

2016 Federal Budget analysis

The 2016 Federal Budget was tabled by the governing Liberal Party on Tuesday, March 22, 2016. It was the first for the new government of Justin Trudeau and for Finance Minister Bill Morneau.

This report and analysis was prepared from within the budget lock-up in Ottawa by Doug Carroll, Vice President of Tax and Estate Planning, Invesco Canada. As is our practice, we focus our report and analysis on the key issues that are relevant to personal taxation, financial planning, investment portfolios and related private corporation taxation.

As usually occurs in the weeks leading up to Budget Day, there were numerous rumours about what may be announced. As it turned out, many of those rumours - specifically the much-discussed increase to the capital gains inclusion rate - were nothing more than empty speculation.

Likewise, the expected limitations on the exercise of stock options received not a word of print. In fact, during Minister Morneau's address to the media lock-up, he stated that consultations within the industry demonstrated that stock options are a useful compensation tool and that any change "is not in the plan."

And while there were certainly measures directed at the use of corporations for income splitting by high-income individuals, they were not as broad as they might have been.

On the other hand, there was one very big surprise on the investment front, with a significant change to the taxation of fund switches within mutual fund corporations. But we'll begin with a recap of current federal income tax brackets.

1. Federal income tax brackets 2016

There were no changes to federal rates and income tax brackets, other than what was announced as the middle-class tax cut in December 2015. Following from the Liberal election promise, the second bracket rate was reduced from 22% to 20.5%, and a new 33% bracket was introduced for income over \$200,000. These are the federal income tax brackets and rates for 2016:

| Income from | Rate |
|-------------|-------|
| \$11,474 | 15.0% |
| \$45,282 | 20.5% |
| \$90,563 | 26.0% |
| \$140,388 | 29.0% |
| \$200,000 | 33.0% |

2. Mutual fund corporations - Tax on switching

Canadian mutual funds can be in the legal form of a trust or a corporation. While most funds are structured as mutual fund trusts, some are structured as mutual fund corporations. These latter types are also known as corporate class funds, as each fund is a class of share of the corporation.

Investors are able to exchange shares of one class of the mutual fund corporation for shares of another class, in order to switch their economic exposure between the mutual fund corporation's different funds. By making use of an *Income Tax Act* provision applicable to convertible corporate securities, this exchange is deemed not to be a disposition for income tax purposes.

Budget 2016 proposes to amend the *Income Tax Act* so that an exchange of shares of a mutual fund corporation that results in the investor switching between funds will be considered for tax purposes to be a disposition at fair market value.

The measure will not apply to switches between different series of shares within the same class where the shares received in exchange differ only in respect of management fees or expenses to be borne.

This measure will apply to dispositions of shares that occur after September 2016.

While tax measures of this nature are usually made effective on Budget Day, it would appear that the government is not content that investor-taxpayers would not be able to manipulate or circumvent the change. Accordingly, investors will have a few more months to rebalance before facing taxable dispositions.

3. Small business corporate tax rate

The small business corporate tax rate was 11% in 2015, and was scheduled to decline to 9% by 2019 in 0.5% increments. The current rate in 2016 is 10.5%.

Budget 2016 proposes that the small business tax rate remain at 10.5% after 2016. To maintain the integrity of corporate-personal tax integration, the current 17% gross-up factor and 21/29 dividend tax credit rate (DTC) rate applicable to non-eligible dividends (generally, dividends distributed from corporate income taxed at the small business tax rate) will remain as they are.

4. Consultation on active versus investment business

Budget 2015 announced a review of the circumstances under which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income and therefore potentially be eligible for the small business deduction. The consultation period ended August 31, 2015.

The examination of the active versus investment business rules is now complete. The government is not proposing any modification to these rules.

5. Multiplication of small business deduction

The small business deduction includes rules that are intended to preclude the multiplication of access to the deduction. Budget 2016 proposes changes to address concerns about partnership and corporate structures that multiply access to the small business deduction.

6. Corporations - Avoidance of the business limit and the taxable capital limit

There are a number of technical rules that apply for the purpose of determining if two or more corporations are associated with each other. Some Canadian-controlled corporations have been found to be misusing certain elections to multiply their small business deduction.

Budget 2016 proposes to amend the *Income Tax Act* to ensure that investment income derived from an associated corporation's active business will be ineligible for the small business deduction. This measure will apply to taxation years that begin on or after Budget Day.

