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2016 Federal Budget—What Tax Changes are in Play?

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Finance Minister Bill Morneau is soon expected to deliver the new Liberal government's first federal budget, although no date has yet been announced. This budget will be closely watched to see which of the tax changes the Liberal party proposed during the election campaign will be included. Many businesses are especially interested in hearing about the new government's plans for changes to the stock option tax regime and potential tax changes for the business income of Canadian-controlled private corporations (CCPCs).

The new government has already moved quickly after the October 19, 2015 federal election to implement some key platform promises. These measures include the promised high-profile personal tax rate changes, including increasing the top marginal tax rate and reducing the rate in the middle tax bracket for 2016. To fulfill its promise on these tax rates and to roll back the Tax-Free Savings Account (TFSA) contribution limit to $5,500 for 2016, the new government introduced Bill C-2 on December 9, 2015.

The 2016 federal budget should provide an update on the status of the remainder of the Liberal party's election promises, including tax measures affecting individuals, small businesses, charities and multinational corporations.

It will also be interesting to see whether the government comments on Canada's plans to potentially adopt some of the tax reforms that the OECD recommended under its high-profile action plan to combat base erosion and profit shifting (BEPS) by multinational corporations.

Catch KPMG's same-day budget coverage
Whatever kind of tax changes are announced in this year's budget, your KPMG adviser can help you understand their effect on your personal finances or business affairs, and point out ways to ease their impact or take advantage of new opportunities.

When the budget date is announced, registration will open for our budget highlights webcast planned for late afternoon on budget day. You can also get highlights from our special budget edition of *TaxNewsFlash-Canada* — expected to be available late in the afternoon on budget day from your KPMG adviser and on our website.

In addition to the Liberal party's election platform, we may see further indications of what to expect in the upcoming 2016 pre-budget report to be issued by the newly formed House of Commons Standing Committee on Finance (the Finance Committee). The Finance

Committee's pre-budget hearings are scheduled for February 16-19, 2016. The report is expected soon after the hearings. This consultation is significantly shorter than the committee's normal pre-budget process, which usually takes about three months.

Recommendations in last year's Finance Committee 2015 pre-budget report, as well as the Liberal party's response to this report, may also be harbingers of what might be included in this year's budget. The recommendations in Finance Committee reports that are not adopted in that particular year's budget are often included in a later year.

What's already done?
The new Liberal government has already acted on certain proposed personal tax measures by including them in Bill C-2 during the December 2015 sitting of Parliament. These measures include the following:

Personal tax rate changes
Two tax rate changes for individuals were announced in early December 2015: a reduction in the federal tax rate for income between $45,283 and $90,563 to 20.5% (from 22%) and an increase of 4% in the tax rate for income over $200,000 to 33% (from 29%), starting January 1, 2016.

As a result of the increase in the top federal tax rate to 33%, consequential changes were made to the tax rate for *inter vivos* trusts, as well as the refundable tax on Canadian controlled private corporations' investment income, among other things.

TFSA contribution limit rollback
The government also announced that the contribution limit for Tax-Free Savings Accounts will be reduced to $5,500 per year starting in 2016 (from $10,000 for 2015).

For details, see KPMG's *TaxNewsFlash-Canada* 2015-38, "Personal Tax Rate Changes Confirmed for 2016".

Personal tax measures

The 2016 federal budget could include measures addressing the following Liberal campaign promises.

Stock options

The Liberal party's election platform states that a Liberal government would "set a cap on how much can be claimed through the stock option deduction". However, "employees with up to $100,000 in annual stock option gains will be unaffected by any new cap". The platform gives no further details or any indication of when such a measure would be effective.

Background
A stock option plan usually gives an employee the right to purchase shares of the employer corporation at a given exercise price that may be above or below the market price of the shares at the time the option is granted.

When an employee of a public company exercises the option and acquires shares, the difference between the price the employee pays for the shares and their market value is treated as a taxable benefit to the employee.

If certain conditions are met, the employee can claim a deduction of one-half of the taxable benefit, effectively taxing the employment benefit at the same rate as a capital gain.

Employees of Canadian controlled private corporations (CCPCs) may report the taxable benefit and claim the 50% deduction when they sell the stock option shares, rather than when they acquire the shares.

After the election, Finance Minister Bill Morneau held a press conference on November 20, 2015, after delivering his economic update, and said that the new federal government will provide grandfathering relief for existing stock options as part of its campaign promise to cap the amount that is eligible for the 50% stock option deduction. At the press conference, the Minister reassured the community that the potential measure on stock options will only take effect once the changes have been announced.

