in last year's budget aimed at insurance swaps which circumvented the rules in the FAPI regime intended to prevent Canadians shifting income from the insurance of Canadian risks (risks in respect of persons resident in, property situated in or businesses carried on in Canada) to foreign affiliates in lower-tax jurisdictions. Taxpayers had been using alternative structures to get around these rules. Under such arrangements, although the foreign affiliate did not have economic exposure to the Canadian risks, it received consideration with an embedded profit component in exchange for ceding its Canadian risks. Under the expanded rule, the income earned from the ceding of its Canadian risks will be included in the foreign affiliate's FAPI. The new rule will apply to taxpayer's taxation years which begin on or after April 21, 2015.

Update on the Automatic Exchange of Tax Information

Canada and the other G-20 countries have endorsed a common reporting standard developed by the OECD and have committed to putting in place the necessary legislative measures to permit the first exchange of information by 2017 or 2018. By July 1, 2017, Canada has proposed to start implementing the common reporting standard. Financial institutions are to have procedures in place by that date to identify accounts held by non-residents and to report the information to the Canada Revenue Agency. As exchange agreements are formalized with other jurisdictions, the bilateral and reciprocal exchange of information will begin. Draft proposals are expected to be released for comment in the near future.

PERSONAL AND GENERAL MEASURES

Increase of TFSA Limit to $10,000

Budget 2015 proposes to increase the TFSA annual contribution limit from $5,500 (originally $5,000 and indexed to inflation in $500 increments) to $10,000 as of January 1, 2015. The TFSA contribution limit will no longer be indexed to inflation.

Introduction of Home Accessibility Tax Credit

Budget 2015 proposes a new "Home Accessibility Tax Credit", a non-refundable credit of 15 per cent on up to $10,000 of eligible expenditures annually in respect of each qualifying individual (up to a maximum of $10,000 per eligible dwelling). Qualifying individuals are those who are 65 years of age or older and persons with disabilities who are eligible for the Disability Tax Credit. The credit may be claimed by the qualifying individual or a spouse, parent, grandparent, child, grandchild, brother, sister, aunt, uncle, niece or nephew of the qualifying individual provided that the qualifying individual lives with such person at such person's principal residence. Expenditures eligible for the credit include those that are of an enduring nature and integral to the eligible dwelling that allow the qualifying individual to gain access to, or to be mobile or functional within the dwelling, or reduce the risk of harm to the qualifying individual within the dwelling or in gaining access to the dwelling. The credit will apply in respect of eligible expenditures for work performed and paid for and/or goods acquired after 2015.

Amendment to RRIF Minimum Withdrawal Factors

Budget 2015 proposes to adjust the RRIF minimum withdrawal factors that apply in respect of ages 71 to 94, on the basis of 5 per cent nominal rate of return and 2 per cent indexing. The new factors will apply for the 2015 and subsequent taxation years.

Increase of the Lifetime Capital Gains Exemption in respect of Qualified Farm Property

Budget 2015 proposes to increase the lifetime capital gains exemption realized by an individual on the disposition of qualified farm or fishing property from $813,600 (originally $800,000 for 2014 and indexed to inflation) to apply to up to $1,000,000 of capital gains. This measure will apply to dispositions that occur on or after April 21, 2015.

Relaxing of the Repeated Failure to Report Income Penalty

A taxpayer who fails to report all of their income in a taxation year and who had failed to do so in any of its three preceding taxation years is liable to a penalty equal to 10per cent of the unreported income. Referred to as the failure to report income penalty, the consequences are, at times, disproportionate when compared to the actual associated tax liability (if any). Budget 2015 proposes to amend the repeated failure to report income penalty to apply in a taxation year only if a taxpayer fails to report at least $500 of income in the year and in any of the three preceding taxation years. The amount of the penalty will be the lesser of 10per cent of the unreported income and an amount equal to 50per cent of the difference between the understatement of tax (or overstatement of credits) and the amount of tax deducted or withheld in respect of the unreported amount. This measure will apply to the 2015 and subsequent taxation years.

Alternative Arguments in Support of Assessments

Budget 2015 proposes that the *Income Tax Act* (Canada) be amended to "clarify" that the Canada Revenue Agency and the courts may increase or adjust an amount included in an assessment that is under objection or appeal at any time, provided the total amount of the assessment does not increase. The budget indicates that the proposal comes as a response to a recent court decision which held that, while the basis of an assessment can be changed after the expiration of the normal reassessment period, each source of income is to be considered in isolation and the amount of the assessment in respect of any particular source of income cannot increase. This measure will apply in respect of appeals instituted after Royal Assent to the enacting legislation.

Charities – Donation of Certain Proceeds of Sale

Currently, the *Income Tax Act* (Canada) exempts capital gains arising on the donation of shares of publicly-listed companies from tax. In addition, the donation of ecologically sensitive land and certified cultural property to certain qualified donees does not result in capital gains tax. The charity sector has lobbied extensively for this exemption to be extended to donations of private company shares and real estate. Budget 2015 does not go as far as many hoped, but will exempt a donation of cash proceeds from the disposition of private company shares and real estate where cash proceeds from the disposition of the private company shares or real estate are donated to a qualified donee within 30 days after the disposition and private company shares or real estate are sold to a purchaser that is dealing at arm's length with both the donor and the qualified donee. The portion of the capital gain that will be exempt on the disposition will be determined by reference to the proportion that the cash proceeds donated is of the total proceeds from the disposition of the shares or real estate. Certain anti-avoidance rules will reverse the exemption in situations where, for example, within five years of the disposition, the donor (or a non-arm's length person) directly or indirectly reacquires the property, which was sold or, in the case of shares, acquires shares substituted for the shares which were sold or the shares that had been sold are redeemed and the donor does not deal at arm's length with the corporation at the time of the redemption. These measures will apply to donations arising from dispositions which take place after 2016.

Charities – Investments in Limited Partnerships

A registered charity, which is a charitable organization or public foundation, can carry on business only to the extent that it qualifies as a related business (that is to say, it is in support of and subordinate to its charitable purposes or it is run exclusively by volunteers) whereas private foundations are not permitted to carry on any business. As the legal definition of a partnership is one or more persons carrying on business in common with a view to profit, private foundations are precluded from holding an interest in a partnership. Budget 2015 will permit charities to hold an interest in a partnership and the interest will not be considered to be carrying on a business provided that the charity acts at arm's length with the general partner and the value of the interests held by the charity (together with non-arm's length persons) does not exceed 20per cent of the fair market value of all interests in the limited partnership. The non-qualifying security rules and the loanback rules that apply to donations of shares will also apply

to donations of interests in limited partnerships. These measures apply to investments in limited partnerships that are made or acquired on or after April 21, 2015.

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