2017 Issue No. 10
22 March 2017

Tax Alert — Canada

Private company insights: federal budget 2017-18

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 advisor or EY Law advisor.

On 22 March 2017, federal Finance Minister Bill Morneau tabled his second budget. The following is the executive summary highlights of Budget 2017 that are relevant to private companies and their shareholders.

For a comprehensive and detailed review of all Budget 2017 measures, please read our Tax Alert on the 2017-18 federal budget.

Private company tax planning

Budget 2017 does not include any specific measures that will impact the taxation of private companies and their shareholders. However, the government confirmed its intent to further review the use of tax planning strategies involving private corporations that reduce personal taxes of "high-income" earners. The government intends to release a paper in the coming months setting out the nature of these issues in more detail.

Budget 2017 specifically outlined the following planning arrangements that "can result in high-income individuals gaining unfair tax advantages," and implied that these arrangements may be addressed in the government's pending review:

Income splitting: The budget addressed the arrangement of "sprinkling" income, whereby taxes are reduced by causing income that would otherwise be realized by an individual at high personal income tax

Building a better working world

rates to be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates, or who may not be taxable at all.

While Budget 2017 did not elaborate specifically on how capital gains may be part of sprinkling strategies, consideration should be given to the current availability of capital gains exemptions (CGEs), which are often accessed by a shareholder's family members through direct or indirect shareholdings. CGE currently allows up to approximately $836,000 to be received tax free on a sale of qualified small business corporation shares. It is unclear whether such arrangements of CGE access may be targeted in a future review by the government.

Accumulation of business retained earnings to invest in passive portfolios: The budget discussed the arrangement of accumulating business earnings that are taxed at "low" corporate rates and then used to acquire passive investments. While the rates of taxation on investment earnings within a private corporation are generally comparable to the rates of tax on investments for individuals at the highest marginal rate, the accumulation of business profits within a corporation (or a holding corporation that owns the shares of an operating entity) for investment purposes represents a significant deferral of personal tax that would otherwise be paid on dividend distributions of the business income retained earnings.

Budget 2017 does not specifically discuss how this perceived advantage would be addressed, or whether it would be targeted only for certain types of businesses.

Conversion of income into capital gains: The budget addressed the arrangement of converting dividend or ordinary income, which is personally taxed at relatively high rates, into capital gains subject to taxation at the preferential 50% inclusion rate. In many provinces, the combined rates of personal tax on dividends are significantly higher than the rates of tax on capital gains.

Budget 2017 does not specifically discuss how this issue will be addressed; however, as noted below, no changes were announced to the capital gains inclusion rate.

No proposals on capital gains, stock option taxation and dividend taxation

Prior to Budget 2017, there was wide speculation that capital gains inclusion rates may increase from 50% to a higher amount. Such changes would have impacted both businesses and individuals.

No changes were proposed to the inclusion rate. Similarly, Budget 2017 did not propose to change or alter the nature of stock option taxation, which had received media attention leading up to the budget. Additionally, there were no changes to the dividend tax credit mechanism, which was also widely speculated.

Business income tax measures

Corporate tax rates

No changes are proposed to the general, small-business or passive rates of corporate income tax.

See Appendix A for a complete listing of corporate income tax rates.

Computation of income for professionals

Current rules for accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors permit the reporting of revenue only when amounts are actually billed to clients. The current rules facilitate a deduction of revenue represented by work-in-progress (WIP).

Budget 2017 includes measures that will phase out the deduction currently available for WIP over a two-year period. For taxation years that commence after 22 March 2017, a deduction for WIP will be available for 50% of the lesser of cost and fair market value of unbilled WIP. In subsequent years, no deduction will be available for unbilled WIP. Consequently, as most professional practices use a calendar tax year, the 50% deduction will be available for 2018 and, starting in 2019, no WIP deduction will be permitted.

Meaning of factual control

The *Income Tax Act* contains two different definitions of control that apply for various purposes. Some provisions rely on legal control while others rely on factual control.

