

2016 Federal Budget

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The March 22, 2016 federal budget (“Budget 2016”) included a number of tax measures that will impact Canadian taxpayers. This report, which was prepared from within the budget lock-up in Ottawa, will focus on the tax measures that are of most interest to individuals and small business owners.

Canada Child Benefit (New)

Budget 2016 has proposed to replace the current Canada Child Tax Benefit (CCTB) and the Universal Child Care Benefit (UCCB) with the new Canada Child Benefit (CCB), which will begin in July 2016.

The CCTB is a non-taxable benefit that is paid monthly, based on adjusted family net income and the number of children in the family. The CCTB has three components: a CCTB base benefit for low- and middle-income families, a national child benefit supplement for low-income families, and a child disability benefit for families caring for a child under age 18 who is eligible for the disability tax credit.

The UCCB (which dates back to 2006 and was originally \$100 per month per child under age six) was enhanced in 2015, increasing the monthly amount for kids under age six to \$160 and expanding the program to include a new benefit of \$60 per month for children aged six through 17.

The new CCB will provide a maximum benefit of \$6,400 per child under the age of 6 and \$5,400 per child aged 6 through 17. Based on the portion of a family’s adjusted net income that falls between \$30,000 and \$65,000, the benefit will be reduced based on a rate that is dependent on the number of children in the family. Once family income hits \$65,000, the remaining benefits will be phased out at lower rates. The phase out rates and adjusted family net income thresholds are shown in Figure 1.

Figure 1:
Canada Child Benefit Phase-out Rates and Adjusted Family Net Income Thresholds

Number of Children (for Phase-out Rates)	Phase-Out Rates (%)	
	\$30,000 to \$65,000	Over \$65,000
1 child	7.0	3.2
2 children	13.5	5.7
3 children	19.0	8.0
4 or more children	23.0	9.5

Source: Tax Measures: Supplementary Information, Department of Finance, Table 2.

An additional benefit of \$2,730 will be available for each child that is eligible for the disability tax credit, but this will be phased out at a rate of 3.2% for families with one eligible child and 5.7% for families with more than one eligible child, on adjusted family net income in excess of \$65,000, effective July 1, 2016.

The new CCB will be paid monthly, beginning in July 2016 and will be based on adjusted family net income for the 2015 taxation year.

Amounts received under the new CCB will not be taxable and will not reduce benefits paid under the GST/HST credit. They will also 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 (GIS) under the Old Age Security system, Canada education savings grants (CESG) and Canada learning bonds (CLB) for Registered Education Savings Plans, or Canada disability savings bonds (CDSB), and Canada disability savings grants (CDSG) for Registered Disability Savings Plans.

Elimination of the Income Splitting Credit (“Family Tax Cut”)

Income splitting can generally be defined as the transferring of income from a high-income family member to a family member who pays tax at lower graduated tax rates, to minimize the overall tax bill of the family. The Family Tax Cut credit, introduced by the previous government in 2014, provided a version of income splitting that allowed an individual to notionally transfer up to \$50,000 of income to his or her lower-income spouse or common-law partner, provided they had a child who was under 18 at the end of the year. The credit was capped at \$2,000 annually and was available for the 2014 and 2015 taxation years.

Budget 2016 has eliminated the Family Tax Cut, effective for the 2016 tax year; however, Budget 2016 made it clear that “(p)ension income splitting

will not be affected by this change.” This means that you can still split eligible pension income with your spouse or partner. Any pension income that qualifies for the federal pension income credit qualifies to be split. Specifically, this would include annuity-type payments from an employer-sponsored registered pension plan, regardless of age, and also includes Registered Retirement Income Fund (RRIF) or Life Income Fund withdrawals, but only upon reaching age 65. (In Quebec, the pensioner must be at least age 65 for provincial pension splitting.)

Other income splitting strategies that remain unaffected include the use of a spousal or common-law partner RRSP and lending funds to lower-income family members at the prescribed interest rate (currently set at 1% until at least June 30, 2016).

