TAX AND ESTATE STRATEGIES

BUDGET 2016

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HIGHLIGHTS

Federal Budget 2016 is the first tabled by the new Liberal government and Finance Minister Bill Morneau. The budget contained few surprises given all that was announced leading up to the October 2015 election and since that time. Nevertheless, there are a number of new measures that are worth noting and will impact many Canadians.

From a personal finance perspective, the Liberals have continued in this budget with the "Robin Hood" theme of helping the middle class and lower-income Canadians by tightening perceived tax loopholes and removing certain tax credits to help pay for increased benefits for those with lower incomes. The measures are also designed to simplify the system of benefits paid to families. We've outlined the changes to personal and business tax measures below.

Budget 2016 projects deficit spending for the next five years as follows: $29.4B (2016-17), $29B (2017-18), $22.8B (2018-19), $17.7B (2019-20) and $14.3B (2020-21). How does this impact our federal debt? Currently, that debt amounts to $619.3B but is projected to increase to $732.5 by 2020-21. The government is quick to point out, however, that our debt-to-GDP ratio, which is currently 31.2 per cent, is expected to remain relatively constant over the next five years and finish 2020-21 at 30.9 per cent.

As expected, Budget 2016 focuses heavily on infrastructure spending in an attempt to spur on economic growth and invest for the future. That spending is projected to be about $120B over 10 years. Phase 1 is to take place over the next five years where $11.9B is to be spent, with focus in the following areas: Public transit, wastewater and green projects, affordable housing, early learning and child care, recreational infrastructure and community health care facilities.

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ECONOMIC AND FISCAL OVERVIEW

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- **The Budget is largely as expected**, focused on the delivery of the government's election platform commitments. Budget is well designed to support the middle class.
- **Deficits of roughly $29 billion** (1.4 % of GDP) are projected for each of the next two fiscal years, narrowing to a $14.3 billion shortfall (0.6% of GDP) by fiscal 2020-21 (FY21).
- **The federal debt** (narrowly defined as the accumulated deficit) is expected to rise from 31.0 % of GDP as of March 2015 through 32% of GDP by March 2017. The debt burden subsequently trends lower every year to FY21, ending up less than 31% by March 2021.
- **The government expresses** a general commitment to regaining a balanced budget with a date for achieving this to be determined later.

THE NO-SURPRISE BUDGET

As expected, the federal Budget delivered on key aspects of the Liberal government's electoral platform, focused largely on measures to support the middle class. The signature policy is the introduction of the Canada Child Benefit, an income-tested transfer to help families with children.

Other key measures include the previously announced middle class tax cut and related measures, investments in a range of infrastructure projects, social housing and additional support for low-income seniors. In addition, the Government is moving forward with an array of small measures designed to appeal to a range of stakeholders.

The net result of these measures is to raise deficit projections to roughly $29 billion during the next two fiscal years (1.4% of GDP). There is no return to balance, as the deficit is projected to be $14.3 billion by FY21 (0.6% of GDP). The Government indicates it is committed to returning to balance, but will only commit to a date once "growth is forecast to remain on a sustainably higher track". This could be interpreted as a weak commitment to budgetary balance, but in our view, this is a reasonable approach given the uncertainty in the outlook.

The federal debt (on an accumulated deficit basis), is projected to move through 32.0% of GDP in FY17, an increase of more than one percentage points from FY15 level. The debt/GDP ratio is projected to fall every year subsequent to that, even as deficits remain. Market debt is expected to rise by more than $150 billion through FY21.

The outlook for expenditures is likely to increase as the Government identifies how it will address other policy imperatives. Absent a significant increase in economic growth, it is likely that a return to balance will require additional revenue at some point over the fiscal planning horizon.

A modest amount of assistance is provided to regions and workers most affected by the decline in commodity prices. The key element is an extension of Employment Insurance benefits in the 12 regions that have experienced the sharpest increase in unemployment. Though the cash stimulus provided in the Budget is at the low end of projections, the Government believes the budgetary measures will add 0.5 percentage points to growth in each of the next two fiscal years. This is likely to be overly optimistic, but the actual boost to the economy should be in line with, or slightly above, our expectations which assumed twice the level of stimulus.

The expected impact of the Budget will feature prominently in the Bank of Canada's next decision. If the economic impacts are as large as those put forward by the Government, the output gap could well be closed by the end of 2017. This, in conjunction with a stronger start to the year and higher commodity prices, should eliminate the odds of a cut in the Bank of Canada's policy rate going forward. This could provide some support to the Canadian dollar. We have long held the view that the Bank of Canada was done easing monetary policy.