7. Donation of real estate and shares of private corporations

Budget 2015 included a proposal to provide, beginning in 2017, an income tax exemption in respect of capital gains on certain dispositions of private corporation shares or real estate, where cash proceeds from the disposition are donated to a registered charity or other qualified recipient within 30 days.

Budget 2016 confirms that the government does not intend to proceed with this measure.

8. Families with young children

a. Canada Child Benefit (CCB)

The new CCB will provide a maximum benefit of \$6,400 per child under the age of six, and \$5,400 per child aged six through 17.

As adjusted family net income crosses the \$30,000 and \$65,000 thresholds, the benefit amount is gradually reduced. The phase-out percentage depends on the number of children in the household, as outlined in the following table:

CCB phase-out and adjusted family net income thresholds

| Number of children | Phase-out rates | |
|--------------------|-------------------|---------------|
| | \$30,000-\$65,000 | Over \$65,000 |
| 1 child | 7.0% | 3.2% |
| 2 children | 13.5% | 5.7% |
| 3 children | 19.0% | 8.0% |
| 4 or more children | 23.0% | 9.5% |

To recognize the additional costs of caring for a child with a severe disability, there will be an additional amount of up to \$2,730 per child eligible for the disability tax credit. The phase-out of this additional amount will be made to generally align with the CCB.

CCB payments under this measure will start in July 2016.

The CCB replaces the Universal Child Care Benefit (UCCB) and Canada Child Tax Benefit (CCTB), which will be eliminated after June 2016.

b. End of the family tax cut

Concurrently, the budget will eliminate the “family tax cut” introduced by the former Conservative government. This was the income splitting tax credit for couples with at least one child under the age of 18 for the 2016 and subsequent taxation years.

9. Phase out/eliminate children’s fitness and arts credits

Budget 2016 proposes to phase out the children’s fitness and arts tax credits by reducing the 2016 maximum eligible amounts to \$500 from \$1,000 for the children’s fitness tax credit (which will remain refundable for 2016). The children’s arts tax credit will be reduced from \$500 to \$250.

The supplemental amounts for children eligible for the disability tax credit will remain at \$500 for 2016. Both credits will be eliminated for the 2017 and subsequent taxation years.

10. Education

a. Teacher supply tax credit

Budget 2016 proposes to introduce a teacher and early childhood educator school supply tax credit. This measure will allow an employee who is an eligible educator to claim a 15% refundable tax credit based on an amount of up to \$1,000 in expenditures made by the employee in a taxation year for eligible supplies.

Eligible supplies would include consumable goods such as the following:

- construction paper for activities, flashcards or activity centres;
- items for science experiments, such as seeds, potting soil, vinegar, baking soda and stir sticks;
- art supplies, such as paper, glue and paint; and
- various stationery items, such as pens, pencils, posters and charts.

This measure will apply to supplies acquired on or after January 1, 2016.

b. Eliminate education and textbook credits, preserve tuition credit

Budget 2016 proposes to eliminate the education and textbook tax credits. This measure does not eliminate the tuition tax credit. Changes will be made to ensure that other income tax provisions - such as the tax exemption for scholarship, fellowship and bursary income - that currently rely on eligibility for the education tax credit, or use terms defined for the purpose of the education tax credit, will be unaffected by its elimination.

This measure will apply effective January 1, 2017. Unused education and textbook credit amounts carried forward from years prior to 2017 will remain available to be claimed in 2017 and subsequent years.

c. Enhanced Canada Student Grants by 50%

Budget 2016 proposes to increase Canada Student Grant amounts by 50%:

- from \$2,000 to \$3,000 per year for students from low-income families;
- from \$800 to \$1,200 per year for students from middle-income families; and
- from \$1,200 to \$1,800 per year for part-time students.

Increased grant amounts will be available for the 2016-17 academic year.