Elimination of the Children’s Fitness & Arts Tax Credits

The children’s fitness tax credit provides a 15% refundable tax credit on up to \$1,000 of eligible fitness expenses for children under 16 years. The children’s arts tax credit provides a 15% non-refundable tax credit on up to \$500 in eligible fees for programs of artistic, cultural, recreational and developmental activity 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 and to \$250 (from \$500) for the children’s arts tax credit.

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

Elimination of the Education & Textbook Tax Credits

The federal tuition, education and textbook credits may help students to reduce their tax bills. The education amount is a 15% non-refundable federal

credit of \$400 for each month of full-time post-secondary education or \$120/month for each month of part-time schooling. The textbook amount is a similar credit, only available if you can claim the education amount and is also worth 15% of \$65/month of full-time post-secondary attendance or \$20/month of part-time schooling. The tuition credit is also non-refundable and is worth 15% of the amount of tuition fees, without limit.

If the student does not have sufficient income to use the credits in the year of attendance, up to \$5,000 can be claimed by the student's spouse or partner, or supporting parent or grandparent. Any remaining amount can be carried forward for use by the student in a future year.

Budget 2016 has eliminated the education and textbook tax credits effective January 1, 2017. It did not, however, propose any changes to the tuition tax credit. The carryforward rules will continue to apply for education and textbook tax credits (as well as the tuition credit) that arose prior to 2017 but have not been claimed.

School Supply Tax Credit (New)

Budget 2016 has introduced a new credit for the cost of educational supplies. The credit is available to teachers and early childhood educators who "often incur at their own expense the cost of supplies for the purpose of teaching or otherwise enhancing students' learning in the classroom or learning environment."

This new credit will allow an employee who is an "eligible educator" to claim a 15% refundable tax credit based on up to \$1,000 in expenditures made by the employee for "eligible supplies."

Teachers will qualify as eligible educators if they hold a teacher's certificate that is valid in the province or territory in which they are employed. Similarly, early childhood educators must hold a certificate or diploma in early childhood education

recognized by the province or territory in which they are employed.

"Eligible supplies" include: games and puzzles, supplementary books for classrooms, educational support software, containers, construction paper, flashcards, items for science experiments, art supplies, and various stationery items, such as pens, pencils, posters and charts.

The new credit applies to eligible supplies purchased as of January 1, 2016 and educators will be required to retain their receipts to back up their claims. Also, employers will be required to certify that the supplies were purchased for the purpose of teaching or otherwise enhancing learning in a classroom or learning environment.

OAS, GIS and CPP

OAS

The previous government stated it was worried about the ability to sustain Old Age Security (OAS) benefits, including the Guaranteed Income Supplement (GIS), in the face of increasing longevity and a decreased number of workers in relation to seniors. The 2012 federal budget announced that eligibility for OAS and GIS would be gradually increased from 65 to 67, starting in April 2023, with full implementation by January 2029.

Budget 2016 has reversed this decision and will restore the eligibility age for OAS and GIS benefits to 65. As the government stated: "These benefits are an important part of the retirement income of Canadians, particularly for lower-income seniors. Vulnerable seniors depend on this support, and without it, face a much higher risk of living in poverty."

GIS

Budget 2016 also announced an increase to GIS by up to \$947 annually "for the most vulnerable single seniors" starting in July 2016. Single seniors with annual income (excluding OAS and GIS benefits) of

about \$4,600 or less will receive the full increase of \$947. Above this income threshold, the amount of the increased benefit will be gradually reduced and will be completely phased out at an income level of about \$8,400.

CPP

The government also provided an update on the future of the Canada Pension Plan (CPP). The CPP is designed primarily to provide working Canadians with a pension equal to about 25% of their pre-retirement income, up to a maximum amount (\$54,900 in 2016). Note that the maximum amount is not the payout in a year, but the wage on which it is computed.