The persistence of deficits through FY21 was well telegraphed and should not have a significant impact on bond markets. The one area of potential concern is the Government's ongoing work to identify how to meet other policy imperatives. This will undoubtedly come at some cost. The extent of these measures could lead to a further delayed return to balance, or may require additional revenue.

PERSONAL TAX MEASURES

The following are the key personal tax measures proposed in Budget 2016:

Personal Income Tax Rate Changes

On December 7, 2015, the Government announced a reduction of the second personal income tax rate to 20.5 percent from 22 percent and the introduction of a 33 percent personal income tax rate on individual taxable income in excess of $200,000, effective for the 2016 and subsequent taxation years. These proposals were included as part of Bill C-2, which was tabled on December 9, 2015.

Many other income tax rules either use the top personal income tax rate or rates or formulas that reflect it. Budget 2016 includes further amendments to reflect the new top marginal income tax rate in these provisions. These measures will apply to the 2016 and later taxation years.

Canada Child Benefits

There are currently two main federal measures which provide financial assistance to families with minor children: the Canada child tax benefit (CCTB) and the universal child care benefit (UCCB). The CCTB is a non-taxable benefit that is paid monthly. The benefit is based on adjusted family net income and the number of children in the family. It has three components: a base benefit, a national child benefit supplement and a child disability benefit.

Whereas the CCTB is non-taxable, the UCCB provides a taxable benefit of $160 per month for each child under the age of six and $60 per month for each child aged 6 through 17.

Budget 2016 introduces a new Canada Child Benefit that replaces the CCTB and UCCB. Depending on the number of children in the family, the new system will be beneficial to families with adjusted family net income under approximately $140,000.

The Canada Child Benefit (CCB) will be non-taxable, tied to family income, and apply to families with children up to 17 years old. It will provide a maximum benefit of $6,400 per child under the age of 6 and $5,400 per child aged 6 through 17.

The benefit will be phased out at increasing rates depending on adjusted family net income and number of children in the family. The budget will continue to provide an additional amount of up to $2,730 per child eligible for the disability tax credit (which is phased-out as family income increases).

The CCB will be effective July 1, 2016, with entitlement for the July 2016 to June 2017 benefit period based on 2015 adjusted family net income.

The CCB will not reduce benefits paid under the GST credit and will not be included in income for the purposes of federal income tested programs delivered outside of the income tax system, such as the guaranteed income supplement.

Family Income Splitting Credit

A non-refundable income splitting tax credit is available for couples with at least one minor child, which allows a higher-income spouse or common-law partner to notionally transfer up to $50,000 of taxable income to their spouse or common-law partner for the purpose of reducing the couple's total income tax liability by up to $2,000.

The income splitting tax credit for eligible couples with minor children will no longer be available for 2016 and subsequent tax years.

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Education and Textbook Tax Credits

The education tax credit and textbook tax credit provide 15 percent non-refundable tax credits based on months of full-time or part-time enrolment in qualifying educational programs at designated educational institutions.

Budget 2016 proposes to eliminate the education and textbook tax credits. This measure does not eliminate the tuition tax credit. 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.

Action Step: Although the budget eliminates the education and textbook tax credits, this was done to provide the ability to enhance the Canada Student Grants and Canada Student Loans programs. On more options regarding education planning, please consult your financial advisor.

Children's Fitness and Arts Tax Credits

The Children's Fitness and Arts Tax Credits provide 15 percent tax credits on fees paid for qualifying programs for children under 16 years of age.

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) and to $250 from $500 for the children's arts tax credit.

Both credits will be eliminated for the 2017 and subsequent taxation years.

"Corporate-Class" Mutual Funds

Canadian mutual funds can be in the legal form of a trust or a corporation. Many of these mutual fund corporations are organized as "switch funds". These offer different types of asset exposure in different funds, but each fund is structured as a separate class of shares within the mutual fund corporation.

Investors are able to exchange shares of one class of the mutual fund corporation for shares of another class, on a tax-deferred basis, in order to switch their economic exposure between the mutual fund corporation's different funds.

Budget 2016 proposes that fund switches within a mutual fund corporation be considered a disposition at fair market value for income tax purposes. The measure will not apply to switches where the shares received in exchange differ only in respect of expenses to be borne by investors and otherwise derive their value from the same portfolio within the mutual fund corporation (e.g., the switch is between different series of shares within the same class).

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

Action Step: The use of "switch funds" or "corporate class" mutual funds in the past provided a good opportunity to defer tax on the switch from one fund to another within the same corporation. If you have made an investment in such a fund in the past, the ability to make tax-deferred switches may be gone, but this doesn't necessarily mean you should rush to sell these funds. After all, making a change could trigger a taxable event. Speak to your advisor about the continued appropriateness of these funds and whether and when a change should be made.

