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Tax Alert – Canada

Federal budget 2016-17: Growing the middle class

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY or EY Law advisor.

"Today, we begin to restore hope for the middle class. Today, we begin to revitalize the economy. Today, we begin a long-term plan that will use smart investments and an unwavering belief that progress is possible to ensure that Canada's best days lie ahead…

"This budget puts people first and delivers the help Canadians need right now. But it's about much more than this moment. It is an essential step in a sustained, strategic effort to restore prosperity and optimism."

Federal Finance Minister Bill Morneau
2016 federal budget speech

Tax policy and economic outlook

On 22 March 2016, federal Finance Minister Bill Morneau tabled his first budget. Building on the Liberal election platform, with a focus on economic growth, job creation and a strong middle class, the minister outlined plans to make investments in infrastructure, health care, postsecondary education, innovation, clean energy, and to introduce a Canada Child Benefit program.

In his budget speech, Morneau states, "The fate of the middle class and the fate of the country as a whole are one. Canada will not prosper if the middle class doesn't prosper.

"But the government must do more for families than merely help them through challenging times. That is why, earlier this year, the government cut taxes for middle class Canadians everywhere. Since 1 January, roughly 9 million people see more money on every paycheque that they receive. To help pay for this middle class tax cut, we raised taxes for the top 1%. It's only fair to ask those who can afford it to pay a little more so that we can help those who need it – and strengthen the economy for everyone."

EY

Building a better working world

Surplus (deficit) and federal debt outlook

In very general terms, the annual surplus (deficit) is the amount by which the government's revenue from all sources exceeds or is less than the aggregate of program expenses (including transfers to other governments) and the public debt charge.

With the ongoing weakness in the global economy and the October 2015 change in government, the latest fiscal 2017 forecast projections are quite different than the $1.7b surplus projected a year ago. It was not that long ago that oil traded at over $100 per barrel and concerns focused on whether there would be sufficient oil supply to meet the global thirst. Few, if any, would have accurately predicted the broad economic implications from the dramatic collapse of the price of oil and the ongoing economic uncertainty that surrounds us.

Fiscal 2016: The November 2015 update reflected the weaker economic and fiscal outlook, which has deteriorated since Budget 2015. Without taking into account the Liberal government's planned measures, the projected fiscal 2016 surplus of $1.4b declined to a deficit of $3.0b. The change in forecast is primarily attributed to lower personal income tax revenue, higher EI benefit payments and an increase in direct program expenses.

The March Budget 2016 update to the fiscal 2016 forecasted deficit of $5.4b primarily reflects increased program expenses.

Table A

Projections of federal budgetary surplus (deficit)
$billions

	Budget 2015	Nov. 2015 Update	March 2016 Update	Budget 2016
	F2016	F2016	F2016	F2017
Revenue outlook				
Income taxes				
Personal	143.4	141.8	142.7	143.9
Corporate	36.8	36.8	38.8	37.9
Nonresident	6.2	6.6	6.3	6.3
Excise taxes				
GST	32.7	33.2	33.1	33.5
Customs	4.9	5.1	5.2	5.0
Other taxes/duties	11.4	11.4	11.5	11.1
EI premiums	23.1	23.2	23.0	22.4
Other revenues	31.7	30.3	30.6	27.7
	290.3	288.4	291.2	287.7
Program expenses outlook				
Major transfers to persons				
Elderly benefits	(45.7)	(46.0)	(45.6)	(48.4)
EI benefits	(18.4)	(19.3)	(19.4)	(21.1)
Children's benefits	(18.0)	(18.2)	(18.1)	(21.9)
Major transfers to other levels of gov't	(65.4)	(65.3)	(65.8)	(68.6)
Direct program expenses	(115.8)	(116.7)	(122.0)	(131.3)
	(263.2)	(265.5)	(270.8)	(291.4)
Public debt charges	(25.7)	(25.9)	(25.7)	(25.7)
Surplus (deficit) outlook	1.4	(3.0)	(5.4)	(29.4)

Fiscal 2017: The fiscal 2017 forecast takes into account the economic and fiscal benefits arising from the government's planned measures, including infrastructure and measures to invest in low-income and middle-income families. The fiscal 2017 forecasted deficit of $29.4b compared to the year-ago forecasted surplus of $1.7b reflects lower-than-forecasted tax revenues of $14.7b and increased program spending of $17.1b, offset by a reduction in public debt charges of $0.7b.

- The $14.7b revenue reduction could be attributed to the lower forecast for nominal GDP, lower projected interest rates which negatively affect other government revenues and the net cost of the middle class tax cut. The weaker-than-expected economic growth has a negative impact on personal

and corporate tax revenue. Revenues from GST, customs duties and other excise taxes and duties are also adversely affected. In addition, EI premiums are lower due to lower projected salaries and wages.

- The $4.6b program spending increase is largely due to higher projected direct program expenses and transfers to persons (including EI benefits)
- Public debt charges are lower due to lower projected interest rates.

Federal fiscal outlook

As set out in Table B, after accounting for economic and fiscal developments, the latest government projections call for budgetary deficits in fiscal 2015-16 through fiscal 2020–21, significantly higher than the announced $10b shortfalls. Measured in relation to the size of the economy, the federal debt is expected to decline to 30.9% of gross domestic product (GDP) by 2020-21. However, the largest component of budgetary revenues is based on an assumption of 4.4% annual growth in personal tax revenues.

Canada's total government net debt-to-GDP ratio remains today the lowest of any G7 country and among the lowest of the advanced G20 countries.

Table B

Projections of federal surplus (deficit) and debt

	Surplus (deficit) outlook	Federal debt	
	$billion	$billion	% of GDP
2015–16	(5.4)	619.3	31.2
2016–17	(29.4)	648.7	32.5
2017–18	(29.0)	677.7	32.4
2018–19	(22.8)	700.5	32.1
2019–20	(17.7)	718.2	31.6
2020–21	(14.3)	732.5	30.9

Totals may not add due to rounding.

In October 2015, the International Monetary Fund World Economic Outlook estimated that Canada's projected 2015 total government net debt-to-GDP ratio is the lowest of any G7 country: Canada 37.8%, Germany 48.4%, US 79.9%, UK 80.3%, France 89.4%, Italy 113.5% and Japan 126.0%.

Budget 2016 measures

The government's projections of the impact of the income tax measures introduced in today's budget are relatively modest (Table C).

Financial assistance will be provided to families with children under the age of 18 through the Canada Child Benefit, which replaces the Canada child tax benefit and the universal child care benefit.

Table C

Budget 2016 cost (revenue) of proposed measures
$millions

	2015-16	2016-17	2017-18
Canada Child Benefit net cost	--	4,510	5,370
Eliminating income splitting for couples with children	(475)	(1,920)	(1,980)
Eliminating Children's Fitness Tax Credit and Children's Art Tax Credit	(20)	(120)	(245)
Corporate income tax measures	--	(102)	(638)

Additional revenue will be provided by eliminating the income splitting credit, the Children's Fitness Tax Credit and the Children's Arts Tax Credit.

The corporate income tax measures include revisions to the taxation of small-business income, life insurance policies and eligible capital property.

