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2016 Federal Budget: Key Tax Changes

Max Walker

The 2016 Federal Budget was released March 22nd. The overarching theme is to provide increased benefits and relief to middle-class individuals and to close or restrict cross-border tax planning. Highlights include:

Income Tax

Increased Individual Marginal Tax Rates

As part of Bill C-2 tabled on December 9, 2015, the federal government announced an increase to the top individual tax rate. The highest individual marginal tax rates for the 2016 tax year are to increase from 29% to 33%.

Mining Exploration Tax Credit for Flow-Through Share Investors

The tax credit available to flow-through shareholders in resource companies that incur Canadian exploration expenses has been extend by one year, and will apply to flow-through share agreements entered into prior to April 1, 2017.

Small Business Deduction

The small business tax rate will remain at 10.5% for the 2016 tax year.

Currently, the ability to multiply the use of the small business deduction has been limited in situations where one or more Canadian-controlled private corporations ("CCPCs") are not associated, but form a partnership such that each CCPC can access its own small business deduction.

The 2016 Budget proposes to broaden these rules by extending the partnership level notional limit to CCPCs that provide services or property to a partnership and that are non-arm's length with one or more members of the partnership.

Eligible Capital Property

The regime governing eligible capital property will be replaced with a new class of depreciable property under the capital cost allowance regime. The previous regime will be phased out starting on January 1, 2017.

Previously, one could include 75% of eligible capital property into a pool that was depreciated at 7% per year. The new regime will allow a 100% inclusion, but with a 5% depreciation rate.

Valuation of Derivatives

The 2016 Budget proposes to eliminate the ability for derivative financial instruments to be valued at the lower of cost and market for both the application of inventory valuation rules and general computation of profit purposes.

Debt Parking to Avoid Foreign Exchange Gains

In a typical debt-parking transaction, instead of directly repaying a debt, a debtor would arrange for a person with which it does not deal at arm's length to acquire the debt from the initial creditor for a purchase price equal to its principal amount. From the initial creditor's perspective, the debt would effectively be repaid, but from the debtor's perspective it would remain outstanding.

The debt-parking rules were introduced to address the use of this technique to avoid the application of the debt forgiveness rules. Where the debt-parking rules apply to a debt, it is deemed to have been repaid for an amount equal to its cost to the new creditor. Any difference between this amount and the principal amount of the debt is treated as a forgiven amount, which is applied against the tax attributes of the debtor; one-half of any remaining amount is then generally included in the debtor's income. While the debt-parking rules would deem the foreign currency debt to have been settled at the time of the acquisition by the new creditor, any foreign exchange gain realized on the debt would not be taken into account in determining the forgiven amount of the debtor. As a result, the foreign exchange gain would neither reduce the tax attributes, nor be included in the income, of the debtor.

The 2016 Budget proposes new rules to require any accrued foreign exchange gain on a foreign currency debt to be realized when the debt becomes a parked obligation.

Taxation of Switch Fund Shares

The government proposes to eliminate the ability for a holder of shares in a mutual fund corporation to exchange those shares for a new class of shares on a tax deferred basis where each type of share represents exposure to a particular asset portfolio. These new rules would apply for dispositions after September 2016.

Back-to-Back Loan Rules

The Budget will expand the scope of the back-to-back loan rules. A back-to-back shareholder loan arrangement will be considered to exist when a third-party "intermediary" is owed an amount by the shareholder and the intermediary owes an amount to the Canadian corporation, and there is a link between the two obligations. If the proposed rules apply in respect of a debt owing by a shareholder of a Canadian-resident corporation, the shareholder will be deemed to be indebted directly to the corporation.

Similarly, there are proposed new "multiple-intermediary" back-to-back loan rules. Under these proposed rules, a back-to-back arrangement will comprise all the arrangements that are "sufficiently connected" to the arrangement under which a Canadian resident makes a cross-border payment of interest or royalties

to an intermediary. The presence of such a connection will be established by applying similar tests to those that are used to establish a sufficient connection in a single intermediary context. Where a back-to-back arrangement involving multiple intermediaries exists, an additional payment (of the same character as that paid by the Canadian resident to the first intermediary) will be deemed to have been paid directly by the Canadian resident to the ultimate non-resident recipient in a chain of connected arrangements.

The character substitution rules also extend the back-to-back rules by deeming economically similar transactions to be part of a back-to-back arrangement.

Country-by-Country Reporting

In response to the OECD's BEPS initiative, the 2016 Budget proposes to implement country-by-country reporting for multinational enterprises with consolidated annual revenue of €750 million or more. Where the ultimate parent entity of that group is resident in Canada, it will be required to file a country-by-country report with the CRA. These filings will be required for 2016 tax years onwards. Draft legislation will follow.

Cross-border Surplus Stripping

Presently, there is an exception to the general cross-border surplus stripping rules that may allow a Canadian corporation's retained earnings in excess of its paid-up capital to be extracted by a non-resident shareholder. This applies when a Canadian corporation purchases shares of a non-resident that holds shares in another Canadian Corporation.

The 2016 Budget would amend the ITA to deny the exception in situations where a non-resident owns, directly or indirectly, the Canadian corporation purchasing shares of the non-resident and does not deal at arm's length with that Canadian corporation.

GST

Closely-Related Test

The 2016 Budget changes the closely-related test. Closely-related corporations or partnerships neither have to charge nor collect GST on certain intercompany supplies.

In addition to the current requirements, the new rules propose that for a subsidiary and a parent corporation, the corporation must hold 90% of the economic value of the corporation and 90% of the votes in respect of every corporate matter.

Other

Employee Stock Deductions

On December 7, 2015, Finance Minister Morneau stated that the federal government planned to cap the available employee stock option benefit deduction to $100,000. There is no mention of this item in the 2016 Budget, and Finance has indicated that it will not proceed with this measure.

Base Erosion and Profit Shifting ("BEPS")

In response to October 2015 BEPS reports[1], the federal government stated that they plan to engage in spontaneous exchange of certain tax rulings with other jurisdictions and consider implementing limitation of benefits provisions in subsequent treaties and/or entering into multilateral treaties.

For more information, please contact a member of our Tax Group.

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Vancouver
Suite 1600, Cathedral Place
925 West Georgia Street
Vancouver, British Columbia
Canada V6C 3L2
(T) 604.685.3456
(F) 604.669.1620

Calgary
Suite 3700, 205-5th Avenue S.W.
Bow Valley Square 2
Calgary, Alberta
Canada T2P 2V7
(T) 403.269.6900
(F) 403.269.9494

Yellowknife
P.O. Box 818
Suite 200, 4915 – 48 Street
Yellowknife, Northwest Territories
Canada X1A 2N6
(T) 867.669.5500 Toll Free: 888.465.7608
(F) 867.920.2206

[1] OECD Final Reports on Base Erosion and Profit Shifting, October 5, 2015, accessible at: http://www.oecd.org/ctp/beps-2015-final-reports.htm.