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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.

The Income Tax Act contains rules that deem interest to accrue on such notes, and an investor in a linked note would accrue the maximum amount of interest that could be payable on the note in respect of a given taxation year. Investors generally take the position that there is no deemed accrual of interest on a linked note prior to the maximum amount of interest becoming determinable.

Investors holding their linked notes as capital property would sell them on a secondary market prior to the determination date to, in effect, convert the return on the notes from ordinary income to capital gains.

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.

This measure will apply to sales of linked notes that occur after September 2016.

Action Step: This change does not necessarily mean that you should make a change to your portfolio if you have invested in linked notes of this type. It simply means that the eventual tax bill could be different than what you were expecting. There may be other reasons to continue to own these notes. Speak to your advisor about the continued appropriateness of these investments in your circumstances.

Northern Residents Deduction

Individuals who live in prescribed areas in northern Canada for at least six consecutive months beginning or ending in a taxation year may claim the northern residents deductions in computing their taxable income for that year.

Budget 2016 proposes to increase the maximum residency deduction that each member of a household may claim from $8.25 to $11 per day and, where no other member of the household claims the residency deduction, to increase the maximum residency deduction from $16.50 to $22 per day for the 2016 taxation year.

Labour Sponsored Venture Capital Corporations (LSVCC) Tax Credit

Prior to 2015, a 15 percent tax credit was available for individuals acquiring LSVCC shares, but it was to be reduced and eventually eliminated by 2017.

Budget 2016 proposes to restore the federal LSVCC tax credit to 15 percent for share purchases of provincially registered LSVCCs prescribed under the Income Tax Act for the 2016 and subsequent taxation years, while the credit for federally registered LSVCCs will remain at five percent for the 2016 taxation year and be eliminated for the 2017 and subsequent taxation years.

Action Step: Speak to your financial advisor about the appropriateness of LSVCC shares in your portfolio. The tax credits available will help to increase your effective after-tax rate of return. Keep in mind, however, that the tax tail should not wag the investment dog. Any investment in these shares should be considered first and foremost on their investment merits. Consult your tax advisor for any advice related to their tax merits.

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Teacher and Early Childhood Educator School 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 percent 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.

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

Action Step: If you or someone you know is an eligible teacher, be sure to speak to your employer about any eligible supplies you have paid for, or would like to purchase. Ensure your employer is willing to certify that you have purchased these supplies, then keep your receipts for these supplies purchased in 2016 or later and make a claim at tax time each year. Your claim will be for costs incurred on a calendar year, not school year, basis.

Donations of Private Company Shares and Real Estate

Budget 2015 announced measures that would provide an exemption from capital gains tax for dispositions of private company shares or real estate, where cash proceeds are donated to a registered charity within 30 days of the disposition. Budget 2016 announces the Government's intention not to proceed with these measures.

Stock Option Deduction

At the date of exercise of an employee stock option, an individual is taxed on the stock option benefit (the difference between the market price of a share and the strike price on exercise of the option). A fifty percent stock option deduction is available where certain conditions are met.

The 2015 Liberal platform proposed changes to limit the stock option deduction to the first $100,000 in annual stock option gains, however, Budget 2016 did not include such measures and the Liberals confirmed they would not move forward with this change.

Employment Insurance

Budget 2016 announces action to improve Employment Insurance, including the following:

- Expanding access to employment insurance for new entrants and re-entrants;
- Reducing the employment insurance waiting period from two weeks to one;
- Extending the "working while on claim" pilot project;
- Simplifying job research responsibilities for employment insurance claimants;
- Extending employment insurance regular benefits in affected regions.

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BUSINESS TAX MEASURES

The following is a brief update regarding some of the proposed changes that will impact those who are business owners:

Small Business Tax Rate

The small business tax rate, applicable to active business income up to $500,000 earned by corporations, had previously been scheduled to decrease from 11 percent to 9 percent by 2019. Budget 2016 proposes that the small business tax rate remain at 10.5 percent after 2016.

In order to preserve the integration of the personal and corporate income tax systems, Budget 2016 also proposes to maintain the current gross-up factor and dividend tax credit rates applicable to non-eligible dividends.

The Small Business Deduction

Multiplication

The small business deduction allows for active business income up to $500,000 earned by corporations to be taxed at the small business tax rate. The Income Tax Act includes rules that are intended to preclude multiplication of the small business deduction.

The small business deduction is generally shared by groups of associated corporations. Where business income is earned through a partnership, corporate partners of the partnership that are not associated with each other must still share the small business deduction through the application specified partnership income rules.

Some partnership and corporate structures seek to circumvent these rules to allow for the multiplication of the small business deduction.