Government policy measures

Budget 2016 includes a number of measures to support economic growth, including investments to help Canadians obtain skills and training for well-paying jobs and by accelerating business growth through support of science, research and clean technologies.

Some of the more significant measures include:

Investing in skills and training

- An additional $125m in 2016-17 for the Labour Market Development Agreements to support unemployed workers who are eligible for Employment Insurance
- $85.4m over five years starting in 2016-17 to develop a new framework to support union-based apprenticeship training
- $3.9m in 2016-17 to extend the Northern Adult Basic Education Program for one year
- Increase in the northern residents daily residency deduction from $16.50 to $22 to help draw more skilled labour to northern and isolated communities
- Introduction of a new teacher and early childhood educator school supply tax credit of 15% on up to $1,000 of eligible supplies (paper, glue, paint, games, etc.). The benefit will apply to 2016 and subsequent tax years and provide a benefit of over $140m over the 2015-16 to 2020-21 period.

Building a more innovative country

- Up to $2b over three years, starting in 2016-17, for a new Post-Secondary Institutions Strategic Fund to support up to 50% of the eligible costs of infrastructure projects at post-secondary institutions and affiliated research and commercialization organizations, in collaboration with provinces and territories
- An additional $95m per year, starting in 2016-17, to granting councils for investigator-led discovery research (Canadian Institutes of Health Research, Natural Sciences and Engineering Research Council, Social Sciences and Humanities Research Council and Research Support Fund)
- Up to $379m over eight years, starting in 2017-18, for the Canadian Space Agency to extend Canada's participation to 2024
- $30m over six years, starting in 2016-17, to Agri-Food Canada to support advanced research in agriculture genomics
- $800m over four years, starting in 2017-18, to support innovation networks and clusters as part of the government's upcoming Innovation Agenda
- Extension of the Automotive Innovation Fund to the end of 2020-21
- An additional $50m in 2016-17 to the NRC IRAP program
- $4m over two years, starting in 2016-17 to renew the Canadian Technology Accelerator Initiative
- $50m over five years, starting in 2016-17 to the National Optics Institute
- $40m over two years, starting in 2016-17, to renew the Strategic Investments in Northern Economic Development program
- Extension of the 15% Mineral Exploration Tax Credit until March, 2017
- $9m in import tariff savings over the next five years through the elimination of tariffs on several manufacturing inputs in the consumer goods and transportation sectors
- $118m in duty savings over six years through the waiver of the 25% tariff on ferries of all sizes imported after 1 October 2015

Investing in clean technology

- Over $130m over five years, starting in 2016-17, to support clean technology research, development and demonstration activities by increasing the funding to Sustainable Development Technology Canada for the SD Tech Funds and Natural Resources Canada for clean energy technologies

- $62.5m over two years, starting in 2016-17, to Natural Resources Canada to support the deployment for alternative transportation fuels, including charging infrastructure for electric vehicles and natural gas and hydrogen refueling stations
- $20m over eight years, starting in 2018-19, to create two additional Canada Excellence Research Chairs in fields related to clean and sustainable technologies
- $100m per year, starting in 2016-17, to Canada's six Regional Development Agencies to support clean technology activities
- $50m over two years, starting in 2016-17, to Natural Resources Canada to invest in technologies that will reduce greenhouse gas emissions from the oil and gas sector
- $3.4b over five years, starting in 2016-17, to address climate change and air pollution, protect ecologically sensitive areas and restore public trust in the environmental assessment processes

Securing a cleaner, more sustainable environment

- $2.9b over five years, starting in 2016-17, to address climate change and air pollution issues, including establishment of a Low Carbon Economy Fund, support for reduction of emissions in transportation and energy, advancement of science and programming activities to better understand and adapt to the changing climate and to enable decisions to address air pollution
- $197.1m over five years, starting in 2016-17, to Fisheries and Oceans Canada to increase ocean and freshwater science, monitoring and research activities and provide support for the Experimental Lakes Area in Northwestern Ontario
- $19m over five years, starting in 2016-17, to Indigenous and Northern Affairs Canada to collaborate with researchers and Inuit communities to gather research and knowledge of the Arctic environment to assess potential environmental impacts of future oil and gas activity in the North

Business income tax measures

Corporate tax rates

No changes are proposed to the general corporate income tax rate.

Previously announced reductions to the corporate income tax rate applicable on small-business income of a Canadian-controlled private corporation (CCPC) have been removed. Budget 2016 proposes that the small business tax rate remain at 10.5% after 2016.

The resultant Canadian federal corporate income tax arising from Budget 2016 rates are summarized in Table D.

Table D

Federal corporate income tax rates		
	2015	2016+
General corporate rate	15.0%	15.0%
Small-business rate	11.0%	10.5%

Small-business deduction limits

Budget 2016 proposes to limit access to the small-business deduction under certain corporate and partnership structures that multiply the number of small-business deduction limits within a group. An example of a structure targeted by the proposed measures includes a Canadian-controlled private corporation (CCPC) owned by a member of a partnership that invoices the partnership for services as an independent contractor. The partner, if incorporated, would otherwise only be entitled to a pro-rata

allocation of the $500,000 small-business limit. Utilisation of the separate CCPC provided access to the full small-business limit.

Of special note, Budget 2016 does not propose to limit access to the general corporate rate of tax earned by a professional corporation on income allocated from a partnership (or generally, any incorporated member of a partnership that earns active business income).

Where a CCPC provides services, directly or indirectly, to a partnership and the CCPC or a shareholder of the CCPC is a member of the partnership, or does not deal at arm's length with a member of the partnership, Budget 2016 proposes to extend the specified partnership income rules to the CCPC that will effectively limit the small-business limit to that available to the connected/relevantly described member of the partnership.

Budget 2016 also proposes to introduce rules to limit multiplication of the small-business limit when a master corporate structure is used instead of a partnership. These proposals will apply where a CCPC provides services or property, directly or indirectly, to another private corporation where the CCPC, one of its shareholders or a person who does not deal at arm's length with such a shareholder has a direct or indirect interest in the private corporation.

This ineligibility rule will not apply to a CCPC if all or substantially all of its active business income for the taxation year is earned from providing services or property to arm's-length persons other than the relevant partnership or private corporation.

Re-characterized property income and taxable capital limits

Under existing legislation, property income earned from an associated corporation that deducts the payment from its active business income is re-characterized as active income and may be eligible for the small-business deduction. Additionally, two corporations not otherwise associated with each other (but associated through a "third corporation") may file an election not to be associated.

Budget 2016 proposes to limit the eligibility of re-characterized property income for the small-business deduction where the property income is earned from a corporation that is not a CCPC, or has made an election not to be associated with the recipient corporation. Such income will still be eligible for taxation at the general corporate rates.

Under existing legislation, an electing third corporation's taxable capital is not included in determining the calculation of the small-business limit grind/reduction. Budget 2016 proposes to include the "third corporation's" taxable capital amount in determining the $15m grind/reduction in available small-business limit.

Consultation on active versus investment business

Budget 2015 announced a review of circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income for purposes of the small-business deduction. The government has completed its review and is not proposing any modification to the small-business rules at this time.

Eligible capital property

Further to Budget 2014's announced consultation on the eligible capital property (ECP) regime, Budget 2016 proposes to repeal the ECP regime, replace it with a new capital cost allowance (CCA) class, and provide rules to transfer existing cumulative eligible capital (CEC) pools to the new CCA class.

