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## 2017 Federal Budget: Key Tax Changes

### [Lawson Lundell LLP's Tax Group](#)

The 2017 Federal Budget (the “**Budget**”) was released March 22<sup>nd</sup>, 2017 (“**Budget Day**”). Highlights include:

#### **Upcoming Review of Private Corporation Tax Planning**

The Budget announced that the federal government will be looking into:

1. Income sprinkling using private corporations: The Budget states that this strategy can reduce income taxes by causing income that would otherwise be realized by an individual at a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates;
2. Holding a passive investment portfolio inside a private corporation: The Budget provides that since corporate income tax rates are generally lower than personal income tax rates, the use of private corporations facilitate the accumulation of earnings that may not be possible for others; and
3. Converting a private corporation's regular income into capital gains: The Budget maintains that, since only one-half of capital gains are included in income, this strategy takes advantage of the lower tax rates on capital gains by converting income to capital gains that should have been treated as income by way of dividends.

The government will release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses. We note that the second point, above, seems to ignore the high rate of tax (49.7% in British Columbia) already paid by Canadian-controlled private corporations on investment income.

#### **Key Income Tax Legislative Changes**

##### Broadening of Factual Control Test

The [Income Tax Act](#) recognizes two types of control of a corporation. The first is legal (*de jure*) control and the second is factual (*de facto*) control. Legal control is generally the right to elect a majority of the board of directors of a corporation. Factual control is a broader test and considers other factors that may allow a person to control a corporation, such as family ties with other shareholders. Factual control is significant for purposes of determining whether one or more corporations are associated for purposes of accessing the small business deduction. The small business deduction must be shared among associated corporations.

The Budget introduced a provision that broadens the scope of factors and circumstances that may be considered in determining whether factual control exists effective for taxation years beginning as of Budget Day. This proposed amendment is in response to recent case law which concluded that some factors or circumstances were too subjective to be considered in determining factual control and would lead to unpredictability in the law.

#### New Election for Mark-to-Market Accounting of Financial Derivatives

In response to recent case law that found that taxpayers are generally permitted to account for their derivatives on income account using a mark-to-market method, as opposed to the realization method on capital account, the Budget introduced an optional election for taxpayers that wish to use the mark-to-market method for “eligible derivatives.” Eligible derivatives are essentially derivatives held on income account valued at fair market value in financial statements.

Additionally, the election will provide a tax-deferral on any accrued gains of existing derivatives that occurs by virtue of making the election until disposed of. Once the election is made, it cannot be revoked without permission of the CRA.

According to the Budget, the election can be made in respect of taxation years beginning on or after Budget Day.

#### Anti-Avoidance Rules on Certain Uses of the Realization Method

The Budget released a new set of anti-avoidance stop-loss rules that generally apply when a taxpayer uses the realization method to account for its derivative positions and engages in selective transactions to realize losses in a tax year without realizing gains. These are known as “straddle” transactions. The rule will operate by deferring recognition of any losses on a derivative position to the extent of any unrealized gain on an offsetting position.

This anti-avoidance stop-loss rule is proposed to come into effect in respect of losses on derivative positions entered into on or after Budget Day.

#### Elimination of Billed-Based Accounting for Professionals

Taxpayers generally must include the value of work in progress in computing their business income for tax purposes. However, certain professionals (such as accountants, dentists, lawyers and doctors) may elect to deduct the value of their work in progress in computing their income for the year through the use of an optional election. This allows for some deferral of tax by allowing for a deduction of expenses without a corresponding inclusion of income in respect of work in progress.

The Budget proposed to disallow the billed-based accounting election for tax years beginning on or after Budget Day, with some transitional relief. For the first tax year after Budget Day, 50% of the lesser of cost and fair market value of the work in progress will be taken into account for purposes of determining inventory for tax purposes. After that tax year, the full amount of the lower of cost and fair market value will be accounted for.

#### Expansion of Tax-Deferral Transfers of Investment Funds

The Budget introduced additional rules in order to allow for the reorganization of a switch mutual fund corporation into multiple mutual fund trusts on a tax-deferred basis. A switch mutual fund corporation is a corporation whereby the returns of various funds or asset portfolios of the corporation are

attributable to a particular class of shares.

These proposed rules will take effect in respect of reorganizations that occur on or after Budget Day.

#### Mineral 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 extended by another year and will apply to flow-through share agreements entered into prior to April 1, 2017.

### **Tax Administration**

#### Added Resources Tax Enforcement and Combatting Tax Avoidance

The Budget provides that the federal government will invest an added \$523.9 million over five years to combat tax evasion and prevent tax avoidance. In particular, the Budget proposes to allocate the money to the following:

1. Increased verification activities;
2. Hiring additional auditors and specialists with a focus on the underground economy;
3. Develop business intelligence systems to target high-risk international tax and abusive tax avoidance; and
4. Improve quality of investigative work targeting criminal tax evaders.

#### Ownership Transparency

The Budget states that the federal government will look to collaborate with provinces and territories to improve the transparency of legal persons and legal arrangements, and increase the availability of beneficial ownership information. The federal government indicates it is looking for ways to enhance the tax reporting requirements for trusts to improve the collection of beneficial ownership information to combat tax evasion, terrorist financing and money laundering.

For more information, please contact a member of our [Tax Group](#).

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