To fund the program, the employer and employee each pay CPP premiums equal to 4.95% (9.9% in total) of the employee's annual pensionable earnings, which includes compensation between \$3,500 and \$54,900 in 2016. The amount of CPP benefits you can receive is based on the number of years you worked and contributed, as well as your salary. The maximum CPP benefit for this year is \$13,110.

Budget 2016 acknowledges that while “most Canadians approaching retirement age appear to be on track to adequately replace their working-age income in retirement...(a)n enhanced Canada Pension Plan would represent a major step in improving retirement outcomes for workers and reducing the uncertainty that many Canadians feel about being able to enjoy a secure and dignified retirement.”

Budget 2016 announced the government's plans to launch a consultation process that will give Canadians an opportunity to share their views on enhancing the CPP “with the goal of being able to make a collective decision before the end of 2016.”

Elimination of Tax Free Switches in Mutual Fund Corporations

A Canadian mutual fund can be structured as either a trust or a corporation. Many mutual fund corporations are organized as “switch funds” and offer different types of asset exposure in different funds. Each fund, however, is structured as a separate class of shares within the same mutual fund corporation.

The benefit of the switch fund structure is that investors are able to exchange shares of one class of the mutual fund corporation for shares of another class, in order to switch their economic exposure among the mutual fund corporation's different funds, without triggering a disposition for tax purposes.

Under the current tax rules, the exchange from one class of shares to another is deemed *not* to be a disposition for income tax purposes, allowing investors to take advantage of this rule and rebalance their portfolios on a tax-deferred basis. This deferral benefit is not available to taxpayers investing in mutual fund trusts or investing on their own account directly in securities.

Budget 2016 will change the tax rules such that a switch within the mutual fund corporation from one class of shares to another will result in a disposition for tax purposes at fair market value. Where the switch occurs between different series of the same class, where the underlying portfolio does not change but merely the fees or expenses differ, the switch will continue to occur on a tax-deferred basis.

This measure will apply to switches after September 2016, meaning that investors have just over six months to continue to take advantage of the current rules and rebalance their mutual fund corporation portfolios on a tax-deferred basis before the new rules take effect on October 1, 2016.

Disposition of Linked Notes

Linked notes are debt obligations issued by financial institutions that provide a rate of return that is “linked” to the performance of one (or more) assets or indices over the term of the note. The underlying linked asset or index is often a basket of stocks, a stock index, a commodity, a currency or even units of an investment fund.

There are two main types of linked notes. *Principal-protected notes* are notes in which the amount payable to the investor at maturity is equal to the principal amount invested plus a return (if any) that is either fully or partially linked to the performance of the underlying asset or index. *Principal-at-risk notes* are similar but there is a risk, depending on the performance of the underlying asset or index, that the amount payable to the investor at maturity can be less than the principal amount invested.

The current tax rules governing linked notes require an investor to accrue the maximum amount of interest that could be payable on the note each year. Investors, however, have generally taken the position that there is *no* deemed accrual of interest on a linked note prior to the maximum amount of interest becoming determinable. Rather, the full amount of the return on the note is only included in the investor’s income in the year in which it becomes determinable, which is generally at, or shortly before, maturity (the “determination date.”)

When a note is sold before maturity, a specific tax rule requires interest accrued to the date of sale to be included in the income of the vendor for the year of sale; however, some investors selling linked notes on the secondary market prior to maturity take the position that no amount received is accrued interest as the determination date has not yet occurred. As a result, these investors include the full amount of return on the note as proceeds of disposition used to calculate the capital gain on sale. The government views this as effectively

converting the return on the notes from ordinary income to a capital gain, of which only 50 per-cent is taxable.

Budget 2016 proposes to change the tax laws governing these investments to treat a gain realized on the sale of a linked note as interest that was earned on the debt obligation.

This new measure will apply to the disposition of linked notes after September 2016, giving investors nearly six more months to consider whether to dispose of their linked notes prior to the rule change to claim capital gains treatment.