This new CCA system will eliminate a tax deferral opportunity that arises from the treatment of gains on the sale of ECP as active business income. Budget 2016 states, "This outcome is consistent with the overall intent of the proposal to treat ECP as a type of depreciable property."

Under the existing ECP regime, when there is an eligible capital receipt, (e.g., proceeds for goodwill on the disposition of a business), the CEC pool is first reduced, followed by recapture of previously deduced CEC, and any excess is included in income from the business at a 50% inclusion rate. By changing the income inclusion into a capital gain (i.e., investment income), this eliminates the deferral opportunity for Canadian private companies on active business income.

Budget 2016 introduces a new class of depreciable property for CCA purposes. Expenditures that are currently added to CEC will be included in new CCA class 14.1 at a 100% inclusion rate. Class 14.1 will have a 5% annual CCA rate (instead of 7% of 75% of eligible capital expenditures). The existing rules relating to recapture, capital gains and depreciation will generally apply.

In order to facilitate the addition of all types of ECP into a CCA system, a special rule will apply in respect of goodwill and expenditures and receipts that do not relate to a specific property of the business. Such expenditures and receipts will be accounted for by adjusting the capital cost of the goodwill of the business. Every business will be deemed to have a single goodwill property associated with it, even if there has not been an expenditure to acquire goodwill.

CEC pool balances will be calculated and transferred to new Class 14.1 as of 1 January 2017. The opening balance will be equal to the balance at that time of the existing CEC pool for that business. For the first 10 years, the depreciation rate for the new CCA class will be 7% in respect of expenditures incurred before 1 January 2017.

Budget 2016 also proposes two special rules to simplify the transition for small business. To allow small initial Class 14.1 balances to be eliminated quickly, CCA in respect of expenditures incurred before 2017 will be equal to the greater of $500 per year and the amount otherwise deductible. The first $3,000 of incorporation costs will also be permitted as a current expense rather than added to the new Class 14.1.

The new rules, including the transition rules, will apply as of 1 January 2017.

Expanding tax support for clean energy

In support of targets set out in the Federal Sustainable Development Strategy, the government has introduced the following measures to encourage investment in technologies that can contribute to a reduction in emissions of greenhouse gases and air pollutants:

- Accelerated capital cost allowance: For assets acquired on or after 22 March 2016 (that have not been used or acquired for use before that time), the budget proposes to expand Classes 43.1 and 43.2 for clean energy generation and conservation equipment. Certain electric vehicle charging stations and electrical energy storage equipment previously included in Class 8 (20% declining balance) will now be eligible for inclusion in Class 43.1 or 43.2 (30% and 50% declining balance, respectively).

Electric vehicle charging stations set up to supply more than 10 kilowatts of continuous power can be included in an accelerated CCA class along with ancillary equipment such as downstream equipment or equipment used to measure electricity.

Electrical energy storage equipment has been clarified and expanded to include equipment ancillary to eligible generation equipment, as well as standalone electrical energy storage property, provided that the round trip efficiency of the equipment is greater than 50%. Electrical energy storage property will include equipment such as batteries, flywheels and compressed air energy storage.

- Emissions trading regime: A taxpayer in a regulated industry may be required to provide a government with emissions allowances, in respect of its emissions in a particular year, at a true-up date in a subsequent year. These allowances may be purchased by emitters, earned in relation to emissions reduction activities or provided by the government at a reduced amount or no cost. To eliminate uncertainty about the tax treatment of transactions under emissions trading regimes, the government has introduced rules clarifying the tax treatment of emission allowances. These measures will apply on emissions allowances acquired in taxation years beginning after 2016 or on an elective basis for emissions allowances acquired in taxation years ending after 2012.

  Under the new rules, emissions allowances will be treated as inventory for all taxpayers. There will be no income inclusions for the receipt of a free allowance by a regulated emitter. The deduction in respect of an accrued emissions obligation will be limited to the amount by which the obligation exceeds the cost of any emissions allowances acquired by the taxpayer and that can be used to settle the obligation. Each year that a taxpayer claims a deduction in respect of an emissions obligation, it will quantify its obligation based on the cost of emission allowances acquired to settle its obligation and the fair market value of any emissions allowances it needs to obtain to fully satisfy its obligation. Deductions claimed in one year in respect of an emissions obligation to be satisfied in a future year will be brought back into income in the subsequent year and re-evaluated each year until the obligation is satisfied.

  Proceeds received on the disposition of an emissions allowance, otherwise than in satisfaction of an obligation under the emissions allowance regime, and in excess of the taxpayers cost, will be included in computing income.

Life insurance policies

Transfers of life insurance policies

The CRA has been opining since 2002 that it was not clear that the taxation results realized on the transfer of an insurance policy to a non-arm's-length private corporation were intended in terms of tax policy, given it can provide a way to extract value from a company without immediate taxation. As well, the amount of the excess consideration over the cash surrender value of the policy can be extracted a second time tax free, through the capital dividend account mechanism.

Budget 2016 proposes for dispositions that occur after 21 March to include the fair market value of any consideration given in the policyholder's proceeds of disposition and the acquirer's cost. In addition, if there is a contribution of capital to a corporation or partnership, any increase in paid-up capital of a corporation or adjusted cost base in a partnership interest will be limited to the amount of the proceeds of disposition.

Budget 2016 also proposes to reduce the inclusion for the excess consideration (the value of the policy in excess of the cash surrender value at the time of the transfer) from the capital dividend account for private corporations and adjusted cost base for partnerships for dispositions of life insurance policies before 22 March 2016 where at least one of the insured individuals is still living. As well, any increase in paid-up capital or adjusted cost base of a partnership interest will be limited to the proceeds of disposition.

Dispositions involving life insurance proceeds

Budget 2016 proposes to amend the Act for deaths after 21 March so that the calculation of the capital dividend account for private corporations and adjusted cost base rules for partnerships apply as intended, even if the entity that receives the insurance proceeds is not the policyholder. There will also be an information reporting requirement where an entity is not a policyholder but is entitled to receive insurance proceeds.

Debt parking to avoid foreign exchange gains

To avoid realizing a foreign exchange gain on the repayment of a foreign currency debt, some taxpayers have entered into debt-parking transactions. In a typical debt-parking transaction, instead of directly repaying a debt with an accrued foreign exchange gain, the debtor would arrange for a person with which it does not deal at arm's length to acquire the debt from the initial creditor. 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.

In a recent technical interpretation, the CRA confirmed that the historical foreign exchange rate rule in paragraph 80(2)(k) of the *Income Tax Act* applies for purposes of determining the forgiven amount that arises as a consequence of the application of the debt parking rules. Rather, such foreign currency gain or loss would be realized on the actual settlement of the obligation in accordance with subsection 39(2).