For details, see KPMG's *TaxNewsFlash-Canada* 2015-34, "Anticipated Stock Option Changes — Government Announces Grandfathering".

The federal government may look to Quebec's tax treatment of stock options as it considers potential changes to the existing regime.

KPMG observation — Quebec's tax treatment of stock options
Quebec only allows a general 25% deduction for a qualifying stock option benefit (compared to the 50% federal deduction) but allows a 50% deduction for employees of innovative small and medium sized companies. A qualifying corporation must meet the following criteria to benefit from the 50% Quebec stock option deduction:

- The options must be issued by a corporation with less than $50 million of assets (including associated corporations) for the taxation year ending in the calendar year before the year in which the options are granted.
- The corporation must carry on a business and have an establishment in Quebec in the calendar year the options are granted.
- The corporation must have claimed a Quebec R&D tax credit in the taxation year that ends in the calendar year that the options are granted, or in one of the three prior taxation years (i.e., the corporation carried out innovative activities).

Stock options — Business community's reaction

Since the election, some sectors of the business community have expressed concern about the potential effect that a change in the tax treatment of stock options could have on growing companies.

According to media reports, the Council of Canadian Innovators — a group of leading technology entrepreneurs — is concerned that increased taxation of stock options will make it more difficult for start-up technology companies to attract the best talent.

It remains to be seen to what extent the government will take these concerns into account when deciding on its policy on the tax treatment of stock options.

Family income splitting and child benefits

The government announced on December 7, 2015 that it will introduce legislation "at an early opportunity" to repeal income splitting for families with children (i.e., the Family Tax Cut credit) but not pension income splitting, starting in 2016. As well, the government confirmed on January 29, 2016 that payments under a new Canada Child Benefit will begin in July 2016 for families with children that have annual household incomes of less than $150,000 and Canada Child Benefits will decrease for higher income families. The 2016 federal budget may provide more details on this front.

Other personal income tax changes

The Liberal party election platform also proposes a variety of personal income tax measures that were not included in the government's December 2015 Bill C-2, but may be included in the 2016 federal budget. The platform says the Liberals intend to:

- Work with the provinces to enhance the Canada Pension Plan
- Cancel the phase-out of the labour-sponsored venture capital corporation tax credit
- Allow the use of the Home Buyers Plan in situations involving "sudden and significant life changes" such as job relocation or marital breakdown
- Decrease the eligibility for old age security (OAS) back to age 65 (from 67) and index OAS benefits
- Introduce a credit that would give teachers up to $150 back on $1,000 worth of school supplies that they purchased out-of-pocket for their classroom
- Cancel the education and textbook tax credits but maintain the tuition tax credit
- Increase veteran's benefits
- Increase and index the northern residents' deduction.

Charitable giving

In its 2015 pre-budget report, the Finance Committee recommended that the government explore measures that would prompt higher levels of charitable donations, such as a stretch

tax credit that would provide an enhanced charitable donation tax credit to individuals who donate an amount in a given taxation year that exceeds their donation in the immediately preceding taxation year. The Finance Committee also recommended a stretch tax credit in its 2014 pre-budget report.

Review of tax benefits

The Liberal campaign platform states that the government will conduct a wide-ranging review of the tax expenditures that now exist, with the objective of looking for opportunities to reduce tax benefits that help individuals with income of more than $200,000 per year. No further details are available at this time.

Small business tax measures

Small business tax relief

The Liberal election platform says the party will reduce the small business tax rate to 9% from 11%. Under current law, the small business rate that applies to the first $500,000 of qualifying active business income of a Canadian controlled private corporation (CCPC) is already scheduled to decrease to 9% by 2019 as follows:

Small business tax rate reduction schedule	
Year	**Tax rate***
2015	11.0%
2016	10.5
2017	10.0
2018	9.5
2019	9.0

*effective January 1 of each year

It is not yet clear whether the new government will change this phase-in schedule for the small business tax rate reduction.

Small business income

The Liberal platform further states that “we will ensure that CCPC status is not used to reduce personal income tax obligations for high-income earners rather than supporting small businesses.” The Liberal platform also cites a study which estimates that approximately $500 million per year in tax revenue is lost, “particularly as high-income individuals use CCPC status as an income splitting tool”.

It is not clear, from these quotes, what the government has in mind in this area. For example, it remains to be seen whether the government will change the rules determining what types

of income qualify for this small business tax rate, otherwise known as the small business deduction.