The most common private company tax provisions that are impacted by control are Canadian-controlled private company (CCPC) status and the sharing of tax benefits such as the small-business deduction and refundable R&D tax credits.

A recent Federal Court of Appeal (FCA) decision restricted the scope of the factual control test. Budget 2017 proposes to remove the restriction established by the FCA. This new provision, which is effective for taxation years that begin on or after 22 March 2017, clarifies that in determining whether factual control exists, factors may be considered that are not limited to the constraints established by the FCA, but instead include all factors that are relevant in the circumstances.

These proposed changes could impact the determination of whether a private company with certain foreign shareholders or voting arrangements meets CCPC status tests, or whether preferential tax benefits are be shared with other associated corporations.

Other corporate measures

Budget 2017 also proposes the following measures:

- The taxation of derivative instruments was clarified to include an elective method of reporting gains/losses from derivatives held on the income account. The derivatives contemplated by the proposals include many commonly used financial instruments such as interest rate swaps or currency hedges. Anti-avoidance rules were also proposed to limit the ability of deferring income on certain hedging arrangements.

- Expenditures related to drilling or completing a discovery well be classified as Canadian development expense, deductible at 30% declining balance, instead of Canadian exploration expense, which is fully deductible in the year incurred.

- Certain alternative energy assets such as geothermal equipment will now qualify for enhanced rates of capital cost allowance deductions. Expenses for determining the extent and quality of a geothermal resource will also now qualify as a Canadian renewable and conservation expense.

- Investment of $523.9 million over five years to prevent tax evasion and improve tax compliance.

- The budget reaffirmed the federal government's commitment to impose a national price on carbon pollution by 2018 and committed to releasing a consultation paper in the coming months with technical details on its proposed carbon pricing backstop system.

- To launch a consultation on the income tax deferral available to deferred cash purchase tickets for deliveries of listed grains for certain farmers.

Personal income tax measures

Personal income tax rates

Budget 2017 did not propose changes to individual income tax rates or tax brackets. The brackets will continue to be indexed for inflation. See Appendix B for the top combined marginal rates by province and territory.

Other personal measures

Budget 2017 includes the following tax credit and other personal tax proposals:

- **Tuition tax credit:** The eligibility criteria for the tuition tax credit will be expanded to include certain occupational skills courses that are not at the post-secondary level.

- **Public transit tax credit:** The public transit tax credit is proposed to be eliminated effective 1 July 2017.

- **Caregiver credits:** The budget proposes to simplify and replace the infirm dependant tax credit, the caregiver tax credit and the family caregiver tax credit with a new 15% non-refundable Canada caregiver credit for 2017 and subsequent years.

- **Disability tax credit:** The budget proposes to add nurse practitioners to the list of medical practitioners who are allowed to certify eligibility for the disability tax credit.

- **Medical expense tax credit:** Individuals who incur costs related to the use of reproductive technologies (such as in-vitro fertilization), but do not have a medical infertility condition, are proposed to be eligible to claim the medical expense tax credit. This measure generally applies for 2017 and subsequent years; however, an individual may elect in a year for this measure to apply for any of the immediately preceding 10 taxation years.

- **Mineral exploration:** As previously announced on 5 March 2017, the mineral exploration tax credit on 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 2018. The credit was scheduled to expire on 31 March 2017.

- **Anti-avoidance:** Budget 2017 proposes to extend the anti-avoidance rules that currently apply to tax-free savings accounts (TFSAs), registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) to registered education savings plans (RESPs) and registered disability savings plans (RDSPs). This includes the advantage tax rules, the prohibited investment rules and the non-qualified investment rules.

- **Home relocation loans:** An employee who has received a home purchase loan that qualifies as a home relocation loan may be entitled to a reduced imputed interest benefit included in employment income. Budget 2017 proposes to eliminate this benefit after 2017.