Budget 2016 proposes to introduce rules such that any accrued foreign exchange gains on a foreign currency debt will be realized when the debt becomes a parked obligation. More particularly, the debtor will be deemed to have made the gain, if any, that it otherwise would have made if it had paid an amount (expressed in the currency in which the debt is denominated) in satisfaction of the principal amount of the debt equal to:

- Where the debt becomes a parked obligation as a result of its acquisition by the current holder, the amount for which the debt was acquired
- In other cases, the fair market value of the debt

Exceptions will be provided so that a foreign currency debt will not become a parked obligation in the context of certain bona fide commercial transactions. In particular, a carve-out will be provided if the debt is acquired by the current holder as part of a transaction or series of transactions that results in the acquisition of a significant interest in, or control of, the debtor by the current holder (or a person related to the current holder) unless one of the main purposes of the transaction or series of transactions was to avoid a foreign exchange gain. Related rules will also provide relief to financially distressed debtors, similar to existing rules for an insolvency deduction under the debt forgiveness rules.

This measure will apply to a foreign currency debt that meets the conditions to become a parked obligation on or after 22 March 2016, with an exception for written agreements entered into before this date.

Valuation for derivatives

Budget 2016 proposes to exclude derivatives from the application of the inventory valuation rules notwithstanding that such property could retain the status of being inventory property if it is held on income account. This proposal, effective 22 March 2016, would prevent derivatives that are not mark-to-market property from being written down to the lower of cost and market, thereby deferring the recognition of any loss until the property is disposed of.

BEPS initiatives

The federal government continues its commitment to protect the integrity of the Canadian tax base. Canada has been actively engaged in the efforts of the G20 and the Organisation for Economic Co-operation and Development (OECD) to address base erosion and profit shifting (BEPS). The government is confirming its alignment to the BEPS project and is acting on certain recommendations of the OECD.

Country-by-country reporting

The federal government is undertaking to introduce legislation to strengthen transfer pricing documentation by introducing country-by-country reporting for large multinationals. Budget 2016 confirms that the measure will only apply to MNEs with total annual consolidated group revenue of €750 million or more.

Where such an MNE has an ultimate parent resident in Canada, the report will be required to be filed with the Canada Revenue Agency (CRA) within one year of the end of the fiscal year to which the report relates. A Canadian-resident subsidiary may also have a filing obligation where the ultimate parent company is a resident of a country that does not require country-by-country reporting, or if the CRA is not able to obtain the information through its information exchange network.

A Canadian subsidiary resident in Canada may also have a filing requirement if the entity is a designated "surrogate." Reporting will be required for taxation years that begin after 2015. First exchanges between jurisdictions of country-by-country reports are expected to occur by June 2018. Before any exchange with another jurisdiction, the CRA will formalize an exchange arrangement with the other jurisdiction and will ensure that it has the appropriate safeguards in place to protect the confidentiality of the reports. It is expected that the draft legislation which will be released for comments in the coming months and the information required will be consistent with the OECD's Action 13 final report released in 2015.

Budget 2016 did not provide any comments on penalties for inaccurate information or failure to file. Nor did it include a proposal to change the transfer pricing documentation requirement in relation to both the master file and local file revised transfer pricing documentation standards and requirements.

Revised transfer pricing guidance

Budget 2016 reaffirms that transfer pricing on intra-group transactions should reflect arm's-length terms and the arm's-length principle as mandated by section 247 of the *Income Tax Act.* There is no proposed legislation in Budget 2016 relating to the revised OECD transfer pricing guidelines on the application of the arm's-length principle. Budget 2016 confirms that the revisions to the OECD transfer pricing guidelines generally support the CRA's current interpretation and application of the arm's-length principle as reflected in its audit and assessing practices.

These revisions are thus being applied by the CRA as they are consistent with current practices. The CRA will not be adjusting its administrative practices on low value-adding services as the BEPS project

participants are still engaged in follow-up work on the development of a threshold for the proposed simplified approach.

Similarly, the BEPS project is continuing to clarify the definition of risk-free and risk-adjusted returns for minimally functional entities. Canada will decide on a course of action with regards to both these measures after the outstanding work is complete.

Spontaneous exchange of tax rulings

The BEPS project developed a framework for the spontaneous exchange of certain tax rulings that could give rise to BEPS concerns in the absence of such exchanges. Budget 2016 confirms the government's intention to implement the BEPS minimum standard for the spontaneous exchange of certain tax rulings. The CRA will commence exchanging tax rulings in 2016 with other jurisdictions that have committed to the minimum standard.

Other international measures

Budget 2016 includes a number of measures and other announcements that are designed "to combat tax evasion and aggressive tax avoidance and improve the integrity of the tax system." There are also measures that would eliminate certain features of the tax system that are perceived to be obsolete or may expose Canada to international criticism.

Cross-border surplus stripping

Section 212.1 of the Act is designed to prevent nonresident shareholders from extracting (or "stripping") a Canadian corporation's retained earnings (or "surplus") in excess of the paid-up capital (PUC) of its shares or to artificially increase the PUC of those shares.

Subsection 212.1(4) is an exception to this "anti-surplus stripping" rule, that essentially turns off subsection 212.1 when conditions are met. Those conditions are generally where (i) a so-called sandwich structure exists (for example, where a Canadian corporation (the "Canadian purchaser corporation") holds shares of a nonresident corporation that in turn owns shares of a Canadian corporation), and (ii) the nonresident corporation disposes of shares (the subject shares) of the lower-tier Canadian corporation to the Canadian purchaser corporation in order to unwind the sandwich structure. The exception in subsection 212.1(4) acknowledges that acquiring the subject shares in this manner does not decrease the distributable reserves of the Canadian purchaser corporation, so the consequences of the anti-surplus stripping rule should not result.

Budget 2016 suggests that some nonresident corporations have misused this exception in subsection 212.1(4) by reorganizing the group into a sandwich structure as a means of artificially increasing the PUC of shares of its Canadian subsidiaries and then relying on the exception when unwinding that sandwich structure. To address this, subsection 212.1(4) will be amended to not apply if there is a sandwich structure, and a nonresident person (i) owns shares of the top-tier Canadian purchaser corporation and (ii) does not deal at arm's length with the Canadian purchaser corporation.

This may have significant consequences for certain arm's-length acquisitions. For example, this amendment should have no application where a nonresident forms a Canadian acquisition corporation that is capitalized with high PUC in order to acquire a Canadian target corporation with low PUC. However, this amendment may prevent taxpayers from engaging in so-called post-acquisition PUC planning in order to achieve the same result.

In addition, subsection 212.1 is amended (in new subsection 212.1(1.2)) to ensure that the anti-surplus stripping rule applies appropriately where a nonresident vendor disposes of shares of a Canadian corporation to a Canadian purchaser corporation but does not receive consideration from the Canadian purchaser corporation (for example, by way of an in-kind dividend distribution or return of capital). In such case, the nonresident will be deemed to receive non-share consideration from the purchaser corporation equal to the fair market value of the subject shares.

This measure will apply in respect of dispositions occurring on or after 22 March 2016.

Treaty abuse

The final report for Action Item 6 of the BEPS/G20 project (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*) recommends that countries include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping.

The BEPS treaty abuse minimum standard requires countries to include in their tax treaties an express statement of a common intention to eliminate double taxation without creating opportunities for non-taxation or tax avoidance, including through treaty shopping arrangements. The treaty abuse minimum standard requires countries to adopt in their tax treaties one of two approaches: (1) a principal purpose test (i.e., to deny treaty benefits where one of the principal purposes of an arrangement or transaction was to inappropriately obtain treaty benefits), or (ii) a limitation on benefits rule.