The new government may also take into account input received by Finance since April 2015 as a result of a consultation process launched by the former Conservative government in the 2015 federal budget. Finance sought comments as part of its review of circumstances where income from a business, whose principal purpose is to earn income from property, should qualify as active income and therefore be eligible for the small business deduction. In particular, the 2015 federal budget noted concerns related to the application of the current rules to income from self-storage facilities and campgrounds.

In designing potential changes to the taxation of small business income, the federal government may consider introducing proposals based on measures currently in place in Quebec.

KPMG observation — Eligibility for Quebec's small business rate
Quebec recently changed its requirements for companies to be eligible for the low small business rate. The rate that applies will depend on whether the company has a minimum number of employees (more than three) and whether the company is in the primary sector (e.g., agriculture, forestry, fishing, oil and gas extraction) or the manufacturing sector. These changes apply to taxation years beginning after December 31, 2016.

Before the 2015 provincial budget in which these changes were announced, a Quebec Taxation Review Committee had recommended replacing the small business deduction with a new "growth premium" to encourage small enterprises to grow to reach levels of income that benefit from favourable tax treatment. The committee's recommended growth premium would reduce the Quebec corporate tax rate to 4% (from 10%) on taxable income between $100,000 and $500,000 for eligible corporations. The committee proposed that access to this rate would be limited to corporations with at least five employees.

Small business taxation — Business community's reaction

In reaction to the Liberal platform's statements about the use of CCPC status to reduce the tax obligations of high income earners rather than supporting small business, CPA Canada recently made a submission to Finance urging the government to carefully reflect on the taxation of CCPCs.

In the submission, CPA Canada notes that in commentary before the federal election, the Liberal party apparently indicated that certain professionals such as doctors, lawyers, dentists and accountants might be inappropriately taking advantage of the small business tax regime. CPA Canada believes these professionals are no different than other small business people and so separately identifying them seems inappropriate.

The submission adds that the taxation of CCPCs includes measures other than the small business deduction, for example, the Specified Investment Business Income, Personal

Services Business and eligible and ineligible dividend regimes. These measures are intended to meet several economic and tax objectives. As such, any changes should consider the full scope of the CCPC tax regime.

CPA Canada asks the government for a thorough consultation with all stakeholders before changes are made.

SR&ED credits for small businesses

The Finance Committee's 2015 pre-budget report recommends that the federal government should work with Canadian businesses in fostering a culture of innovation, such as through aiding small and medium sized businesses that wish to access the Scientific Research & Experimental Development investment tax credit and through exploring the feasibility of a "patent box" regime. This regime would reward innovative companies with a lower corporate tax rate on profits earned through the commercialization of their patents in Canada.

KPMG observation — OECD's patent box guidelines
If this patent box measure is adopted in the 2016 federal budget, it will be interesting to see whether the government follows the patent box guidelines recently developed by the OECD.

Earlier in 2016, the U.K. introduced new rules for its patent box regime based on these guidelines, which restrict the benefits available to the proportional research and development the company itself has undertaken in developing the qualifying intellectual property right.

General business tax measures

Energy and resources

The Liberal platform states that the government will enhance existing tax measures to generate more clean technology investments and "work with the provinces and territories to make Canada the world's most competitive tax jurisdiction for investments in the research, development and manufacturing of clean technology".

In his mandate letter to the new Minister of Finance, Bill Morneau, the Prime Minister states that Finance's top priorities should include developing proposals to allow a Canadian Exploration Expenses tax deduction only in cases of unsuccessful exploration and to re-direct any savings to investments in new and clean technologies.

Financial institutions

Canadian financial institutions need to get ready to comply with new global automatic exchange of information (AEOI) requirements. Countries around the world are beginning to implement domestic legislation under the OECD's Common Reporting Standard (CRS) and

CRS legislation for Canada is expected in the coming weeks. It remains to be seen whether the 2016 budget will include these measures or whether they will be released separately.

Accelerated CCA

The Finance Committee's 2015 pre-budget report recommends that the federal government either extend the accelerated capital cost allowance (CCA) or create similar tax incentives. As well, with a view to providing Canadian sectors — such as manufacturing, energy and clean technology — with a competitive advantage in the North American marketplace, the government should explore the feasibility of a longer horizon for the accelerated CCA.

Employment Insurance

The Liberals' platform proposes to reform the Employment Insurance (EI) program by:

- Reducing EI premiums to $1.65 per $100 of insurable earnings (from $1.88) in 2017
- Ending the rule that requires new workers and those reentering the workforce to accumulate 910 hours of work to qualify for EI benefits
- Reducing the waiting period for benefits to one week (from two).