Donations of Real Estate and Private Company Shares

Budget 2016 announced that it will not be proceeding with the implementation of the previous government’s measure that would have eliminated the capital gains tax on the sale of appreciated *private* company shares and real estate if the proceeds are donated to charity within 30 days. This change was scheduled to come into effect on January 1, 2017.

Since 2006, donations of *publicly-traded* shares, mutual funds or segregated funds to a registered charity not only get you a tax receipt equal to the fair market value of the securities or funds being donated, but are also not subject to capital gains tax on any accrued gain on the shares or funds donated. Similarly, if you’re an employee who has received stock options, you can choose to donate the shares acquired from an option exercise to charity within 30 days of exercise which may effectively result in the stock option benefit not being subject to tax.

No changes are being proposed to the rules governing the donation of publicly traded securities.

Stock Option Deduction

Budget 2016 contained no mention of any changes to the taxation of employee stock options. The government had previously announced its intention to limit the stock option deduction to the first \$100,000 of stock option benefit realized annually.

Taxation of Life Insurance

The death benefit associated with a life insurance policy is generally received tax-free. When the policy is corporately-owned, some or all of the proceeds flow into the corporation's capital dividend account, typically allowing a tax-free capital dividend to be paid out of the corporation to its shareholder(s).

Budget 2016 will close several loopholes that allow private corporations, and in some cases, partnerships, to use a life insurance policy to distribute amounts tax-free that would otherwise be taxable. Specifically, the new rules would target policies in which the corporation that pays the premiums is not the beneficiary of the policy and additionally, when life insurance policies are transferred between non-arm's length persons, such as when you transfer your life insurance policy to your corporation.

Changes for Canadian Controlled Private Corporations (CCPCs)

Many Canadian controlled private corporations (CCPCs) take advantage of the small business deduction, which allows them to pay federal tax at a rate of 10.5% on active business income up to \$500,000 and 15% on remaining business income. These corporate tax rates are substantially lower than the top federal marginal personal tax rate of 33%. As a result, a federal tax deferral advantage of 18% to 22.5% can be achieved by leaving the after-tax business income inside the corporation as opposed to paying it out immediately. Provincial taxes also apply and there is generally also a tax deferral advantage at the provincial level.

While many business owners were concerned that the government would introduce major changes to limit access to the small business deduction, especially for incorporated professionals, Budget 2016 did not do this.

Rather, Budget 2016 proposes that the small business tax rate remain at 10.5% after 2016, rather than decrease over the next few years, as was announced in last year's budget. (The federal small business tax rate was to decrease to 10% for 2017, 9.5% for 2018 and 9% for 2019 and beyond.)

In addition, Budget 2016 proposed some technical changes to address concerns about partnership and corporate structures that multiply access to the small business deduction.

Eligible Capital Property

In 2014, the government launched a consultation process to discuss the conversion of eligible capital property (ECP) into a new class of depreciable property in an attempt to "simplify the tax compliance burden for affected taxpayers."

An "eligible capital expenditure" (ECE) is an expense incurred by a business to purchase intangible rights or benefits for the purpose of earning income. It includes the cost of goodwill when a business is purchased but also includes the cost of certain intangible property such as customer lists and licenses, franchise rights and farm quotas of indefinite duration.

Budget 2016 proposes to repeal the ECP regime and to replace it with a new capital cost allowance (CCA) class available to businesses and provide rules to transfer taxpayers' existing cumulative eligible capital (CEC) pools to the new CCA class.

Under the current ECP regime, 75% of an eligible capital expenditure is added to the CEC pool and is amortized at 7% annually.

Under the new rules, a new class of depreciable property for CCA purposes will be introduced and

expenses that are currently added to the CEC pool (at a 75% rate) will be included in the new CCA class (at 100%), but with a reduced depreciation rate of 5% (vs. 75% of 7%). For the first ten years (until 2027), the depreciation rate of the new CCA class will continue to 7% for ECE incurred before January 1, 2017. CEC balances will be transferred

to the new CCA pool as of January 1, 2017. All the existing normal CCA rules will apply.

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