Budget 2016 confirms the government's intention to address treaty abuse in accordance with the treaty abuse minimum standard. The government will amend its treaties in accordance with either of the principal purpose test of limitations on benefits rule, depending on the circumstances and discussions with Canada's tax treaty partners. The government also indicates that amendments to Canada's tax treaties could be achieved through bilateral negotiations, a multilateral instrument whereby multiple treaty partners agree to the same amendments, or a combination of the two.

Of interest, Budget 2016 indicates that "Canada is actively participating in international work to develop the multilateral instrument," which may in their view streamline implementation.

Extension of the back-to-back rules

The Act contains "back-to-back loan" rules that prevent taxpayers from interposing a third party between a Canadian borrower and a foreign lender in order to avoid or reduce adverse tax consequences (such as withholding tax on interest payments) that may apply to loans made directly between the two taxpayers.

Budget 2016 proposes to build on the existing back-to-back loan rules by:

- Extending the back-to-back loan rules in Part XIII (withholding tax on nonresidents) to apply in respect of rents and royalties
- Adding character substitution rules for the back-to-back rules in Part XIII
- Extending them to apply to the shareholder loan rules (i.e., upstream loans)
- Clarifying that back-to-back loan rules apply to multiple intermediary structures

Application to rents and royalties

Although no wording is included in the NWMM, the supplementary information indicates that the proposed rules for rents and royalties will consider two arrangements to form a back-to-back arrangement if they are sufficiently connected. Specifically, a back-to-back arrangement will exist where a Canadian resident

makes a royalty payment (the "Canadian leg") to a person resident in a tax treaty country (the "intermediary") and the intermediary (or a non-arm's-length person or partnership) has an obligation to pay an amount to another nonresident person (the "second leg") and if one of the following conditions is met:

- The amount the intermediary is obligated to pay is established by reference to the royalty payment made by the Canadian resident in the first leg or by reference to the fair market value of, revenue profits or income from or other similar criteria in respect of property, where the right to use the property is granted under the Canadian leg; or
- It can reasonably be concluded that the Canadian leg was entered into or permitted to remain in effect because the second leg was, or was anticipated to be, entered into. In this regard, the fact that the Canadian leg and the second leg are in respect of the same property would on its own generally not be considered sufficient to conclude that this condition has been met.

The proposed rules for rents and royalties will apply to a back-to-back arrangement where the Part XIII withholding tax that is payable to the intermediary is less than what would have been payable in respect of a direct payment to the other nonresident.

This measure will apply to payments made after 2016.

Character substitution rules

Budget 2016 proposes to extend the back-to-back rules in Part XIII to prevent their avoidance by substituting economically similar arrangements between the intermediary and another nonresident person. Specifically, a back-to-back loan arrangement may exist in situations where either interest or royalties are paid by a Canadian-resident person to an intermediary, and the intermediary has obligations to pay amounts of a different character to a nonresident person in such manner that the back-to-back loan rules may not technically apply.

Where a back-to-back arrangement exists under these character substitution rules, an additional payment of the same character as that paid by the Canadian resident (i.e., interest or royalty, as the case may be) to the intermediary will be deemed to have been made by the Canadian resident directly to the other nonresident person.

This measure will apply to interest and royalty payments made after 2016.

Back-to-back shareholder loan rules.

Under the shareholder loan rules, where a shareholder of a corporation owes a debt to a Canadian corporation, the amount of the debt, or an amount determined by reference to a prescribed rate, may be included in the income of the shareholder as a shareholder benefit. Where the shareholder is a nonresident, the inclusions are deemed to be a dividend that is subject to withholding tax under Part XIII.

Budget 2016 proposes to extend the back-to-back loan rules to prevent taxpayers from circumventing the shareholder loan rules by lending indirectly through an intermediary. The conditions of application are expected to be similar to the conditions in the existing back-to-back loan rules in Part XIII (i.e., that may apply in respect of debts owed by a Canadian corporation).

If the proposed rules apply, the shareholder will be deemed to be indebted directly to the corporation in an amount equal to the lesser of (i) the amount of the shareholder debt, and (ii) the amount of the intermediary debt plus the fair market value of property over which the intermediary was granted a

"specified right." To the extent that the lesser of these two amounts changes at any particular time, any increase is deemed to be a new debt that arose at that time, and any decrease will be deemed to be a repayment of a prior deemed debt on a first in, first out basis.

The measure will apply to back-to-back shareholder loan arrangements as at 22 March 2016. For back-to-back loan arrangements that are in place on 22 March 2016, the deemed indebtedness will be deemed to have become owing on 22 March 2016.

Multiple-intermediary structures

Budget 2016 proposes to clarify the application of the existing back-to-back loan rules in Part XIII to ensure that the rules work as intended where there are multiple intermediaries. This will also address multiple-intermediary arrangements within the proposed back-to-back shareholder loan rules.

This measure will apply to payments of interest or royalties made after 2016 and to shareholder debts as of 1 January 2017.

Tax relief for individuals and families

Personal income tax rates

There are no individual income tax rate or tax bracket changes in this budget. On 7 December 2015, the government announced that effective 1 January 2016 the second federal income tax bracket will be reduced from 22.0% to 20.5% and a new 33.0% tax bracket will apply for taxable income in excess of $200,000. The brackets will continue to be indexed for inflation. See Table E for the 2015 and 2016 federal rates.

Table E

Federal personal income tax rates		
	2015	2016
Up to $45,282	15.0%	15.0%
$45,283 to $90,563	22.0%	20.5%
$90,564 to $140,388	26.0%	26.0%
$140,389 to $200,000	29.0%	29.0%
Over $200,000	29.0%	33.0%

Various provincial governments have also modified their personal income tax rates. See the Appendix for the 2016 maximum combined personal marginal income tax rates by province and territory.

Top marginal income tax rate: consequential amendments

As a result of the increase in the top marginal personal income tax rate to 33% on taxable income in excess of $200,000 for 2016 and subsequent years, Budget 2016 proposes further consequential amendments. These amendments include:

- Charitable donation tax credit rate for trusts: For donations made after the 2015 taxation year, the charitable donation tax credit rate on gifts above $200 is increased to 33% for trusts that are subject to the 33% tax rate on all of their taxable income.

- Employee profit sharing plan contributions: For 2016 and later taxation years, the new 33% top marginal personal tax rate will apply to excess employee profit sharing plan contributions.

- Personal services business corporation: Effective 1 January 2016, the tax rate on personal services business income earned by a corporation will be increased from 28% to 33%. The rate increase will be prorated for taxation years that straddle 1 January 2016.

- Relevant tax factor for FAPI rules: Effective for 2016 and subsequent years, the "relevant tax factor" for purposes of computing the grossed-up deduction of foreign accrual tax is reduced from 2.2 to 1.9.

- Other technical amendments affecting certain trusts: The formulas used to calculate the refundable tax under the capital gains refund mechanism for mutual fund trusts will be amended to reflect the new 33% top marginal rate. In addition, the Part XII.2 tax rate on the distributed income of certain trusts will be increased from 36% to 40%, and the recovery tax rule for qualified disability trusts will be amended to reflect the new 33% top marginal rate.