Budget 2016 contains measures to address such partnership and corporate structures. These changes will effectively eliminate the multiplication of the small business deduction commonly seen in the context of professional partnerships, and result in each corporate partner paying tax at general corporate rates.

These measures will apply to taxation years that begin on or after Budget Day.

Passive Income and the Taxable Capital Limit

There is a special rule under which two corporations that would not otherwise be associated will be treated as associated if each of the corporations is associated with the same third corporation. However, where the third corporation is not a Canadian Controlled Private Corporation, or elects not to be associated with the other two, the other two will not be associated with each other.

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 where the exception to the deemed associated corporation rule applies. In addition, where this exception applies, the third corporation will continue to be associated with each of the other corporations for the purpose of applying the $15 million taxable capital limit in relation to the small business deduction.

This measure will apply to taxation years that begin on or after Budget Day.

Active Versus Investment Business Income

Budget 2015 announced a review of the situations where income from a business, the principal purpose of which is to earn income from property, would qualify for the small business deduction.

Budget 2016 announces that the government is not proposing any changes to these rules at this time.

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Action Step: The new rules designed to restrict access to the Small Business Deduction (SBD) in some cases may significantly change your tax planning. If you are a partner who has claimed the SBD or have more than one corporation in your life that has claimed the SBD, be sure to speak to your tax advisor about the changes and whether your planning should be revised.

Life Insurance Policies

Transfers of Life Insurance Policies

Where a policyholder disposes of an interest in a life insurance policy to a non-arm's length person, a special 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 "cash surrender value").

As a result, the former policyholder would have an income inclusion equal to the difference between the cash surrender value and the adjusted cost base of the policy, while still being able to receive proceeds equal to the fair market value of the policy.

Budget 2016 proposes amendments to the Income Tax Act to ensure that amounts are not inappropriately received tax-free by a policyholder as a result of a disposition of an interest in a life insurance policy. The measure will cause an inclusion of the fair market value of any consideration given for an interest in a life insurance policy in the policyholder's proceeds of the disposition and the acquiring person's cost.

This measure will apply to dispositions that occur on or after Budget Day.

Distributions Involving Life Insurance Proceeds

On the death of the insured, only the portion of the policy benefit received by the corporation or partnership that is in excess of the policyholder's adjusted cost basis of the policy may be added to the capital dividend account of a corporation. Some taxpayers have structured their affairs so that the insurance benefit limit may not apply as intended, resulting in an artificial increase in a corporation's capital dividend account balance which allows for tax-free distributions to the shareholders.

Budget 2016 proposes to amend the Income Tax Act to ensure that the capital dividend account rules for private corporations apply as intended. This measure will provide that the addition to the capital dividend account is reduced by the adjusted cost base of the policy regardless of whether the corporation that receives the policy benefit is a policyholder. This measure will apply to policy benefits received as a result of a death that occurs on or after Budget Day.

Action Step: While this budget closes down some lesser-known opportunities, there are still many effective uses of life insurance. Speak to your financial advisor about what can be accomplished with life insurance and whether those opportunities can apply in your situation.

Eligible Capital Property (ECP) and Capital Cost Allowance (CCA) Rules

In an effort to simplify the tax compliance for affected taxpayers, Budget 2014 announced a consultation on the conversion of ECP into a new class of depreciable property. Budget 2016 proposes to repeal the ECP regime, replace it with a new CCA class available to businesses and provide rules to transfer taxpayers' existing cumulative eligible capital (CEC) pools to the new CCA class. Under the proposal, CEC pool balances will be calculated and transferred to the new CCA class as of January 1, 2017.

The current CCA regime provides accelerated CCA rates for investments in specified clean energy generation and conservation equipment. Budget 2016 proposes to expand the applicable CCA classes to include certain electric vehicle charging stations and also expand the range of electrical energy storage property that is eligible for accelerated CCA on the basis that it is ancillary to eligible clean energy generation equipment. These measures will apply in respect of property acquired for use on or after Budget Day that has not been used or acquired for use before Budget Day.

OTHER INDIRECT TAX CHANGES

Medical and Assistive Devices

Budget 2016 proposes to add insulin pens, insulin pen needles and intermittent urinary catheters to the list of zero-rated medical devices for GST/HST purposes to reflect the evolving nature of the health care sector.

STATUS OF OUTSTANDING TAX MEASURES

Budget 2016 confirms the Government's intention to proceed with tax measures to take into account consultations and deliberations since their announcement or release, including the conversion of capital gains into tax-deductible inter-corporate dividends (section 55). We will communicate when there is a further update.

This publication is intended as a general source of information and should not be considered as personal investment, tax, legal or pension advice. It is recommended that you consult with your qualified advisors before taking any action based on the information found in this publication.

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