The platform also proposes a 12-month break on EI premiums for employers that employ people between the ages of 18 and 24 who are hired in permanent positions in 2016, 2017 or 2018.

Indirect tax

The Liberal platform states that the government will encourage the construction of new rental housing by removing all GST on new capital investments in affordable rental housing.

Interestingly, the platform also states that a new system for the legal sale and distribution of marijuana will apply "appropriate federal and provincial excise taxes".

International tax measures

Canada has supported the OECD's ambitious Action Plan on Base Erosion and Profit Shifting (BEPS) since this initiative began. The new government has not yet made a comprehensive statement on how Canada will support this initiative in the future.

Many countries have already introduced legislation to implement some of the OECD's recommendations, which may affect Canadian multinational corporations. For example, several countries have acted on the recommendations for country-by-country reporting of tax payments, as discussed in Action Plan 13. These countries include the U.S., the U.K., Australia, the Netherlands and Ireland. For details on U.S. country-by-country reporting, see KPMG's *TaxNewsFlash-Canada* 2015-40, "U.S. Multinational Companies to Begin Country-by-Country Tax Reporting".

The OECD's recommendations that deal with the use of hybrid instruments and hybrid entities to obtain certain tax advantages, as outlined in Action Plan 2, are also on several countries' radar screens. The U.K. recently released draft legislation aimed at counteracting the effect of hybrid mismatch arrangements that is scheduled to take effect from January 1, 2017.

It will be interesting to see whether the 2016 budget introduces Canada's version of country-by-country reporting rules or other proposed measures that address the OECD's BEPS initiative.

Charities and not-for-profits

The Liberal election platform states that the government will modernize the tax rules governing the charitable and not-for-profit sectors, including clarifying the rules governing "political activity". It will be interesting to see how quickly the government may act on this promise.

Administration

Tax evasion

The Prime Minister's mandate letter to the new Revenue Minister, Diane Lebouthillier, states that the CRA should make it a top priority to invest additional resources to help it crack down on tax evaders and work with international partners to adopt strategies to combat tax avoidance. The election platform states that the government will invest an additional $80 million over four years to help meet this priority.

These comments are consistent with the Liberal party's response to a 2013 Finance Committee report, "Tax Evasion and the Use of Tax Havens". The Liberal party stated, at that time, it applauded the decision to conduct this study, and agreed with many of the Conservative government's findings. However, it believed stronger action was needed. In particular, the Liberal party said at that time that the government's cuts to the CRA were "ill-timed" and that, without adequate CRA resources, it would be difficult for Canada to estimate its tax gap and commit to an effective international strategy, including a leadership role in reducing the international use of tax havens.

The government may revisit this 2013 Finance Committee report as part of its decision making on measures to implement in this context.

Review of tax expenditures

The Prime Minister's mandate letter to the new Minister of Finance, Bill Morneau, states that one of Finance's top priorities will be to work with the President of the Treasury Board and other Ministers to conduct a review of tax expenditures and other spending. This review is

intended to reduce poorly targeted and inefficient measures, wasteful spending and government initiatives that are ineffective or have outlived their purposes.

Outstanding tax measures from the 2015 budget

Although not yet mentioned as a priority of the new government, it will be interesting to see what they have to say about remaining tax measures from the Conservative government's 2015 federal budget that were not passed into law before the October 2015 federal election. These measures include:

- Amending the anti-avoidance rule in subsection 55(2) of the Income Tax Act that recharacterizes certain tax-free inter-corporate dividends as capital gains subject to tax (for details, see KPMG's *TaxNewsFlash-Canada* 2015-23, "Are Your Tax-Free Inter-Corporate Dividends in Jeopardy?")

- Introducing an exception to the Regulation 102 employee withholding tax rules when certain conditions are met (the CRA has begun administering this change — see KPMG's *TaxNewsFlash-Canada* 2016-04, "Foreign Employers of Cross-Border Employees — Deadline Extended to March 1 for Canadian Tax Relief")

- Allowing a registered charity to hold a limited partnership interest in certain circumstances

- Exempting from capital gains tax capital gains that occur on the disposition of shares of private corporations and real estate where the cash proceeds of disposition are donated to a qualified donee and certain conditions are met

- Tightening the anti-avoidance rules for captive insurance companies.

Complete tax-sensitive transactions before budget day

As with any budget, there's no telling what types of changes the government may have in store this year. Since federal budgets often propose measures that take effect on budget day, your best defense against adverse tax changes is to complete or close all tax-sensitive transactions before budget day.