Family tax cut eliminated

Effective for 2016 and later years, the family tax cut (also referred to as the income splitting credit) is eliminated. In general terms, the non-refundable tax credit allowed a higher-income spouse or common-law partner to effectively transfer up to $50,000 of taxable income to a spouse or common-law partner in a lower tax bracket. The tax credit was calculated based on the difference in the marginal tax rates of the spouses or common-law partners, subject to a cap of $2,000.

Canada Child Benefit and Children's Special Allowance

Effective 1 July 2016, the Canada Child Benefit (CCB) program will replace the Universal Child Care Benefit (UCCB) and Canada Child Tax Benefit (CCTB).

In general terms, the CCB will provide a maximum benefit of up to $6,400 per child under the age of 6 and $5,400 per child aged 6 through 17. The amount of the benefit will be reduced (phased out) when adjusted family net income exceeds $30,000. The phase-out rate varies depending on the amount of adjusted family net income and the number of children per family.

An additional benefit amount of up to $2,730 will continue to be available under the new CCB program for each child that is eligible for the disability tax credit. The phase-out of this additional benefit will generally align with the phase-out of the CCB for eligible families with adjusted family net income in excess of $65,000.

The benefits will be paid monthly to eligible families beginning in July 2016. Entitlement to the CCB for the July 2016 to June 2017 benefit year will be based on adjusted family net income for the 2015 taxation year.

In addition, the Children's Special Allowance, which is paid to provincial and territorial child protection agencies, will be increased to the same level as the CCB, effective 1 July 2016.

Tax credits

Budget 2016 includes the following tax credit proposals:

- Mineral exploration: The mineral exploration tax credit, equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors, will be extended to flow-through share agreements entered into on or before 31 March 2017. This program, initially

introduced in 2000, was previously extended and scheduled to expire on 31 March 2016.

- Labour-sponsored venture capital corporations (LSVCCs) tax credit: The LSVCCs tax credit (also referred to as the labour-sponsored funds tax credit), which is currently set to be eliminated by 2017, will be reinstated for share purchases of provincially registered LSVCCs prescribed under the Income Tax Act for 2016 and subsequent taxation years. The reinstated credit will be equal to 15% (i.e., the same tax credit rate in effect prior to 2015) of the net cost of approved shares of a provincially registered LSVCC. Budget 2016 also proposes that newly registered LSVCCs under existing provincial legislation will be eligible for prescription under the Income Tax Act provided the enabling provincial legislation is modelled after currently prescribed provincial legislation.

  The LSVCC tax credit for federally registered LSVCCs will remain at 5% for the 2016 taxation year and will continue to be eliminated for 2017 and later taxation years.

- Teacher and early childhood educator school supply: This new refundable tax credit will apply to the purchase of up to $1,000 worth of eligible school supplies each year, providing a cash benefit of up to $150 each year for licensed and certified teachers and educators, starting in the 2016 tax year. Employers will be required to certify that the supplies were purchased for the purpose of teaching or enhancing learning in a classroom or learning environment. Individuals claiming this credit will be required to retain receipts to support their claim.

- Education and textbook tax credits: The budget proposes to eliminate the education and textbook tax credits for 2017 and later taxation years. Unused education and textbook credit amounts carried forward from years prior to 2017 may be claimed in 2017 and subsequent years.

- Children's Fitness and Arts Tax Credits: The budget proposes to phase out the children's fitness and arts tax credits by 2017. The maximum eligible amount for the refundable children's fitness tax credit will be reduced from $1,000 (in 2015) to $500 for 2016, and the maximum eligible amount for the non-refundable children's arts tax credit will be reduced from $500 (in 2015) to $250 for 2016. The supplemental amounts for children eligible for the disability tax credit will remain at $500 for the 2016 tax year. Both credits will be eliminated for 2017 and subsequent years.

Taxation of switch fund shares

Many mutual fund corporations are organized as "switch funds," which offer different types of asset exposure in separate funds, with each fund structured as a separate class of shares of the corporation.

Investors may exchange shares of one class of the mutual fund corporation for shares of another class, in order to switch economic exposure between different funds. This exchange is deemed not to be a disposition for income tax purposes; however, this deferral benefit is not available to investors in mutual fund trusts or taxpayers investing directly in securities.

Budget 2016 proposes to treat an exchange of shares of a mutual fund corporation between funds as a disposition at fair market value. This measure will not apply to switches where the shares received in exchange differ only in respect of fees or expenses borne by investors, and otherwise derive their value from the same portfolio or fund within the corporation. The measure will apply to dispositions of shares that occur after September 2016.

Sales of linked notes

A linked note is a debt obligation, the return on which is linked to the performance of reference assets or indexes. Although the *Income Tax Act* contains rules that deem interest to accrue annually on a prescribed debt obligation, investors generally take the position that there is no deemed accrual of interest on a linked note before the maximum amount of interest becomes determinable. As a result, the full amount of the return on the note is included in income in the taxation year when it becomes determinable, generally near maturity.

Some investors who hold their shares as capital property sell them prior to the determination date, which in effect converts the return on the notes from interest income to capital gains income. As a result, only 50% of the amount is included in income. To assist with this planning, issuers of linked notes establish a secondary market where investors can sell their linked notes before maturity to an affiliate of the issuer.

Budget 2016 proposes that the return on a linked note will retain the same character, whether earned at maturity or upon a sale before maturity. A deeming rule will apply to treat the gain realized on the sale of a linked note as interest that accrued on the debt obligation. When a linked note is denominated in a foreign currency, foreign currency fluctuations will be ignored for the purposes of calculating this gain, such that the gain or loss from foreign currency fluctuations will be treated as a capital gain or loss. Where a portion of the return on a linked note is based on a fixed rate of interest, any portion of the gain that is related to market interest rate fluctuations will also be excluded from the accrued interest, and treated as a capital gain.

Other personal measures

Ontario electricity support program

To ensure certain assistance payments provided (under the Ontario Electricity Support Program) to low-income households in Ontario for the cost of electricity in 2016 and later years does not reduce income-tested benefits, Budget 2016 proposes to exclude such amounts from the recipient's income for 2016 and later years.

Northern residents' deduction

An individual who lives in a prescribed northern zone or in a prescribed intermediate zone may be eligible to claim the northern residents' deduction. The budget proposes to increase the residency component of the deduction by 33% to a maximum of $22 per day (for residents of prescribed northern zones), effective for the 2016 taxation year. Residents of a prescribed intermediate zone will be entitled to deduct half of the increased amount.

Increase in the Guaranteed Income Supplement

Budget 2016 proposes to increase the Guaranteed Income Supplement top-up benefit by up to $947 annually for low-income single seniors. Single seniors with annual income (other than Old Age Security and Guaranteed Income Supplement benefits) of about $4,600 or less will receive the full increase of $947. Above this threshold, the amount of the increased benefit will be reduced and phased out at an income level of about $8,400. Benefits will be adjusted quarterly based on increases in the cost of living.

Enhancing the Canada Pension Plan

In December 2015, the government began discussions on enhancing the Canada Pension Plan with provinces and territories. The government will expand this process, launching consultations to give Canadians an opportunity to share their views on enhancing the Canada Pension Plan.