11. Seniors

Many of the provisions for seniors in the budget were already announced.

a. Old Age Security (OAS) to remain at 65

As announced by Prime Minister Trudeau the week before the budget, the OAS eligibility age will remain at 65.

b. Increased Guaranteed Income Supplement (GIS) for single seniors

Budget 2016 proposes to increase the GIS top-up benefit by up to \$947 annually for the most vulnerable single seniors starting in July 2016.

c. Seniors living apart

Amendments will be introduced to the *Old Age Security Act* that will ensure that couples who receive GIS and allowance benefits and have to live apart for reasons beyond their control (such as a requirement for long-term care) will receive higher benefits based on their individual incomes.

d. Pursuing enhancements to the Canada Pension Plan (CPP)

In December 2015, the government began discussions on enhancing the CPP with provinces and territories, with the goal of being able to make a collective decision before the end of 2016.

In the coming months, the government will launch consultations to give Canadians an opportunity to share their views on enhancing the CPP.

e. New Seniors Price Index

The government restated its commitment to ensuring that OAS and GIS benefits keep pace with the actual costs of living faced by seniors.

However, no further developments were announced regarding how and when the proposed Seniors Price Index will come about, other than that the government is looking at how this could be developed.

12. Other investment developments

a. Federal labour-sponsored venture capital corporations (LSVCC) federal tax credit reinstated

The LSVCC tax credit was reduced to 10% in 2015, 5% in 2016, and is scheduled to be eliminated for 2017 and later.

Where a province continues to allow registration of LSVCCs, the 15% federal tax credit will be reinstated for 2016 and later years.

b. Mineral exploration - Flow-through shares continued

Flow-through shares allow resource companies to renounce or “flow through” tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income.

Budget 2016 proposes to extend eligibility for the mineral exploration tax credit for one year, to flow-through share agreements entered into on or before March 31, 2017.

c. Sale of linked notes

A linked note is a debt obligation, most often issued by a financial institution, the return on which is linked in some manner to the performance of one or more reference assets or indices over the term of the obligation. The two main types of linked notes are principal-protected notes and principal-at-risk notes.

For some linked notes, investors sell them prior to the determination date to, in effect, convert the return on the notes from ordinary income to capital gains, only 50% of which are included in their income.

Budget 2016 proposes to amend the *Income Tax Act* so that the return on a linked note retains the same character whether it is earned at maturity or reflected in a secondary market sale.

13. Eligible capital property

Budget 2014 had announced a consultation on the conversion of eligible capital property (ECP) into a new class of depreciable property. This conversion will simplify the tax compliance burden for affected taxpayers.

A new class of depreciable property for capital cost allowance (CCA) purposes will be introduced. Expenditures that are currently added to cumulative eligible capital (at a 75% inclusion rate) will be included in the new CCA class at a 100% inclusion rate. Because of this increased expenditure recognition, the new class will have a 5% annual depreciation rate (instead of 7% of 75% of eligible capital expenditures).

14. Life insurance

a. Distributions from life insurance

Life insurance proceeds received as a result of the death of an individual insured under a life insurance policy (a “policy benefit”) are generally not subject to income tax.

A private corporation may add the amount of a policy benefit it receives to its capital dividend account, which in turn can be paid as a tax-free amount to shareholders. The income tax rules for partnerships also account for a policy benefit being non-taxable. Some taxpayers have structured their affairs so that the insurance benefit limit may not apply as intended.

Budget 2016 proposes to amend the *Income Tax Act* to ensure that the capital dividend account rules for private corporations, and the adjusted cost base rules for partnership interests, apply as intended. This measure will provide that the insurance benefit limit applies regardless of whether the corporation or partnership that receives the policy benefit is a policyholder of the policy.

b. Transfers of life insurance

Where a policyholder disposes of an interest in a life insurance policy to a non-arm’s length person, a special rule (the “policy transfer rule”) deems the policyholder’s proceeds of the disposition, and the acquiring person’s cost, of the interest to be the amount that the policyholder would be entitled to receive if the policy were surrendered.

The effect of this rule is that an amount paid by a corporation in excess of a policy’s surrender would not be taxed, and in turn the policy proceeds (on a later death) could come out tax-free from the corporation. A similar effect could apply in the context of the adjusted cost base of a partnership interest. In both cases, there is an unintended second-time access to a tax-free benefit.

Budget 2016 proposes amendments to the *Income Tax Act* to ensure that these amounts are not inappropriately received tax-free. The measure will apply to dispositions that occur on or after Budget Day.

For dispositions that occurred before Budget Day where the death occurs after Budget Day, the capital dividend account rules and partnership adjusted cost base rules will be amended to achieve a similar result as for post-Budget Day transfers.



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