Webcast

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 Client Services practice, and EY Tax Partners John Sliskovic and Ryan Ball.

Learn more

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

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

Appendix A

2017 combined corporate income tax rates (as at 22 March 2017)

	Corporate income tax rates for active business income			Corporate investment income tax rates	
	Income eligible for small business deduction (SBD) (%) (generally up to $500,000)	**Manufacturing and processing (M&P) income not eligible for federal SBD (%) (greater than $500,000)**	**General income not eligible for SBD (%) (non-M&P income)**	**Investment income earned by CCPCs (%)**	**Investment income earned by non-CCPCs (%)**
	%	%	%	%	%
Federal only	10.50	15.00	15.00	38.67	15.00
British Columbia	12.60	26.00	26.00	49.67	26.00
Alberta	12.50	27.00	27.00	50.67	27.00
Saskatchewan	12.50	24.75	26.75	50.42	26.75
Manitoba	10.50 (up to $450K) 22.50 ($450K-$500K)	27.00	27.00	50.67	27.00
Ontario	15.00	25.00	26.50	50.17	26.50
Quebec	18.50	26.80	26.80	50.47	26.80
New Brunswick	13.62	29.00	29.00	52.67	29.00
Nova Scotia	13.50 (up to $350K) 26.50 ($350K to $500K)	31.00	31.00	54.67	31.00
Prince Edward Island	15.00	31.00	31.00	54.67	31.00
Newfoundland and Labrador	13.50	30.00	30.00	53.67	30.00
Northwest Territories	14.50	26.50	26.50	50.17	26.50
Nunavut	14.50	27.00	27.00	50.67	27.00
Yukon	12.00/13.50	17.50	30.00	53.67	30.00

*Rates presented above are prorated, where applicable, on a calendar-year basis.

Appendix B

Maximum combined personal marginal income tax rates (as at 22 March 2017)

	Ordinary income			2017		
	2016	2017	Increase (decrease)	Eligible dividends	Ordinary dividends	Capital gains
	%	%	%	%	%	%
Federal only	33.00	33.00	0.00	24.81	26.30	16.50
BC	47.70	47.70	0.00	31.30	40.95	23.85
Alberta*	48.00	48.00	0.00	31.71	41.24	24.00
Saskatchewan	48.00	47.75	(0.25)	30.33	39.62	23.88
Manitoba	50.40	50.40	0.00	37.78	45.74	25.20
Ontario	53.53	53.53	0.00	39.34	45.30	26.76
Quebec	53.31	53.31	0.00	39.83	43.84	26.65
NB	53.30	53.30	0.00	33.51	45.96	26.65
NS	54.00	54.00	0.00	41.58	46.97	27.00
PEI	51.37	51.37	0.00	34.22	43.87	25.69
NL	49.80	51.30	1.50	42.61	43.62	25.65
NWT	47.05	47.05	0.00	28.33	35.72	23.53
Nunavut	44.50	44.50	0.00	33.08	36.35	22.25
Yukon	48.00	48.00	0.00	24.81	40.17	24.00

**Alberta's 2017 budget proposed to introduce changes to the dividend tax credit. No further details were provided. The rate above is the pre-budget rate.*

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's Tax Services
EY's tax professionals across Canada provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. We offer a range of tax-saving services backed by in-depth industry knowledge. Our talented people, consistent methodologies and unwavering commitment to quality service help you build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its potential. It's how we make a difference.

For more information, visit ey.com/ca/tax.

About EY Law LLP
EY Law LLP is a national law firm affiliated with EY in Canada, specializing in tax law services, business immigration services and business law services.

For more information, visit eylaw.ca.

About EY Law's Tax Law Services
EY Law has one of the largest practices dedicated to tax planning and tax controversy in the country. EY Law has experience in all areas of tax, including corporate tax, human capital, international tax, transaction tax, sales tax, customs and excise.

For more information, visit eylaw.ca/taxlaw.

ey.com/ca