Restoring eligibility ages of the Old Age Security program

Budget 2016 proposes to cancel the provisions in the *Old Age Security Act* that increase the age of eligibility for Old Age Security (OAS) and Guaranteed Income Supplement (GIS) benefits from 65 to 67 and Allowance benefits from 60 to 62 over the 2023 to 2029 period. The eligibility age for OAS and GIS benefits will be restored to 65.

Improving Employment Insurance

Immediate action is being taken to improve Employment Insurance by changing the eligibility rules for new entrants and re-entrants, and temporarily enhancing benefits in certain regions. Starting in 2017, the waiting period for benefits will be reduced from two weeks to one week.

Charities and nonprofit organizations

Private corporation shares and real estate dispositions

Budget 2016 announced the government's intention not to proceed with the capital gains exemption announced in the 2015 budget in respect of arm's-length dispositions of private corporation shares or real estate, where cash proceeds from the disposition are donated within 30 days. Such measure was to be applicable to donations made in respect of dispositions occurring after 2016.

Sales and excise tax measures

De minimis financial institutions

Financial institutions are subject to special GST/HST rules that generally limit the extent to which input tax credits can be claimed to recover tax incurred on business inputs. For these purposes, financial institutions include banks, insurance companies, investment dealers, investment plans and other principal suppliers of financial services.

However, under current legislation, additional persons will also be treated as "de minimis financial institutions" for a particular year where their income from interest earned on investments, or fees or other charges associated with the lending of money or the granting of credit during the previous year, exceeded $1 million. As a result of this treatment, persons who earn significant interest income through bank deposits are subject to restrictive rules which were generally intended to apply only to active participants in the financial services industry.

Budget 2016 proposes amendments to correct this problem. It is proposed that interest earned by a person from conventional savings vehicles such as demand or term deposits or guaranteed income certificates with a maturity period of less than one year will not be included in the $1 million dollar de minimis threshold.

This measure will apply to taxation years of a person beginning on or after 22 March 2016 and, for purposes of determining if the person is required to file a Financial Institution GST/HST Annual Information Return, it will apply to the person's GST/HST fiscal year that straddles 22 March 2016.

Cross-border reinsurance measures

The GST/HST rules apply to both domestic purchases of property and services and to importations. The tax is collected on tangible personal property importations by the Canada Border Services Agency, but persons who acquire imported intangible personal property or services are generally required to self-assess and remit the tax where applicable. Under special rules that apply to financial institutions, including insurance companies, entities must self-assess GST/HST on any outlays or expenses incurred outside Canada that are deductible for Canadian income tax purposes and that relate to their Canadian activities, unless one of several exceptions applies.

The issue has been particularly problematic for insurance companies who have branches or subsidiaries outside Canada. It is common for Canadian insurers to transfer a portion of their risk related to insurance policies to a nonresident affiliated reinsurer. In the context of these contracts of reinsurance, certain non-arm's-length supplies of financial services are subject to self-assessment to the extent that an outlay or expense constitutes "loading" as defined in section 217 of the *Excise Tax Act*. Reinsurance premiums are determined through complex actuarial calculations. Significant concerns were therefore expressed regarding the meaning of the term "net premium" for purposes of determining the loading element of a reinsurance premium, and particularly the extent to which certain components of the premium were required to be included in the self-assessment base.

Budget 2016 now includes proposals to clarify that two specific components of imported reinsurance services, including ceding commissions and the margin of risk transfer, will not form part of the tax base that is subject to the self-assessment provisions. It is also proposed that specific conditions will be added to the legislation, under which GST/HST would not be imposed on reinisurance premiums charged by a reinsurer to a primary insurer.

These measures will apply on a retroactive basis to the time when the special GST/HST imported supply rules were introduced for financial institutions. They will therefore apply to any specified year of a financial institution that ends after 16 November 2005. In addition, special transitional measures will be introduced to allow a financial institution to request a reassessment by the CRA for a past specified year, as well as any related penalties or interest, solely for the purpose of taking into account the effect of the new measures. The reassessment must be requested within one year after the date on which the proposals receive Royal Assent.

Closely related test

The GST/HST legislation currently contains rules which apply to relieve the tax that would otherwise apply to certain intercompany supplies between members of a group of closely related corporations or partnerships. In order for the rules to apply to transactions between a parent corporation or partnership and their subsidiary corporation, the parent must own 90% or more of the value and number of voting shares of the subsidiary.

Budget 2016 contains an additional measure intended to ensure that this closely related test will apply only in situations where the parent has nearly complete voting control over the subsidiary. As a result, it is proposed that in addition to meeting the current 90% test, in order for the parent and the subsidiary to be considered to be closely related, the parent corporation or partnership must also hold and control 90% or

more of the votes in respect of every corporate matter ("qualifying voting control") of the subsidiary corporation.

This measure will generally apply on a day that is one year after 22 March 2016. However, it will also apply on the day following 22 March 2016 for the limited purpose of determining whether the conditions for making a closely related election under section 150 or 156 of the *Excise Tax Act* have been satisfied, where the election is intended to take effect after 22 March 2016.

Definition of capital property

For GST/HST purposes, "capital property" is currently defined under the *Excise Tax Act* to largely parallel the definition of the term as it appears in the *Income Tax Act*. With the exception of property belonging to Class 12, 14 or 44 of Schedule II to the Income Tax Regulations, capital property of a person for income tax purposes will qualify as such for GST/HST purposes. Eligible capital property (ECP) that is effectively excluded from capital property under the *Income Tax Act* is similarly excluded for GST/HST purposes.

Budget 2016 proposes to repeal the ECP regime for income tax purposes and replace it with a new capital cost allowance Class 14.1 in Schedule II to the *Income Tax Act*. In order to ensure that this proposal does not affect the application of GST/HST in this area, the definition of "capital property" under the *Excise Tax Act* will be amended to exclude property described in new Class 14.1. Consequential amendments will also be made to the Streamlined Accounting (GST/HST) Regulations. These amendments will come into force on 1 January 2017.

Medical and assistive devices

The supply of insulin pens, insulin pen needles and intermittent urinary catheters will be zero-rated. This measure will generally apply to supplies made after 22 March 2016.

Cosmetic procedures

Budget 2016 proposes to clarify that the supply of purely cosmetic procedures provided by registered charities are taxable. This measure will apply to supplies made after 22 March 2016.

Exported call centre services

Budget 2016 proposes to zero-rate certain exported supplies of call centre services providing certain conditions are met (e.g., at the time the supply is made it can reasonably be expected that the technical or customer support is to be rendered primarily to individuals who are outside Canada at the time the support is rendered). This measure will generally apply to supplies made after 22 March 2016.

Grandfathered housing sales reporting

The special reporting by builders of certain sales of newly constructed (or substantially renovated) homes that were grandfathered for HST purposes will be simplified by limiting the reporting to sales of at least $450,000.

Builders will also be able to correct past misreporting and avoid penalties by making an election to report all past grandfathered sales for which the consideration is at least $450,000.

These proposed simplification measures will generally apply in respect of any reporting period that ends after 22 March 2016. Builders will generally have between 1 May 2016 and 31 December 2016 to make the election.

Donations to charities

The income tax split-receipting rules, where property or services are provided in exchange for a donation, will also apply for GST/HST purposes, providing an income tax receipt may be issued for a portion of the donation. As a result, only the value of the property or services supplied will be subject to the GST/HST (provided the supply is already exempt) rather than the full value of the donation as is generally currently the case.

This measure will apply to supplies made after 22 March 2016. However, a transitional relief will also be provided for charities and public institutions that did not collect GST/HST on the full value of donations for supplies made between 21 December 2002 and 22 March 2016.

Excise tax measures

Budget 2016 proposes to restrict the excise tax relief for diesel oil used as heating oil or to generate electricity. Specifically, the relief for heating oil will be limited to heating in respect of buildings and the generation of electricity exemption for diesel fuel used in or by a vehicle will be eliminated.

These measures will generally apply to fuel delivered or imported after June 2016.

Excise duty measures

Budget 2016 includes measures to enhance the security and collection rules which apply to support compliance with the *Excise Act, 2001*, legislation that imposes excise duty on tobacco products, spirits and wine.

When a person objects to or appeals an assessment of excise duty payable, the CRA is generally precluded from taking action to collect the amount payable while a decision or judgment is pending in respect of the objection or appeal. There is also no current requirement that security be posted by the taxpayer to ensure that the amount assessed will be paid. Budget 2016 includes proposed measures that will authorize the Minister of National Revenue to require that security be posted for assessed amounts and penalties in excess of $10 million, to the extent that the amounts have not been collected. The measures will also provide that if the requested security is not supplied, the Minister will be authorized to take collection action to recover an amount equal to the security that had been requested. This measure will apply to amounts assessed and penalties imposed after the day on which the enacting legislation receives Royal Assent.

Manufacturers of tobacco products are currently required to hold a licence and all tobacco products for duty-paid entry into the Canadian market must be stamped to indicate that duty has been paid. These manufacturers, and any other persons who import tobacco products, must post security with the CRA in order to acquire the licence or duty-paid stamps. Budget 2016 proposes to increase the maximum amount of security required to be issued a licence, or to obtain duty-paid stamps, from $2 million to $5 million. This change will be effective on the later of the day following the day on which the legislation enacting the new collection measures described above receives Royal Assent, or three months following 22 March 2016.

Other measures

In Budget 2016 the government confirmed its willingness to continue to discuss and give effect to direct sales tax and personal income tax arrangements with interested Aboriginal governments, and to support similar arrangements between those governments and provincial or territorial authorities.

Other administrative tax measures

Improving tax compliance

Further investments were announced to crack down on tax evasion and combat tax avoidance:

- The CRA will hire additional auditors and tax specialists, develop a more robust business intelligence infrastructure, increase verification activities and improve the quality of investigative work that targets criminal tax evaders.
- The CRA will invest in improving its ability to collect outstanding tax debts
- The CRA will also continue ramping up its outreach efforts to ensure that taxpayers understand and meet their tax obligations. These efforts improve tax compliance through a "get it right from the start" approach to educate, inform and support taxpayers by improving service and encouraging voluntary compliance.

Pending legislation

Bill C-2, *An Act to Amend the Income Tax Act*

Bill C-2 includes a number of the Liberal government's election platform personal income tax proposals and other consequential changes, including:

- Reduction in the second federal tax bracket from 22.0% to 20.5%
- Introduction of a 33% tax bracket for individuals with taxable income of more than $200,000
- Restoration of the tax-free savings account annual contribution limit of $5,500
- Consequential changes related to the integration of investment income earned through private corporations, including an increase in the refundable portion of Part I tax on investment income earned by a CCPC from 26.67% to 30.67% and an increase in the refundable Part IV tax rate on portfolio dividends received by a private corporation from 33.33% to 38.33%.

Read more in our Tax Alerts 2015 No.58 and 2015 No. 59.

Bill C-4, *An Act to Amend the Canada Labour Code, the Parliamentary Employment and Staff Relations Act, the Public Service Labour Relations Act and the Income Tax Act*

Bill C-4 includes provisions to amend the Income Tax Act to remove the requirement that labour organizations and labour trusts provide annually to the Minister of National Revenue certain information returns containing specific information that would be made available to the public.

Previously announced measures

The government confirmed its intention to introduce a number of previously announced measures, as modified to take into account consultations and deliberations since their release.

- Common reporting standard established by the Organisation for Economic Co-operation and Development for the automatic exchange of account information between tax authorities
- Legislative proposals on the income tax rules for certain trusts and their beneficiaries (draft legislative proposals were released for comment on 15 January 2016)
- "Synthetic equity arrangements" under the dividend rental arrangement rules
- Conversion of capital gains into tax-deductible inter-corporate dividends (section 55)
- Offshore reinsurance of Canadian risks
- Alternative arguments in support of an assessment
- An exception to the withholding tax requirements for payments by qualifying nonresident employers to qualifying nonresident employees
- The repeated failure to report income penalty
- The acquisition or holding of limited partnership interests by registered charities
- The qualification of certain costs associated with undertaking environmental studies and community consultations as Canadian exploration expenses
- The sharing of taxpayer information within the Canada Revenue Agency to facilitate the collection of certain non-tax debts
- The sharing of taxpayer information with the Office of the Chief Actuary
- The tax deferral in respect of the commercialization of the Canadian Wheat Board
- The goods and services tax/harmonized sales tax joint venture election
- Relief of the goods and services tax/harmonized sales tax for feminine hygiene products

Webcasts

22 March webcast: Following the budget stakeholders' lockup, members of the EY tax team will record their analysis and insights on the tax measures in the 2016 budget. View our webcast at ey.com/ca/budget.

24 March webcast: Join us for a candid discussion of how the budget measures might impact Canadian private companies. The session will be hosted by David Steinberg, Co-leader of EY's Canadian Private Mid-Market practice, and EY Tax Partner Ryan Ball. Please confirm your attendance by 23 March by completing the online registration form.

Learn more

For more information, contact your EY or EY Law advisor.

For up-to-date information on the federal, provincial and territorial budgets, visit ey.com/ca/budget.

Appendix

Maximum combined personal marginal income tax rates (as at 22 March 2016)

	Ordinary income			2016		
	2015	2016	Increase (decrease)	Eligible dividends	Ordinary dividends	Capital gains
	%	%	%	%	%	%
Federal only	29.00	33.00	4.00	24.81	26.30	16.50
BC	45.80	47.70	1.90	31.30	40.61	23.85
Alberta	40.25	48.00	7.75	31.71	40.24	24.00
Saskatchewan	44.00	48.00	4.00	30.33	40.06	24.00
Manitoba	46.40	50.40	4.00	37.78	45.69	25.20
Ontario	49.53	53.53	4.00	39.34	45.30	26.76
Quebec	49.97	53.31	3.34	39.83	43.84	26.65
NB	54.75	53.30	(1.45)	36.26	45.37	26.65
NS	50.00	54.00	4.00	41.58	46.97	27.00
PEI	47.37	51.37	4.00	34.22	43.87	25.69
NL	43.30	48.30	5.00	38.47	39.40	24.15
NWT	43.05	47.05	4.00	28.33	35.72	23.53
Nunavut	40.50	44.50	4.00	33.08	36.35	22.25
Yukon	44.00	48.00	4.00	24.81	40.17	24.00

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